THIRD CONFERENCE ON “PORTUGUESE ECONOMIC DEVELOPMENT IN THE EUROPEAN CONTEXT”: A SYNTHESIS

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Following identical initiatives in 2004 and 2004, the Bank of Portugal organized on the 10th of February a conference on the topic of “Portuguese Economic Development in the European Context”. This article provides a personal synthesis of the communications to the conference as well as of their major policy implications.

A nation’s standard of living is determined by the productivity of its workers that is, by the amount of goods and services produced for each hour of a worker’s time. For a given state of technological knowledge, this productivity depends essentially on the quantity of factors of production per worker and on the efficiency of their utilization. Generally speaking, most of the papers presented to the Conference address some basic forces behind productivity growth namely, human capital accumulation, market competition, the role of the services sector and the efficiency costs of taxes.

Olivier Blanchard’s keynote address to the conference (“Adjustment with the Euro: The difficult case of Portugal”) focused not so much on the fundamentals of economic development but rather on the current Portuguese economic situation. Portugal, as Blanchard’s put it, is a country in economic trouble: very low growth, low productivity growth, increasing unemployment, large current account and fiscal deficits. A major culprit is the continuous overvaluation clearly apparent in the cumulative growth of 22.3% of unit labor cost relative to the euro area since 1995. Blanchard pointed out two and only two ways out of the current ordeal: an increase in productivity growth or a cut in nominal wages. Given the current low euro area wage growth, a mere wage freeze will increase competitiveness only very slowly. Nominal wage cuts however difficult are not different from currency devaluation and will eventually occur if unemployment continues to rise. There is a large scope for productivity improvements (the papers in the conference provide some clues how) but this is necessarily a slow process. Interestingly, however, and contrary to popular belief, Blanchard remarked that the targets for productivity gains in a shorter run are not necessarily the tradable’s sector or high tech industries. Given the stock of human capital of work force, the level of R&D and the existing employment protection legislation, Portugal has no real comparative advantage in high tech. More promising look to the author the services in general and especially those related directly or indirectly to tourism, leisure and third-age (the Tuscan model in Blanchard’s words).

In the second-half of the twentieth century the Portuguese aggregate productivity grew at a remarkable pace close to 4% per year. Taking the U.S. as a benchmark, this translated into a significant convergence of standards of living. At the same time, as all developed countries, Portugal underwent a process of marked structural transformation with the share of employment in agriculture dropping almost 40 p.p. and the share of services increasing about 30 p.p. The paper by Margarida Duarte and Diego Restuccia (“The Structural Transformation and Aggregate Productivity in Portugal”), quantifies the relative contributions of structural transformation and sectorial productivity to the growth of aggregate labor productivity. The authors show that the observed convergence reflected mainly the increase of the

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productivity in manufacturing since productivity growth in agriculture and services lagged behind the US. Owing to an income elasticity of demand superior to unit, services tend to gain weight in GPD as economies progress. Consequently, the authors point out that further convergence of GDP per capita will be in jeopardy unless productivity in services starts growing faster.

The previous analysis is probably too aggregate to draw specific policy recommendations on how to increase productivity. Nevertheless, the focus on the service sector is quite useful and important. Indeed, since services industries are usually more regulated and shielded from market forces than manufacturing and are also more human capital intensive, faster productivity growth will demand increased competition and faster human capital accumulation. These were the topics of five of the communications to the conference.

Education is unanimously regarded as critical to increase productivity. Pedro Carneiro (“Equality of Opportunity and Educational Achievement in Portugal”) shows that education explains roughly half of the variability observed in Portuguese workers’ wages (a measure of their productivity) which is quite a significant share as, a similar figure for the US is 15% and for several European countries is often below 30%. Also, an overwhelming proportion of low wage and non employed individuals have very low levels of education. At the same time it was found that there is a very strong association between parent’s education and their children education. The author goes further, and disentangles the relative contribution of the school’s quality and of family background for the student’s success (measured by PISA test scores taken by 15 year old individuals) in Portugal. Schools quality and socio-economic family background both influence the academic achievement (although they jointly explain less than half of the scores variance). More interesting, however, is that the most important factor explaining school’s quality indices is the family background of students in the school and not measures of school resources. The author thus concludes that the family background of ones school peers is the most important factor affecting individual performance while school resources only play a limited role. Quite important is also the large degree of persistence in educational status: the chances of a child of parents with less than primary education never completing high school are more than 90% while virtual all of offspring of parents with a university degree complete at least high school. Changing significantly the stock of human capital of Portuguese working force will take generations and traditional policies based upon increasing the amount of resources in schools have a very limited effect. The family, Carneiro concludes, must be seriously taken into account when designing new policies and it is necessary to intervene at the family level much before children get to school.

But, not only formal education increases the stock of human capital: as Rita Almeida and P. Carneiro note (“On-the-Job Training: Estimating Returns Using Firm Level Data”), more than 50% of the human capital accumulated during a typical life time results from post schooling investments in particular from on-the-job training. The rate of return on this type of investment was found to exhibit a huge dispersion: there are firms for which investing in training is a bad idea while others have suboptimal levels of investment. The sources of this inefficiency are left unexplained but, one may safely infer that incentive schemes to formation and training that do not accommodate the existing heterogeneity in returns should be avoided.

