PORTUGUESE ECONOMIC DEVELOPMENT IN THE EUROPEAN AREA: DETERMINANTS AND POLICIES*

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For the fourth time the Bank of Portugal as promoted its bi-annual conference on the topic of “Portuguese economic development in the European area: determinants and policies”. The main purpose of this initiative is to have the Academia reflecting on the long-term or structural problems of the Portuguese economy.

This article presents a personal (and, necessarily, biased) account of what the author has learnt from the Conference.

1. Fostering growth in Portugal

The central talk at the conference, “Fostering Growth in Portugal”, was delivered by the Harvard professor and growth theory specialist, Philippe Aghion. The problems of fostering Portugal's growth were analyzed from the vantage point of the so called “Schumpeterian theory”, a paradigm originally proposed and developed by Aghion himself. The central tenant of this approach is that growth results from quality improving innovations; it thus focus on quality improving innovations that render old products obsolete, and hence involves the force that Schumpeter called “creative destruction.”

Under this framework the growth effects of various policies are highly context dependent, as opposed to “one-size-fits-all” approaches, policies or institutions. Typically, the Schumpeterian theory gauges that context by proximity to the technological frontier (representing the stock of global technological knowledge available to innovators in all sectors of all countries). Far below from the frontier a country will maximize growth by favoring institutions that facilitate implementation (imitation) activities; here practices such as long term bank finance, export promotion, incumbent's protection or subsidies to production may be beneficial for growth. However as it catches up with the technological frontier, to sustain a high growth rate the country will have to shift from implementation-enhancing institutions to innovation-enhancing institutions; now, well functioning capital markets, product market competition, entry deregulation or labor market flexibility are key for growth.

A central idea is thus, that institutions and policies that favor frontier innovation are not necessarily the same as those that favor imitation. Two further examples highlight this context dependence. Higher education investment should have a bigger effect on a country’s ability to make frontier innovation, whereas primary and secondary education are more likely to make a difference in terms of the country’s ability to implement or imitate existing (frontier) technologies. Labor market flexibility is more necessary for frontier innovation than to imitation and, consequently is more growth-enhancing the closer a country is to technological frontier.

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In summary, the basic message from Aghion’s talk is that for Portugal to move up on the skill and productivity ladders and thus resist the emerging economies’ competition, the growth-enhancing institutions should evolve. Have they? Will they?

Several institutions or policies always promote growth. Chief among those are property right protection, the rule of law and product market competition. Two papers (“The impact of firm size and market size asymmetries on national mergers in a three-country model” by Luís Santos Pinto and “Merger analysis in the banking industry: the mortgage loans and short term corporate credit markets” by Duarte Brito, Pedro Pereira and Tiago Ribeiro) provide analytical frames to analyze quantitatively the impact on welfare of mergers in industries as banking, mobile communications, cement and fuel retail trade. Within the limits of its assumptions, the papers provide tools that might be used to design more efficient competition policies.

With the accession to EU more than 20 years ago, Portugal’s economic institutions and policies changed significantly. Chief among those are, of course, the freedom of movements of capital, goods, services and people associated with the Single European Market. Also, a vast privatization program was launched. Additionally, several laws reforming corporate governance were passed: provisions reinforcing the protection outside investor’s rights; a new securities law; and a reformed bankruptcy law. The paper “The Economic impacts of improving investor rights in Portugal” by Rui Castro, tries to evaluate the relative contribution of those reforms for improved performance of the Portuguese economy since joining the EU. The main conclusion is that, among the reforms under scrutiny, the improvement of investor’s protection is the one most consistent with the macroeconomic facts (aggregate productivity growth) and micro-evidence of more efficient resource allocation. The rational underlying this conclusion has a “Schumpeterian” gist: poor investor’s rights protections takes a disproportionate toll on the industries where economic activity involves higher risks (“capital goods” sectors in Castro’s paper, “frontier sectors” in Aghion’s).

2. Social Security

People live longer, living longer is more expensive and people don’t save enough for it. These are three uncontroversial facts about modern societies that have far reaching implications. The paper by João Cocco and Francisco Gomes (“Longevity risk, retirement savings and individual welfare”) estimates that a 65 years old male in Portugal to needed 24% more wealth in 2000 than in 1970 in order to ensure the same level of consumption after retirement. Only because he’s expected to live longer.

An interesting point addressed in that paper is that longevity is very likely to continue to increase but these increases are typically underestimated by actuaries and insurers: this uncertainty makes that private savings only partially accommodate the increases in life expectancy.

The deficits of existing social security pensions systems are to a large extent explained by the increase in life expectancy. Governments react to these deficits by cutting on pension benefits or by creating incentives for additional private saving; Markets also adjust by introducing new types of financial instruments that hedge longevity risk (discussed in the paper “Hedging longevity risk”, by J. Cocco and F. Gomes).

Several proposals to reform existing pay-as-you-go state pensions systems have been launched. Ricardo Rodrigues (“Simulation of unemployment insurance savings accounts in Portugal”) discusses one of them: The creation of individual unemployment insurance savings accounts to replace the existing unemployment benefits system. A similar system is in place in Chile since 2002 and has the following basic ingredients: (i) Employers and employees contribute to an individual account earning a
market interest rate; (ii) The individual unemployment benefits are financed by that account; (iii) If balances not enough the State makes loan at market rate; (iv) Upon retirement or death the balance is collected or, if negative, debt is forgiven.

The idea of the proposed system is to overcome the incentives to work problems of the existing system without cutting social protection levels. In spite of several drawbacks of the simulation the system shows promise of constituting a viable alternative.

3. Climate change

The most widely raised ecological problems are ones involving open-access common-property resources such as the depletion of the ozone layer or the emission of green house gases. Given this nature of global public good, markets fail in delivering efficient solutions to dealing with the consequences of climate changes. The paper by Antonieta Cunha-e-Sá discusses what economic science has to say about appropriate actions to reconcile rapid economic growth and reduced risks of climate change.

In addition to the usual problems raised by public goods’ provision and allocation, global warming presents some compounding difficulties. The first relates to the very long time horizon since the greatest costs of today’s emissions will be felt in more than 50 years from now. The second, is that there is a huge uncertainty on the economic consequences (in spite of the significant progresses the science) of climate change; some of the consequences may be so large (even with low, and difficult to estimate, probability) that traditional cost-benefit analysis may be meaningless. Finally, emission control clearly requires world wide cooperation but impacts are not uniformly distributed among countries.

Two major consequences stem from these difficulties: It is hard to design incentives to foster innovation and R&D investment in low-carbon technologies (a time-inconsistency problem of the optimal “ramp” (increasingly tighter over time) policy, since it is not credible to announce today the tighter future caps); and it is also hard to design incentives for international cooperation.

These constitute major obstacles since any long term solution will necessarily rely on the development and adoption of new technologies and the global nature of the climate change externality require global cooperation. A solution will probably require – more than policies or, better, prior to policies – new institutions of international cooperation where groups of countries with common interests can achieve with the global environment what some are achieving with their local environments.