Bela Balassa

Economic Policies in Portugal


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Economic Policies in Portugal

This report makes recommendations for short-term policies aimed at remedying existing economic disequilibria in Portugal as well as for medium term policies aimed at facilitating Portugal's entry into the European Common Market. The discussion of the proposed policy changes will be preceded by a short review of Portugal's policy performance in the 1973-1981 period and by a consideration of its long-term policy objectives.


The Policies Applied After the Revolution

After attaining rapid rates of economic growth in the 1960-1973 period, Portugal suffered the twin shocks of a substantial deterioration in its terms of trade and the Revolution of April 1974 that also led to the independence of the African colonies. The policies applied further aggravated the situation, with the rapid growth of public expenditures, substantially negative real interest rates, large wage increases in the face of declining productivity, and the appreciation of the escudo in real terms vis-a-vis the currencies of the partner countries contributing to the deterioration of Portugal's balance of payments, a substantial deficit in the government budget, and declines in domestic savings. In 1977, the deficit in

the current account reached 9.2 percent of the gross domestic product while the ratio of the government budget deficit \(^2\) to GDP attained 11.4 percent and the share of domestic savings in GDP declined to 16.2 percent \(^1\).

Following partially successful efforts to remedy the situation in the second half of 1977, a policy package was adopted in conjunction with the IMF in May 1978. The main elements of the package were a devaluation of 7 percent, accompanied by an increase in the pre-announced monthly rate of depreciation (crawling peg) from 1.0 percent to 1.25 percent, increases in interest rates by four percentage points, the application of credit ceilings, and the liberalization of imports. Credit ceiling were, however, exceeded as higher interest rates led to increased savings \(^4\).

The results have been qualified as spectacular; after declining to 4.7 percent of GDP in 1978, the current account deficit was practically eliminated in 1979 while domestic savings reached 22.0 percent of GDP. Although part of the improvement represented a "stock adjustment" in the form of the repatriation of the savings Portuguese workers had accumulated abroad \(^5\), much of the improvement in the balance of payments reflected increases in merchandise exports and in tourist receipts. The dollar value of merchandise exports increased by one-half, with a volume increase of three-tenths complemented by higher prices that in part reflected lessened incentives for under invoicing, and tourist receipts rose by three-fifths.

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\(^2\) Defined as the overall balance of the current and capital transactions of the general government.

\(^1\) Unless otherwise noted, all data originate from the Bank of Portugal.


\(^5\) The dollar value of remittances increased by 46 percent in 1979 and by 20 percent in the following year.
Rapid increases in exports permitted attaining a GDP growth rate of 4.5 percent in 1979, notwithstanding the near-stagnation of domestic private expenditure that was brought about by declines in real wages and in fixed investment. However, the growth of public consumption did not subside and the ratio of the government budget deficit to GDP was still 9.8 percent in 1979.

With the rise of public consumption exceeding that of the gross domestic product, the government budget deficit increased to 10.9 percent of GDP in 1980. At the same time, the relative contributions of the growth of private demand and exports were reserved, with the former accounting for nearly three times the increment in the gross domestic product than the latter. All in all, GDP increased by 5.5 percent in 1980, but this was attained at the all, GDP increased by 5.5 percent in 1980, but this was attained at the expense of the deterioration of the balance-of-payments, with the current account deficit reaching 5.2 percent of GDP.

Apart from the adverse effects of increases in the prices of imported fuels, the results obtained in 1980 reflected the effects of expansionary fiscal and monetary policies and of changes in exchange rate policy. The rise in the government budget deficit was accompanied by an acceleration in the growth of credit to firms and individuals (including public enterprises) from 21 percent between December 1978 and December 1979 to 26 percent in the following year, with the money supply increasing by 35 percent. Furthermore, the escudo was revalued by 6 percent in February 1980 and the crawling peg reduced to 0.5 percent a month, following decreases in two steps to 0.75 percent in 1979. At the same time, with the rise in domestic prices being kept down by price control, real wages rose by 6 percent, on the average between 1979 and 1980.

*Developments in 1981 and Early 1982*

As price control was eased, inflation accelerated in 1981. The consumer price index, excluding rent, rose by 25 percent between December 1980 and December 1981. Also, the balance
of payments deteriorated to a considerable extent, with the current account deficit reaching $2.8 billion in 1981, equivalent to 11.7 percent of GDP. These results reflect declines, in terms of dollar values, of 9 percent in merchandise exports, 11 percent in tourist receipts, and 3 percent in workers' remittances, and increases in the dollar value of imports of 8 percent. In turn, the share of domestic savings in GDP fell from 20.3 percent in 1980 to 14.7 percent in 1981.

