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The Role of the State in the Labour Market: Its Impact on Employment and Wages In Portugal as Compared with Spain*

by

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Abstract

The role of the State in the economy and in the social arena was deeply transformed in the second half of the 1970s, on account of the change of the political regime. The integration into the European Union since 1985 has brought new radical changes in that role. The paper describes the most important of those changes, putting a special emphasis on social policies and on the labour market, and on the challenges that have to be faced because of European Monetary Union.

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I. Introduction

Since Portugal became a member of the European Economic Community (EEC) in 1985, the evolution of its labour market has presented significant differences in relation to the average of the European Union and to Spain: its unemployment rates have been lower; its wages have increased faster; and its labour regulations continued to be tighter.

The contrasts between the Portuguese labour market experience and those of Spain and other European Union countries (EU-15) have puzzled many economists. Several analyses have been undertaken with the objective of trying to find explanations for such contrasts. But the conclusions reached have not always been sufficiently clear cut.

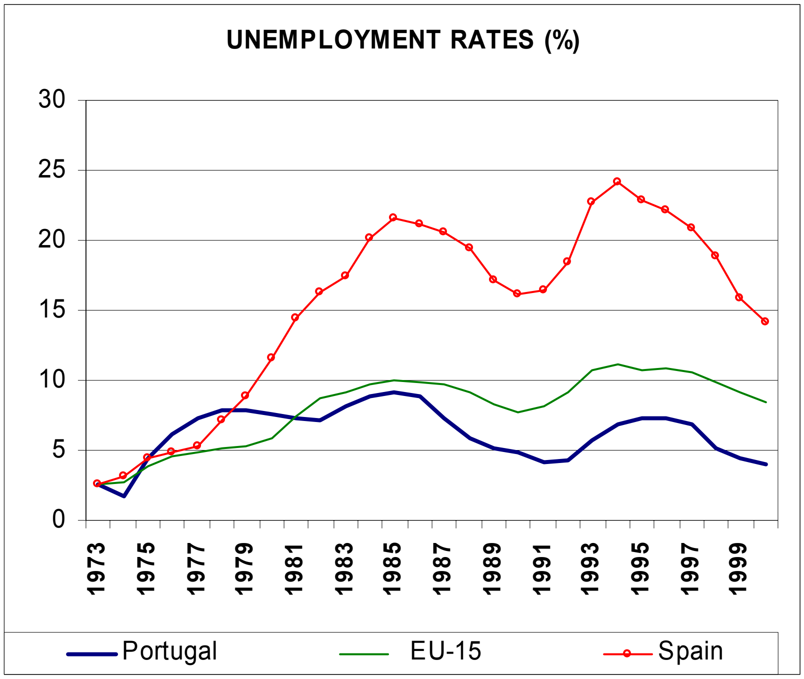
The present paper describes the behaviour of the Portuguese unemployment and wages in the last two decades, and in particular since the accession to the EEC in 1985. It comments on the explanations that have been proposed in several studies for the differences in relation with Spain. And it emphasises the role of the government and central bank policies, especially as regards the management of domestic demand and the exchange rate.

II. Unemployment

In the four-year period 1974 to 1978, Portuguese unemployment rates rose from 1.7 percent to 7.9 percent. As in other European countries, this sudden increase was to a large extent explained by the adverse effects of the first oil price shock. But two other causes, specific to Portugal, had even more weight: the troubles of the revolutionary period of 1974-75, after the change of political regime; and the influx of more than 700,000 refugees from the former colonies of Angola and Mozambique. In such conditions, in 1978 the Portuguese unemployment rate exceeded the average of Western Europe and was higher than that of Spain.

However, since 1978 Portuguese unemployment ceased to increase in contrast with what happened in most European countries and especially in Spain. As shown in Figure 1, it fluctuated in accordance with economic cycles, but it remained below the European average. During that period, Spain had always the highest unemployment rate in EU-15 and Portugal one of the lowest. The accession to the EEC in 1985 does not appear to have had a significant impact, either positive or negative, in the Portuguese unemployment rates.

Figure 1



It has sometimes been argued that the Spanish statistics overstate true unemployment and that the Portuguese ones understate it. But careful comparisons and some specific tests suggest that the possible errors in statistical measurement were almost certainly not large enough to invalidate the wide differences in unemployment between Portugal and Spain.[1]

The following sections discuss possible causes for such differences that have been investigated by a certain number of authors. They will deal with the labour intensity of economic growth, the flexibility in the volume of employment and the behaviour of wages. The concluding section analyses the impact of the constraints imposed by the European Monetary Union on the unemployment outlook for forthcoming years.

The levels of employment have also been influenced by the active labour policies of the government, but these are not examined in the present paper.

[1] Blanchard (1999), p. 26.

3. Labour intensity of economic growth

One of the explanations for the contrast in the unemployment experiences of the two Iberian countries is based on the argument that economic growth has been more labour-intensive in Portugal than in Spain[2].