Besides their direct effects, education and training have also indirect effects on productivity. As the paper by Cátia Batista (“Joining the EU: capital Flows, Migration and Wages”) remarks the aggregate technology in Portugal is characterized by complementarities between physical capital and skilled labor. These complementarities imply that the more qualified the work force is the more productive capital will be, the higher the return on investment and, consequently, the more attractive will Portugal be to new capital.
Improving the productivity of workers and firms is certainly a way of improving aggregate productivity. The paper by Luis Cabral (PME’s em Portugal: Factos, Teorias e Consequências para Política Económica) draws attention to an alternative: the selection process. The micro structure of the Portuguese economy as far firms’ demography is concerned is quite similar to that of most European countries: high turnover rates, lower survival probability of smaller firms, higher growth rates of smaller firms conditional on survival. The share of firms with less than 20 employees in the total number of firms and in total employment is also remarkably constant across countries. But in one respect is Portugal different: the average productivity is half of European leaders. However, and in a sense this constitutes the major point of the paper, focusing on average is highly misleading since within each sector, firms with low productivity coexist with those with relatively high productivity: 10 to 20% of firms have productivity levels that more than double the sector average. This dispersion is quite natural in face of uncertainty about cost and demand conditions. Given the spread of productivity, if somehow resources were relocated from less efficient top more efficient firms, average productivity would necessarily increase. Is this relocation that Cabral refers to when he speaks about selection process of firms. So, one way of improving aggregate productivity is to ensure that competition works on a “leveled playing field” so that the most efficient firms survive and prosper. Properly functioning markets are thus key to productive efficiency.

The capital market is preeminent in this respect; distortions in this market imply that the best projects may lack funding and less efficient firms survive. The paper by Rui Albuquerque and Clara Vega (“Asymmetric Information in the Stock Market: Economic News and Co-movement”) studies how the Portuguese capital market reacts to local and U.S. news and, in this way, provide a test of its efficiency. Using real time U.S. and Portuguese macroeconomic announcements and high frequency stock market returns, the authors find a strong correlation between U.S. public macroeconomic news and PSI-20 stock market index. The question is whether such correlation is spurious and due to mere contagion of the American market responses or results from correlated fundamentals and, thus, is consistent with market efficiency. The evidence provided indicates that the correlation of returns remains unchanged when news about the U.S. economy are released, as if the Portuguese market was free riding on the American market and on its treatment of U.S. information; however, the correlation is substantially lower during Portuguese announcement days. The authors conclude against the hypothesis of contagion and that the co-movements between indices of the two markets are consistent with efficiency in the sense of adequate reaction to fundamentals.

Governments’ interventions have also major effects on the incentives to an efficient use of resources and on productivity. Susana Peralta (“Budget Setting Autonomy and Political Accountability”) deals with the issue of budget decentralization. Specifically, she proposes a game theoretical model of political accountability to analyze the case for decentralizing taxes in a context where local governments already decide on the provision of local public goods. Under the centralized regime budgets are set by the central government and local officials decide on the public good level. With decentralization, local officials decide both on the budget size and the public good. At this stylized level, Portugal clearly falls in the centralized regime category since the fiscal autonomy of local government is extremely low. The basic trade-off identified in the model is between ability to identify and vote out bad incumbents – bigger under tax autonomy – and discipline – bigger under a centralized tax regime. No system dominates but, autonomy tends to be preferred the higher the proportion of politicians who care with the public interest. However, since quality in endogenous, greater autonomy may increase the number of good politicians and, thus, reinforce its own attractiveness.

André C. Silva (“Taxes and Labor Supply: Portugal, Europe, and the United States”) analyses the impact of taxation on income and consumption on the labor supply decisions. From 1986 to 2003 the number of hours worked per week in Portugal dropped more than 2.5 hours; in the same period the
hours in the U.S. fell only 0.5 hours. The paper purports to explain these changes with the changes in taxes. From the theoretical standpoint the effect is clear: higher taxes increase the opportunity cost of market activities and, thus, labor supply decreases and, with it, the aggregate output and per capita income. The question is whether that effect is sizable enough to mimic the hour’s worked behavior. The author shows that the increase in taxes is shown to explain the reduction in hours worked in Portugal and in some other European countries over the last decade and a half. Taxes, he concludes, displace people from the market into less productive activities and, thus, lower productivity.

As a very personal summation, four major lessons may, in my view, be drawn from these communications to the Bank of Portugal 3rd Conference:

- Services are critical to continued convergence of productivity and standards of living.

- Income and consumption taxes destroy incentives to work and this effect in empirically relevant.

- It is not enough to invest additional resources in education in order to improve results; policies should address the issue of the student’s family background and reach children well before they enter the school system.

- Sound competition policies (in a broad sense that include also flexible labor laws, efficient judicial system, combat to corruption and informality) promoting economic mobility may provide a significant boost to aggregate productivity.