Various considerations explain the observed results. Continued increases in fuel prices under long-term contracts and the adverse effects of the drought added to the import bill. These effects were aggravated by expansionary fiscal and monetary policies that continued unabated until the third quarter of 1981. In that quarter, current public expenditures exceeded the year-earlier level by 58 percent. Also, increases in total domestic credit reached a peak of 32 percent, and the growth of the money supply a peak of 38 percent, during the period.

A more restrictive monetary policy was adopted after September 1981 and efforts were also made to limit the growth of public expenditures, in particular through reductions in consumer subsidies. The rate of increase of domestic credit fell to 28 percent in February 1982 while the rate of growth of the money supply declined to 30 percent. However, with increases in capital expenditures, the slowdown in the growth of current public expenditures did not bring a decline in the rate of increase of credit to the general government that continued at 43 percent a year.

The brunt of the slowdown in credit expansion was thus borne by firms and households, with the rate of growth of credit accorded to them declining from 30 percent in the third quarter of 1981 to 23 percent in February 1982. And while credit to public enterprises rose at below-average rates, this was more than offset by foreign borrowing, mostly on a short-term basis. In 1981, taken as a whole, the external borrowing of nonfinancial public enterprises reached 10.6 percent of GDP, more than double the 1980 figure of 4.4 percent, while

\* All data relate to changes over a twelve-month period.
the ratio of their domestic borrowing to GDP declined from 4.1 percent to 3.1 percent (Table 1).

Taken together, the consolidated borrowing requirements of the nonfinancial public sector increased from 18.8 percent of GDP in 1980 to 25.4 percent in 1981. Apart from the rise in the borrowing requirements of nonfinancial public enterprises, this result reflected increases in the deficit of the government budget. In 1981, taken as a whole, current public expenditures reached 36.6 percent of GDP, compared to the original estimate of 33.0 percent and a ratio of 33.7 percent in 1980. With capital expenditures also exceeding the projections, the overall budget deficit reached 11.5 percent of GDP in 1981, compared to the initial estimate of 9.2 percent and a ratio of 10.9 percent in 1980.

Interest rates remained unchanged in nominal terms until July 1981, notwithstanding the acceleration of the average rate of increase of consumer prices from 17 percent in 1980 to 20 percent in 1981 and increases in interest rates abroad. The resulting decline in real rates adversely affected savings through increased purchases of consumer durables and reductions in workers' remittances and it contributed to the excess demand for credit. Interest rates were increased by 2 percentage points in July 1981 and, again, in April 1982. However, in the meantime, the rate of inflation reached 25 percent. By comparison, interest rates are 21.5 percent on 6-month time deposits and 24 percent on 6-month nonpreferential loans.

Also, until December 1981, the crawling peg remained unchanged in terms of a basket of currencies heavily weighted by the U.S. dollar that much increased in value during the year. The OECD reports that, in March 1981, the dollar had a weight of approximately 22 percent in the currency basket that was used by the Bank of Portugal to set the crawl. This compares with a U.S. share of 6 percent in the exports, and 11 percent in the imports, of Portugal in 1980.

The procedure applied led to a considerable deterioration of Portugal's competitive position. Between 1980, on the average, and the fourth quarter of 1981, the exchange rate vis-a-vis