According to that argument, Spain has implemented deep structural reforms in its industrial sector in the late 1970s and early 1980s, while in Portugal few changes of that type were introduced. The Spanish reforms involved large cuts in the output of several industries and the destruction of many jobs. They resulted in a serious worsening of the employment situation, but it is suggested that they created the conditions for significant productivity improvements, for fast real wage increases and for gains in international competitiveness. This explanation points out, that, by contrast, Portugal maintained its traditional industries (textiles, clothing, shoes, etc) without significant restructuring and relied heavily on them to expand the GDP. According to such an interpretation, Portugal opted for a strategy of weak progress in productivity, of slowly increasing real wages and of the maintenance of the international competitiveness on the basis of low wages costs.

This explanation is however based on statistical data which do not provide an adequate picture. The data covering a larger period, on which figures 4 and 5 are based tell a very different story:

- labour productivity increased in Portugal as much as in Spain from 1975 to 1986, but it rose much more rapidly from 1986 to 2000;
- it is true that average wages in Portugal are substantially lower than in Spain (in correspondence with differences in productivity levels) and that, in real terms, they increased less than in Spain from 1977 to 1985. However their slow growth in real terms from 1977 to 1985 corresponds mainly to the gradual correction of the unsustainable wage explosion in Portugal that occurred during the revolutionary period of 1974-75. If the entire period from 1974 to 2000 is considered, the increases in real wages appear to be far higher in Portugal than in Spain.

It can not therefore be said that the comparatively low unemployment levels of Portugal are due to weak improvements in labour productivity and to more stagnant wages, as compared with Spain and with the average of the EU-15 countries.

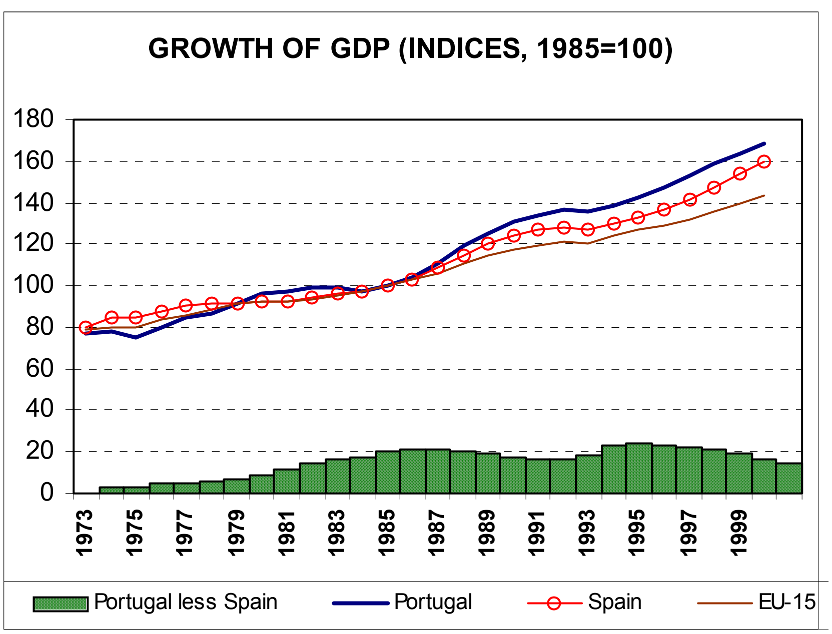
[2] Marimon (1996), pp. 24-25 and 79-85.

A more plausible explanation can be found by looking at the statistical data on employment and GDP. Figure 2 suggests that the satisfactory experience of Portugal in the area of unemployment results to a large extent from faster economic growth that in Spain and the EU-15 during most of the years of the last quarter of the twentieth century. It has also been due to slower increases in the labour force than in Spain, except during the second half of the 1970s (Figure 6).

On the basis of the information provided by Figures 3 to 5, it can not be said that Spain had a bad unemployment record because its economic growth has been based on high productivity increases rather than in jobs creation or because its labour-costs have risen too much. The key explanation seems to be that the Spanish labour force has increased very fast since the beginning of the 1980s and that, with the comparatively low rate of economic growth, it has been difficult for the labour demand to adapt quickly to such increase.

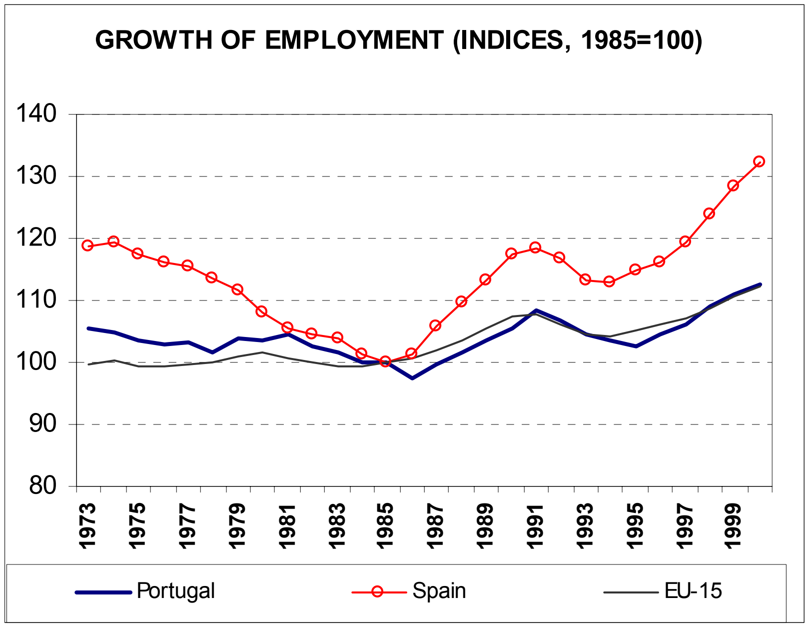
I should, however, be pointed out that from 1993 to 2000, the unemployment situation in Spain improved considerably and that the differences of unemployment rates in relation to Portugal became much smaller, due to the dynamism in the creation of new jobs (but not in productivity increases).

Figure 2:
Portugal less Spain: Difference between Portugal and Spain
Accumulated since 1974



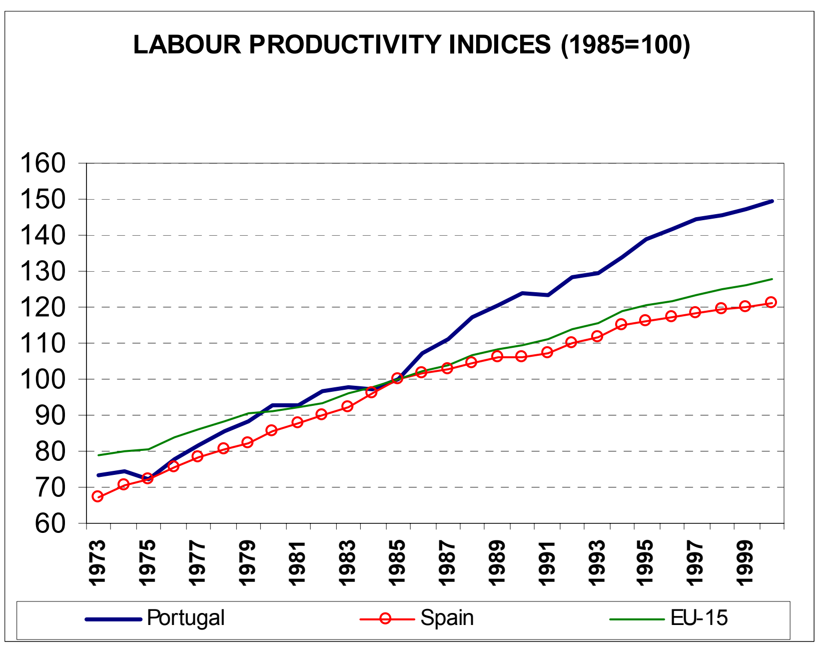
Source: European Commission (2000)

Figure 3



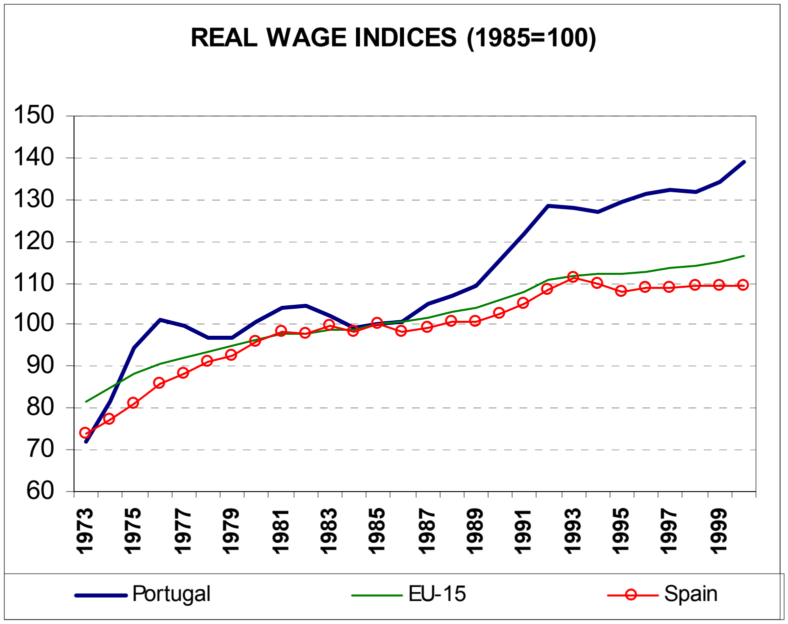
Source: European Commission (2000)

Figure 4



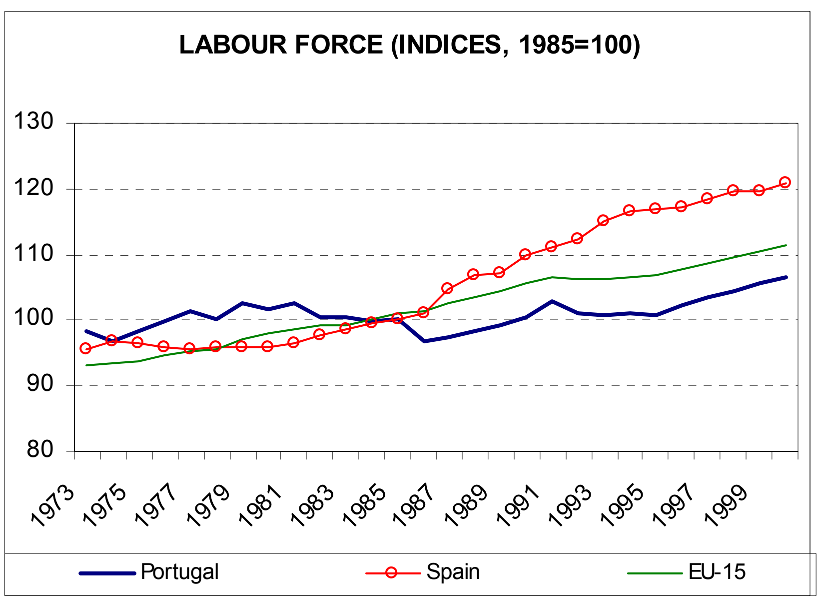
Source: European Commission (2000)