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TABLE 1  
*Public Sector Accounts in Portugal*  
(in billions of escudos; as percent of GDP in parenthesis)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>General Government</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current revenue</td>
<td>361.8</td>
<td>451.3</td>
<td>451.3</td>
<td>568.8</td>
</tr>
<tr>
<td></td>
<td>(30.0)</td>
<td>(29.7)</td>
<td>(31.3)</td>
<td>(32.4)</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>407.0</td>
<td>478.9</td>
<td>527.6</td>
<td>608.3</td>
</tr>
<tr>
<td></td>
<td>(33.7)</td>
<td>(33.0)</td>
<td>(36.6)</td>
<td>(34.6)</td>
</tr>
<tr>
<td>Current balance</td>
<td>-45.2</td>
<td>-47.6</td>
<td>-76.3</td>
<td>-39.5</td>
</tr>
<tr>
<td></td>
<td>(3.7 )</td>
<td>(3.3)</td>
<td>(5.3)</td>
<td>(2.2)</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>91.8</td>
<td>97.2</td>
<td>98.3</td>
<td>124.7</td>
</tr>
<tr>
<td></td>
<td>(7.6 )</td>
<td>(6.7)</td>
<td>(6.8)</td>
<td>(7.1)</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-131.1</td>
<td>-133.0</td>
<td>-166.1</td>
<td>-154.5</td>
</tr>
<tr>
<td></td>
<td>(10.9)</td>
<td>(9.2)</td>
<td>(11.5)</td>
<td>(8.8)</td>
</tr>
<tr>
<td><strong>Total financing</strong></td>
<td>124.3</td>
<td>135.5</td>
<td>167.7</td>
<td>158.5</td>
</tr>
<tr>
<td></td>
<td>(10.3)</td>
<td>(9.3)</td>
<td>(11.6)</td>
<td>(9.1)</td>
</tr>
<tr>
<td>External financing, net</td>
<td>22.7</td>
<td>24.2</td>
<td>30.0</td>
<td>32.4</td>
</tr>
<tr>
<td></td>
<td>(1.9 )</td>
<td>(1.7)</td>
<td>(2.1)</td>
<td>(1.8)</td>
</tr>
<tr>
<td>Domestic financing, net</td>
<td>101.6</td>
<td>111.3</td>
<td>137.7</td>
<td>127.1</td>
</tr>
<tr>
<td></td>
<td>(8.4 )</td>
<td>(7.7)</td>
<td>(8.6)</td>
<td>(7.2)</td>
</tr>
</tbody>
</table>

**Nonfinancial public enterprises**

| Total borrowing require- | 101.9 | 198.7 |
| ment | (8.5 )| (13.8) |
| External borrowing, net  | 53.0  | 153.4 |
|                          | (4.4 )| (10.6) |
| Domestic borrowing, net  | 48.9  | 45.5  |
|                          | (4.1 )| (3.1)  |

**Nonfinancial public sector**

| Consolidated borrowing requirement | 226.2 | 386.4 |
| External borrowing, net | 75.7  | 183.4 |
|                          | (6.3 )| (12.7) |
| Domestic borrowing, net  | 150.5 | 183.0 |
|                          | (12.5)| (12.7) |

*Source: Ministry of Finance and Planning.*

1. Calculated as a percent of initial GDP forecasts.
2. Includes capital transfers and net lending.
3. National accounts basis.
4. Cash basis.
the French franc and the Spanish peseta remained approximately unchanged while consumer prices increased by 30 percent in Portugal and by less than 20 percent in the other two countries. Measured in terms of real effective exchange rates, weighted by 1973 export and import shares, the escudo appreciated in real terms by 10 percent between 1980 and the fourth quarter of 1982 (Table 2). A slightly larger appreciation is shown if more recent export-import weights are used in the calculations, and the extent of appreciation reaches 12 percent if exports in the year 1980 are used as weights. Preliminary results indicate that these results also apply to March 1982.

The rate of appreciation is 14 percent of 16 percent, depending on whether export-import or export weights are used in the calculations, if the wholesale price index for Portugal is replaced by an index of unit labor costs. This calculation indicates the squeeze on profits in the export sector that is also demonstrated by the fact export prices rose to a lesser extent than wholesale prices in 1981.

The use of export weights in the calculation of real exchange rates permits evaluating changes in Portugal's export competitiveness. These weights will also be appropriate for assessing the effects of changes in the real exchange rate on the balance of payments, to the extent that Portugal's imports are dominated by food (16 percent in 1981), mineral and metal products (33 percent), chemicals (11 percent), and machinery and equipment (17 percent), for which demand is relatively price inelastic while past experience indicates that changes in relative prices affect Portugal's export shares in foreign markets to a considerable extent. The latter conclusion also applies to tourism, and including tourism as well as workers' remittances in the currency basket would increase the extent of the appreciation of the real value of the escudo further.

Tourism and workers' remittances were included in the currency basket until early 1981. Their exclusion cannot be justified on economic grounds, and they should be considered on the same footing as merchandise exports. At the same time, these transactions concern largely European markets.
<table>
<thead>
<tr>
<th>Period</th>
<th>Exchange Rate Escudo/Dollar</th>
<th>Index of the Exchange Rate</th>
<th>Index of Relative Prices vis-a-vis the United States</th>
<th>Index of Relative Prices vis-a-vis Portugal's Trading Partners</th>
<th>Index of the Real The US Dollar</th>
<th>Exchange Rate vis-a-vis The Currencies of Portugal's Main Trading Partners</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>24.673</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>1974</td>
<td>25.408</td>
<td>103.0</td>
<td>105.8</td>
<td>105.6</td>
<td>97.4</td>
<td>97.4</td>
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<td>1975</td>
<td>25.553</td>
<td>103.6</td>
<td>103.9</td>
<td>102.2</td>
<td>99.7</td>
<td>101.4</td>
</tr>
<tr>
<td>1976</td>
<td>30.223</td>
<td>123.5</td>
<td>142.0</td>
<td>124.0</td>
<td>101.7</td>
<td>98.8</td>
</tr>
<tr>
<td>1977</td>
<td>35.277</td>
<td>155.1</td>
<td>146.3</td>
<td>145.9</td>
<td>106.0</td>
<td>106.3</td>
</tr>
<tr>
<td>1978</td>
<td>43.940</td>
<td>178.1</td>
<td>177.4</td>
<td>93.5</td>
<td>100.4</td>
<td></td>
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<tr>
<td>1979</td>
<td>48.824</td>
<td>198.3</td>
<td>192.5</td>
<td>91.3</td>
<td>103.6</td>
<td></td>
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<tr>
<td>1980</td>
<td>50.062</td>
<td>202.9</td>
<td>202.7</td>
<td>178.6</td>
<td>100.1</td>
<td>114.8</td>
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<tr>
<td>1981</td>
<td>61.546</td>
<td>243.4</td>
<td>227.4</td>
<td>230.9</td>
<td>109.7</td>
<td>108.0</td>
</tr>
<tr>
<td>Q1</td>
<td>55.552</td>
<td>225.2</td>
<td>214.5</td>
<td>202.1</td>
<td>105.0</td>
<td>111.4</td>
</tr>
<tr>
<td>Q2</td>
<td>60.591</td>
<td>245.6</td>
<td>216.9</td>
<td>216.3</td>
<td>113.2</td>
<td>113.6</td>
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<tr>
<td>Q3</td>
<td>65.459</td>
<td>265.3</td>
<td>232.2</td>
<td>251.1</td>
<td>114.3</td>
<td>105.7</td>
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<tr>
<td>Q4</td>
<td>61.508</td>
<td>261.6</td>
<td>245.2</td>
<td>252.7</td>
<td>106.3</td>
<td>103.5</td>
</tr>
</tbody>
</table>

Sources: Banco de Portugal and IMF, *International Financial Statistics*.

Notes: The index of the real exchange rate has been calculated by adjusting an index of the nominal exchange rate for changes in wholesale prices at home and abroad. Calculations for Portugal's main trading partners, covering 63.5 percent of Portuguese exports and 70.0 percent of Portuguese imports in 1973 (The United States, Japan, Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland, United Kingdom and Spain) have been made by weighting with the sum of exports and imports combined in the year 1973.
Policy Objectives and Instruments

Given its low income level compared to the present member countries of the European Common Market, rapid economic growth may be appropriately considered Portugal’s principal long-term policy objective. In fact, the gross domestic product of Portugal would need to grow at a rate of 8 percent a year until 2000 in order to attain the present average per capita income level of the EEC countries by that time.

Rapid economic growth requires exports as well as efficient import substitution. But, unless associated with new exports, the possibilities for import substitution in manufacturing industries have largely been exhausted in Portugal’s limited domestic market. At the same time, the elimination of protection against the EEC countries, and reductions in protection vis-a-vis thirds countries, are bound to increase Portugal’s import share. Intra-industry specialization in the framework of the EEC through the exchange of a variety of consumer and producer goods will have similar effects.

In this connection, reference may be made to the experience of smaller European countries, such as Belgium and the Netherlands, where a one percent increase in GDP was associated with an approximately 2 percent rise in imports following entry into the Common Market. But even if Portugal had a lower income elasticity of import demand, it would have to increase its export market shares in the EEC. Such was the case during the sixties in Italy and during the seventies in Ireland, the erstwhile low-income countries in the Common Market, which were able to reduce the economic distance that had separated them from the other EEC countries.

Portugal’s task will be made more difficult by reason of the fact that rates of economic growth in the Common Market are likely to be substantially lower in the future than they were until 1973. Correspondingly, especial importance attaches to the choice of the policies applied. The goal should be to provide appropriate incentives to economic activities in Portugal and to encourage investment and savings, including foreign savings.