Figure 5



Source: European Commission (2000)

Figure 6



Source: European Commission (2000)

4. Unemployment and the rigidity of labour regulations

Many of the analysis for the persistence of high unemployment levels in the European Union conclude that the main explanations lie in the rigidity of labour regulations, especially those which seek to improve the employment protection for workers (EPL). On the basis of the argument that tight labour regulations increase the natural rate of unemployment, the flexibilization of such regulations has been one of the key recommendations of the "Jobs Strategy" of OECD.

International comparisons published by OECD[3] show that, among its members, Portugal has been the country with strictest labour regulations, in particular as regards EPL (See Table 1). This is still the situation, at present, despite changes introduced in 1989, which made some of regulations slightly less restrictive (mainly by allowing dismissal on the grounds of lack of economic performance and of economic redundancy). In the 1980s, Spain had, on average almost the same tightness in the labour regulations as Portugal, but in the 1990s it relaxed them. Now they seem to be more flexible than in several other European countries.

In the OECD comparisons, the countries involved are ranked on the basis of the ascending order of the strictness of a variety of aspects of the labour legislation. One of the more recent of such comparisons produced the results which are summarized in Table 1.

The explanation of the coexistence in Portugal of rigid labour regulations with low unemployment rates has been a challenging problem to many labour-market analysts. If the tightness of labour regulations is considered a good explanation for high unemployment, it is difficult to understand why it applies to Spain but is not valid for Portugal.

Several interpretations have been proposed for that puzzle.

First, recent researches suggest that the effects of EPL on unemployment levels are weaker than is was assumed before. Empirical studies published by the OECD[4] show that tight EPL regulations tend to affect certain groups of workers (such as, for instance, the new entrants into the labour market) and tend to increase self-employment, but are not significantly correlated with unemployment levels. If these results are valid, the coexistence in Portugal of strict employment protection regulations (EPL) with low unemployment can be more easily accepted.

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[3] OECD (1999)
[4] OECD (1999), p. 75-99

Table 1:

Rankings in ascending order of the indicators of the strictness of EPL

	Late 1980s			Late 1990s		
Types of Regulations	Number of countries covered	Rank of Portugal	Rank of Spain	Number of countries covered	Rank of Portugal	Rank of Spain
Employment protection for regular employment						
Regular procedural inconveniences	22	19	20.5	27	24.5	12
Notice and severance pay for non-fault individual dismissals	20	20	19	27	27	23
Difficulty of dismissal	20	20	15	27	26.5	16
Overall strictness against dismissals	20	20	19	27	27	18
Regulations of temporary employment						
Fixed term contracts	19	11	8	27	19	21
Temporary work agencies	24	15	20	26	23	24
Overall strictness of regulations	19	12	13	26	21	22
Regulations of collective dismissals						
Overall strictness relative to individual dismissals				27	20	13
Overall Strictness of Employment Protection Legislation	19	19*	17*	26	26**	22**

Source: OECD (1999), pp. 57, 63 and 65.

* Average of indicators for regular contracts and temporary contracts
** Weighted average of indicators for regular contracts, temporary contracts and collective contracts

NOTES: Higher ranks represent higher strictness of the regulations. When two countries have the same rank, the average of that rank and the following integer is attributed to both of them. Thus, for instance if two countries have the rank of 26, the value 26.5 is attributed to each of them.

Second, the strictness of EPL is, to a large extent, evaded by the recourse to non-regular forms of work: fixed-term contracts, self-employment, temporary work, underground work, etc. In recent years, regular work corresponded to only 60 percent of total employment in Portugal. The rest consisted of self-employment (26 percent of the total), fixed term contracts (8 percent) and other forms of non-regular work (6 percent).

Third, the measures of EPL provided in Table 1 are not entirely adequate. Small differences in the texts of the regulations of two countries, may result in widely divergent real effects: the specific institutional structures of each country may have a strong influence of the strictness of its regulations, when they are actually implemented. This is the reason why surveys based on employers' assessments of the restrictions which they face in dismissing workers (Table 2) put Portugal and Spain in better relative situations than the comparisons of Table 1.

Finally, non-compliance with labour regulations is also an important factor for reducing the effects of the rigidity of EPL. In Portugal, that non-compliance is mainly found among small- and medium-sized enterprises, but these account for a larger proportion of the total economic activity than in other EU-15 countries, except Greece.