In the short term, Portugal also needs to reduce its current account deficit to acceptable levels that will ensure the inflow
of foreign capital without endangering the country's creditworthiness. Section II of the report makes recommendations for a short-term policy package, consisting of changes in the exchange rate, in interest rate and credit policy, and in fiscal policy and the public sector. The proposed measures would involve a discrete devaluation of the escudo, accompanied by the adoption of a higher crawling peg; increases in interest rates, together with reductions in the scope of — preferential credits and the setting of appropriate credit and money supply targets; as well as reducing public consumption in real terms and lowering the ratio of the overall financial requirements of the public sector to GNP by limiting government spending, cutting subsidies to fuel oil and fertilizer, postponing the proposed steel project, and increasing taxes on consumer durables that would also lead to reductions in luxury consumption.

The proposed measures aim at remedying the disequilibrium in the balance of payments while pursuing the growth objective by putting emphasis on reducing consumption rather than investment and shifting resources from the public to the private sector. They would need to be complemented by medium term policy measures aimed at rapid economic growth in facilitating entry into the European Common Market. This purpose would be served by changes in the system of incentives, in the tax system, in financial markets, in industrial policy, and in agricultural policy.

In Section III of the report recommendations are made for simplifying and modifying the schemes of export incentives, investment incentives, price control and import licensing. Further consideration is given to the need to improve the efficiency of the tax system, to revitalize bond and stock markets, and to eliminate the existing prohibition on the stock establishment of foreign and private banks. As regards industry, the importance of the liberalization of labor laws, labor training, research and development, and industrial concentration is emphasized. Also, attention is given to the infrastructural requirements of the expansion of Portuguese industry and agriculture. Finally, the conditions for the modernization of agriculture are briefly noted.
II — Short-Term Policy Recommendations

The Exchange Rate

As noted above, measured in terms of effective exchange rates weights are used in the calculations. An even larger appreciated in real terms by 10 percent between 1980 and March 1982. The extent of the revaluation reaches 12 percent if export weights are used in the calculations. An even larger appreciation, 14 or 16 percent depending on the choice of the trade weights, is shown if unit labor costs rather than the wholesale price index used in the calculations. And, the extent of appreciation will increase further if tourist receipts and workers' remittances are included in the currency basket.

Improving Portugal's competitive position would require reversing the appreciation of the escudo in real terms. This could be accomplished by changing the currency basket used to determine changes in the exchange rate and increasing the monthly crawl to 1.0 percent retroactively to 1980. In this way, one could undo the effects on the exchange rate of the excessive weight given to the U.S. dollar in the currency basket and of the inadequate allowance made for international differences in rates of inflation in setting the crawl. At the same time, formulating the exchange rate change in terms of a retroactive modification in the currency basket and in the rate of the crawl could serve to underline the determination of the authorities to avoid a further discrete devaluation of the escudo.

Under the proposed formula, the depreciation of the escudo vis-a-vis the U.S. dollar would have been 59 percent and 63 percent between the average of 1980 and March 1982, depending on whether export-import or export weights are used in the calculation. Compared to an actual exchange rate change of 40 percent, a one-step devaluation of 14 or 16 percent would be warranted under the two alternatives, respectively.

* On the choice of this rate, see below.

* For lack of information, tourist receipts and workers' remittances have not been included in the calculations.
Such a change would permit to fully offset the adverse effects of increases in labor costs in Portugal. At the same time, the need to improve export competitiveness and the relatively high elasticity of export demand would favor the second of the two alternatives. This would, however, add to inflation through higher import prices, although the inflationary effects of the devaluation would by-and-large be compensated by the expected deceleration of increase in food prices.

Food prices rose by 30 percent between the first quarters of 1981 and 1982, compared to 10 percent a year earlier, fully accounting for the acceleration of increases in consumer prices from 15 percent to 25 percent during this period. In turn, the rate of increase of the price index for clothing and footwear declined by more than one-half, from 29 percent to 14 percent, while an increase from 18 percent to 23 percent occurred in regard to other items, mostly services. The rise in food prices reflects the effects of the poor harvest and, to a lesser extent, of reductions in food subsidies. Following increases in the price of bread in April, food price increases are expected to moderate to a considerable extent, thereby reducing the rate of increase of consumer prices.