Table 2

Assessments by employers of the strictness of
employment protection regulations
(Ranks in ascending order of restrictiveness)

	International Organization of Employers	*EC ad-hoc surveys*	
	1989	*1989*	*1994*
Number of countries compared	14	10	10
Rank of Portugal	7.5	10	4
Rank of Spain	13	3	2

Source: OECD (1999), p.67

In view of these explanations, it is not difficult to understand why the average labour market flexibility in Portugal appears to be higher than in Spain and other European countries, despite the high rigidity of the regulations shown in Table 1. This means that the Portuguese labour market has a dual structure: around half of the workers, especially those who have jobs in the public sector and in large enterprises, enjoy levels of employment protection that are among the highest in Europe; while the other half (including workers in small and medium sized enterprises, the self-employed and non-regular workers) receive little protection from the labour market regulations and provide a high flexibility to the labour market.

5. Wages, inflation and unemployment

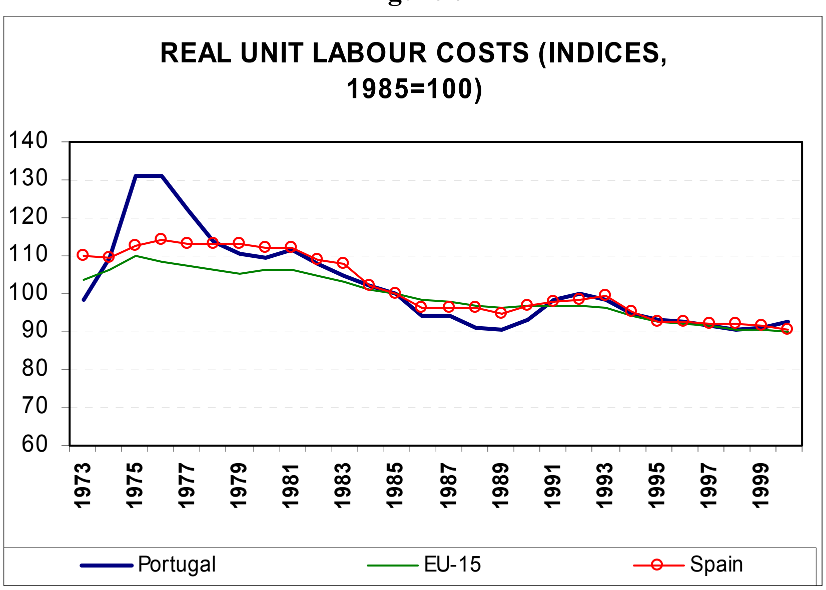
Real wage flexibility is commonly considered as the most important explanation for the comparatively low employment in Portugal. It is argued that such flexibility has been much higher in Portugal than in Spain and in other EU countries. Consequently, in periods of economic slowdown and in face of shocks, unemployment has increased less in Portugal than in other economies.

As already shown above (Figure 5), during the last two decades real average wages *per* worker have risen more in Portugal than either in Spain or in the whole of the European Union. The trend has however been irregular.

The change in the Portuguese political regime in April 1974 was immediately followed by a wage explosion. During the revolutionary period of labour unrest of 1974-76, real wages shot up by around 40 percent. The excessive labour cost increases that were thus imposed on enterprises rendered the situation unsustainable for practically all of them and led to a serious crisis in the external competitiveness of economy.

In order to restore the equilibrium, during the years 1977-79 the authorities imposed nominal wage ceilings, which were lower than expected inflation, and made substantial devaluations of the escudo, which contributed to the acceleration of inflation. During those three years, real wages fell by about 4 percent, despite rapidly rising labour productivity, and real unit labour costs were reduced by about 17 percent (See Figures 5 and 7). The equilibrium of the balance of payments was thus re-established.

Figure 7



The cuts in real wages which occurred then corresponded to a correction of the excesses of 1974-75, but they were a first sign of flexibility of real wages in Portugal. They were tolerated by workers, without substantial problems of labour unrest, because of the menaces of rising unemployment.

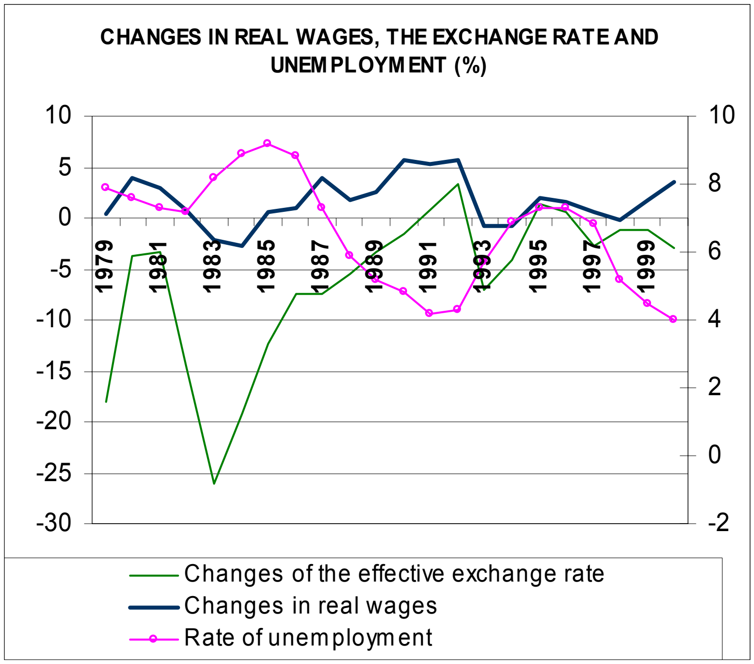
During the 1980s, Portuguese real wages increased less than productivity. Unit labour costs fell much more than the average of the EU-15 (Figure 7).

With the objective of fighting inflation in 1989, the Portuguese authorities dismantled the crawling peg, and replaced it by a stable exchange rate, anchored to the currencies of the European Monetary System (EMS). As expected, the new exchange regime had an immediate impact on the behaviour of the prices of tradable goods, which began to follow closely those of the EMS countries. The inflationary expectations of workers and producers of non-tradable goods adjusted however at a much slower speed. The consequence was that from 1989 to 1993, nominal wages and the prices of non-tradables rose far more than those of tradable goods and than overall inflation. This is the reason for the sharp increases in real wages from 1989 to 1992, which can be seen in Figure 5.

In the subsequent years, those increases were not reversed except temporarily in 1993, in consequence of the depreciation of the escudo, associated with the troubles of the EMS in 1993, and the rise of unemployment, caused by the cyclical depression of that year. In spite of rising real wages and the decline of inflation, unemployment after 1995 was not negatively affected; first, because productivity improvements offset a large proportion of the real wages increases; second, because of the effects of short run wage flexibility; and, third, because the rapid fall of interest rates and large increases in foreign borrowing allowed quite a good expansion of domestic demand.

As shown in Figure 8, real wages tended to fall or to increase more slowly in years of strong devaluations of the nominal effective exchange rate of the escudo and in years of high and rising unemployment.

Figure 8



These relationships are confirmed by a linear regression covering the years from 1980 to 2000. That regression shows that changes in real wages were correlated positively with devaluations of the exchange rate and negatively with increases in the unemployment rate. The regression coefficients of the two independent variables have the expected signs and are significantly different from zero, the first at the 95 percent confidence level and the second at the 90 percent (but not at the 95 percent) confidence level.[5]

The escudo was depreciated continuously, under a system of crawling peg, from 1977 to 1989. Many economists tend to express the view that the effects of currency depreciation on real unit labour costs are usually temporary, and will disappear after one or two years. This view does not seem to be borne out by the Portuguese experience. It can be see in Figure 8 that when the depreciation of the nominal effective exchange rate of the escudo was accelerated there were reductions or slower increases in real wages and that the consequent reductions in unit labour costs were not offset in the following years. What happened was that high rates of depreciation accelerated domestic inflation beyond the levels previously expected by economic

[5] The regression for the period 1980-2000 is

$$w = 2.75 + 0.20\,E - 0.90\,u_{-1}$$

(t=5.53) (t=3.74) (t=1.90) R^2=0.55 F=10.9 d.f.=18

where

w = annual increases in real wages

e = annual depreciation of the nominal effective exchange rate

u_{-1} = increase in the unemployment rate in the preceding year.

agents and led in consequence to non-anticipated declines in real wages, which were not entirely reversed afterwards.
The accumulated exchange rate depreciations of the exchange rate during the 1980s led thus to falling unit labour costs, which contributed to the creation of jobs and to avoid large increases in unemployment.

The influence of changes in unemployment rates on the behaviour of real wages was almost as important as that of the exchange rate policy. That influence implies that real wage rigidity has been very low in Portugal. The same conclusion has been reached by means of more sophisticated analysis.[6]

Due to the higher flexibility of real wages, employment in Portugal was less affected by economic shocks (resulting for instance from shifts in prices, in demand, in the labour force, in productivity or in external competitiveness) than in Spain or in other European countries.

There are three main explanations for the low rigidity of real wages in Portugal. First, inflation was high and variable from 1975 to the early 1990s and in several years it generated large differences between the inflationary expectations of workers and other economic agents and the actual changes in the aggregate price level. Second, actual wages have exceed frequently the wages agreed in collective agreements; in periods of high or increasing unemployment, the excesses can be reduced quite easily and actual real wages may fall or increase less than contractual wages. And thirdly, there has been strong fears of the workers of loosing their jobs when unemployment is high or increasing.

There are good indicators to justify the last of these reasons – the fear of workers of loosing their jobs. One of such indicators is the attachment of workers to their work-places, repeatedly found in enterprises in serious financial situations, even when their wages cease to be paid or begin to be paid with long delays. Often they continue to cling to their jobs, despite the weak prospects of recovering their wages in arrears. Another is the low degree of protection provided in the past by unemployment benefits.[7] Up 1985 to 1989, the eligibility criteria for unemployment benefits were so strict that less than 20 percent of the actual unemployment were covered. Subsequently those criteria were relaxed and the coverage rose to around 40 percent to 50 percent. In Spain the generosity of the system of unemployment benefits was much higher than in Portugal during the 1980s but it was reduced in the 1990s[8] and the two countries are now in a more similar situation.

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[6] Castillo, Rolado and Jimeno (1997)
[7] Blanchard and Jimeno (1995).
[8] Bover, Garcia-Perea and Portugal (1998)

The weakness of the Portuguese system of unemployment subsidies as compared with that of Spain has been considered as a major explanation for the high real wage flexibility and for the low employment rates in the 1990s. However, the contrast in the experiences of both countries became smaller during the 1990s. In Spain, the reductions of the generosity of unemployment benefits and the relaxation of the strict EPL were probably important factors in explaining why unemployment has been falling quickly since 1994. In Portugal, the more generous system of unemployment subsidies, combined with the maintenance of tight EPL, with lower inflation rates and with the stability of the exchange rate, may have resulted in a reduction of the real wage flexibility. The fact that Portuguese real wages increased from 1994 to 1996, despite unemployment rates around 7 percent, may be a sign of higher real wage rigidity than in the preceding decade, but so far the statistical data do not allow a robust conclusion (See Figure 8). In any case, even if we accept the hypothesis that real wage flexibility is now lower than in the 1980's, there are not yet any signs that unemployment was negatively affected by that change.

6. Wages and external competitiveness

It was shown in the preceding section that in the 1980s the rapid growth of real wages in Portugal was, in comparative terms, compensated by high increases in labour productivity and that, in consequence, the behaviour of real unit labour costs expressed in the national currency was not much different from that of Spain or from the European average. Because of the fast real appreciation of the escudo from 1989 to 1992, the conclusion is however radically different when we look at the competitiveness of nominal labour costs expressed in euros.

As already explained above, the stabilization of the exchange rate after 1989 was reflected only with a quite long delay in the slowing down of nominal wage increases. Consequently, Portuguese nominal wages denominated in euros, rose abruptly from 1989 to 1992. Since 1994, Portuguese inflation continued to exceed the European average, although by smaller margins than before. The increases of nominal wage in euros tended, therefore, to exceed those of Spain and of other EU-15 countries. And since the differences in such increases were larger than differences in productivity improvements, unit labour costs in euros at current prices rose far more in Portugal than in the EU-15 as a whole or in Spain (Figures 9 and 10).

Figure 9

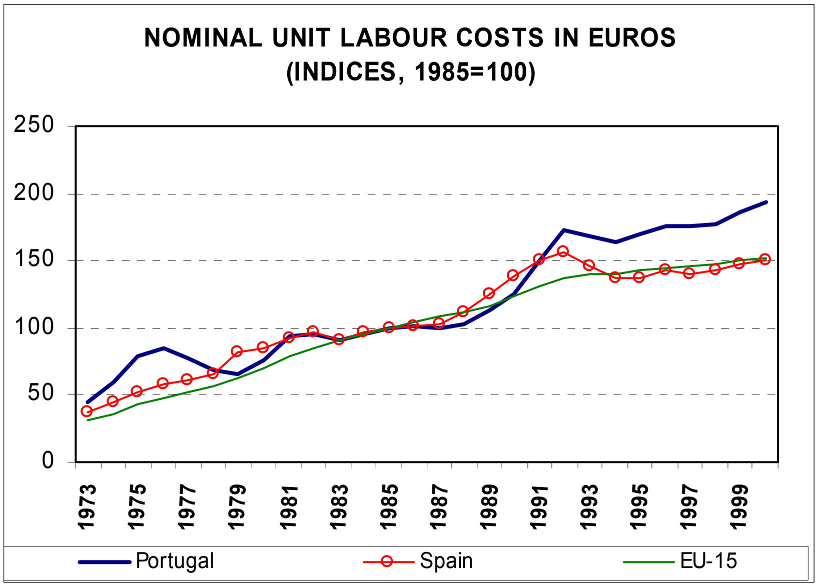
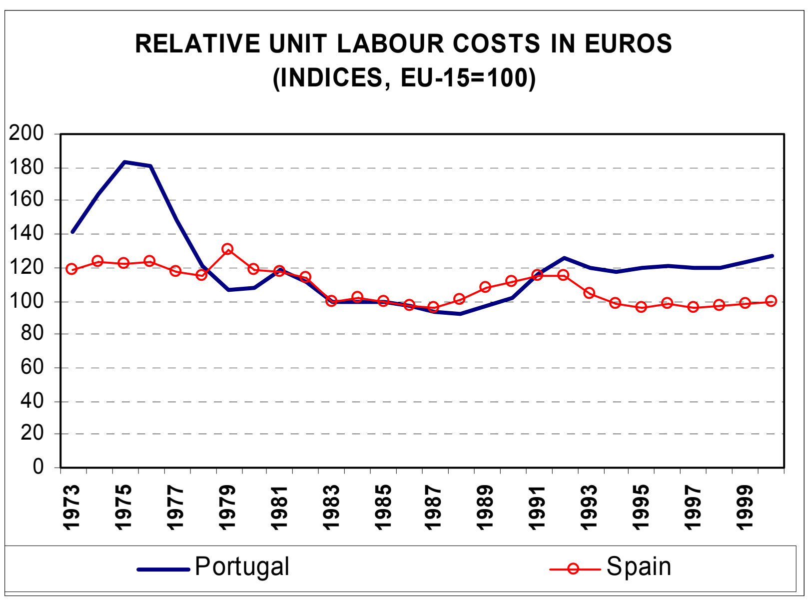


Figure 10



The outcome was a considerable deterioration in the competitiveness of the tradable goods produced in Portugal.

A regression covering the period of 1977-2000 shows that the growth of the volume of imports was positively correlated with the growth of GDP and with unit labour costs denominated in euros relative to the average of the EU-15.[9] The higher those relative unit labour costs, the faster the increase in imports tended to be. The fast increase of those costs denominated in euros in Portugal as compared with the EU-15 average, explains why, during the 1990s the volume of imports increased on an annual basis 2 percent, for each 1 percent of expansion in the volume of total demand.

A regression aimed at explaining the growth of the volume of Portuguese exports by the increases in the real import demand of the EU-15 and the relative unit labour costs does not produce entirely satisfactory results. It shows, as it would be expected, that the behaviour of those exports depends closely on import demand in the EU-15, but the influence of relative unit costs seems to be weak. The regression coefficient for the last of those variables is negative, as it would be expected, but it is low in absolute terms (-0.17) and is significantly different from zero only at a 58% level of confidence.[10]

The reasons for the weakness of the impact of relative unit costs on the volume of exports are to be found in the data for the 1990s. Until 1996, Portuguese exports continued to grow very satisfactorily, despite much higher relative unit labour costs, because of the start of the operations of a few large export oriented projects (mainly in the automobile industry) financed by foreign direct investments negotiated in the late 1980s or early 1990s. But after 1996, there was a return to the pattern of the period 1976-80: foreign investments in new industrial undertakings fell to very low levels, as a result of the strong rise of the relative Portuguese unit labour costs since 1989; and consequently the export performance of Portugal in the period 1997-2000 was very disappointing – as shown in Table 3.

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[9] The import regression is: $M=-406.1+3.19Y+1.47L$

(t=-12.5) (t=27.7) (t=3.63) $R^2=0.977$ F=455.1 d.f.=21

where : M=Index of the volume of imports of goods and services ;

Y=Index of real GDP; L=Index of relative unit labour costs.

[10] The export regression is: $X=-69.6 + 1.68D - 0.17L$

(t=-2.37) (t=3.40) (t=-0.55) $R^2=0.980$ F= 521.6 d.f. 21

Table 3

Export performance of Portuguese manufactured goods
Percentage changes from previous year

	1995	*1996*	*1997*	*1998*	*1999*	*2000*
Export performance	3.3	6.4	-0.9	-5.2	-3.7	-3.9

Export performance is calculated as the percentage change in the ratio of
of export volumes to export markets.

Source: OECD Economic Outlook, numbers 58, 61, 63, 65, 67 and 69.

The result of the unsatisfactory performance of exports and the rapidly increasing imports was that the deficit in the balance of goods and services rose progressively from 6.2 percent of GDP in 1995, to 6.6 percent in 1996, 7.7 percent in 1997, 9.2 percent in 1998, 10.7 percent in 1998 and 12.2 percent in 2000. This growing gap between imports and exports was partially covered by emigrant's remittances and transfers from the Structural Funds of the EU, but it required sharp increases in loans and other forms of capital inflows from abroad. In 2000 almost 10 percent of domestic spending in Portugal was financed by foreign borrowing and by portfolio or direct investments.

The dramatic intensification of the dependence from foreign financing during the period 1995-2000, as a remedy for the losses of competitiveness, made it possible to achieve annual increases of GDP above 3 percent. It is clear, however, that such a dependence can not be maintained for many years at present levels. It will inevitably fall in the future. The differences between the amounts of imports and exports will therefore have to become narrower. That result will impose strict constraints in the growth of domestic demand, unless there are quick improvements on external competitiveness, achieve either by rapid increases in labour productivity without increases of the same size in real wages or by increases in nominal wages at much lower rates than those of the EU-15.

Where : X=Index of volume of goods and services; D=Index of the volume of total imports of EU-15;
L=Index of relative unit labour costs.

Quick improvements in labour productivity would reduce Portuguese unit labour costs in relation to the EU average. The problem is that steady productivity increases require structural changes (in technologies, in human capital, in the environment for enterprises, etc.) that can only be achieved in the medium and long run. Apart from cyclical fluctuations, it is not realistic to expect quick productivity improvements over a period of only a few years.

It is also unrealistic to expect that Portuguese wages, can fall in nominal terms or that they may easily fall in real terms if inflation in the EMU is kept at the very low levels which the European Central Bank intends to maintain. In the 1980s reductions in real wages were feasible because it was possible to resort to devaluation and to higher than expected inflation, but those instruments are not available any more. The only feasible solution to increase competitiveness seems thus to be the reduction, during several years, of the Portuguese inflation to levels lower than the European average – a situation which is just the opposite of the experience of the last few years. There may be even reasons to fear that in order to recover its lost competitiveness in labour costs, Portugal may need a deflation. In such a case, the risks of rising unemployment would be very serious. Portugal had in the last twenty years an enviable unemployment record, but because of the loss of competitiveness of its labour costs in the 1990s, which can not be solved by exchange rate depreciations as in the past, the prospects for the forthcoming years are far from encouraging.

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