Nevertheless, in view of the fact that price increases average slightly below 10 percent a year in Portugal’s major trading partners, it would be necessary to increase the crawling peg. In the expectation that the rate of inflation will decelerate once the effects of the devaluation on domestic prices have been absorbed, a monthly crawl of 1.0 percent may be appropriate. An additional consideration is that a higher crawl would necessitate excessively large increases in interest rates.

*Interest Rate and Credit Policy*

Increases in interest rates by two percentage points in April 1982 have established an interest rate differential of 8 percent between Portugal and the London market that approximately equals the annualized crawl of the escudo at 0.75 percent a month. Increasing the crawl to 1 percent a

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11 The comparisons are made between the 6-month deposit rate in Portugal and the 3-month Euro-market rate in London.
month would call for raising interest rates another 3 percentage points in order to maintain the same differential. Reductions in U.S. inflation rates, however, give promise of some easing of interest rates internationally. Correspondingly, it may suffice to raise interest rates by 2 percentage points at this time.

Increases in interest rates have been objected to on account of their cost-raising effects for private business. However, at present rates, there is an excess demand for credit and higher interest rates would serve as a rationing device for loans, thereby limiting the need for quantitative credit allocation by the banks. Furthermore, higher interest rates would encourage saving — and discourage dissaving — by consumers.

At the same time, the scope of credit preferences would need to be reduced. Following recent reductions in preferential credits to agriculture, it would be desirable to limit the extent of such credits to housing. Any adverse effects this would have on new construction could be offset by abolishing rent control for newly-constructed apartments; the recently-introduced option of permitting rent increases from a low base at rates set by the government has not proved satisfactory. In turn, the credit needs of house buyers could be ensured by refinancing interest payments at nonpreferential rates.

One should further lower overall credit ceilings and the rate of growth of the money supply. Providing sufficient credit to private enterprises would, at the same time, necessitate reducing the rate of growth of credit to the public sector. This, in turn, would call for lowering the rate of growth of public expenditures as well as the overall general requirements of the public sector.

Fiscal Policy and the Public Sector

The 1982 budget, prepared in December 1981, called for increasing the current expenditures of general government by 15 percent, current revenues by 26 percent, and capital expenditures by 27 percent over the previous year's level, with the government budget deficit projected to decline from
11.6 percent to 9.1 percent of GDP. While the projections were made assuming an inflation rate of 20 percent and they apparently do not fully account for some expenditures, such as interest payments on the public debt, it would be desirable to keep total current expenditures to the budgeted level and to increase tax receipts, thereby reducing the budget deficit. The measures that may be used for this purpose include increasing taxes on durable consumer goods, in particular automobiles, lowering subsidies to fuel oil and fertilizer, and reducing central and local government expenditures.

Apart from adding to budget receipts and putting the burden of the adjustment on higher income groups, higher taxes on consumer durables would lead to reductions in consumer spending on highly import-intensive commodities. For this purpose, an indirect tax is preferable to increasing the import surcharge that would raise the protection of domestically manufactured products, thereby increasing profits as well as the volume of domestic sales which have a high import content.

Automobiles are a prime candidate for increases in indirect taxes, since registration requirements minimize the possibilities for smuggling. At the same time, in order to avoid a windfall to emigrants who can bring a car home dutyfree, the additional tax should apply to their purchases as well. A tax of 50,000 escudos per car on sales of 80,000 cars would add roughly 5 billion escudos to budgetary receipts.

In turn, setting fuel oil prices at the average of the European level, and thereby reducing existing price differences vis-à-vis gasoline, may represent a saving in fuel subsidies by as much as 20 billion escudos. Furthermore, as the example of the United States and European countries indicates, higher fuel oil prices would have beneficial effects on the balance of trade by encouraging conservation by firms as well as by households.

Smaller gains could be obtained by reducing fertilizer subsidies which, at any rate, should be done slowly in order to avoid unduly raising costs to agriculture. However, further savings could be achieved by limiting increases in spending in areas such as education and health, which experienced especially large expenditure growth in recent years.
Limitations would also need to be imposed on transfers to localities. Localities have accounted for a substantial portion of the increase in civil service employment, reportedly averaging 7.5 percent a year between 1975 and 1980. They have also accounted for an increasing portion of investment by the general government, reaching nearly one-half in 1981. More generally, one should reduce the budgeted 27 percent increase in capital expenditure by the general government.

Reductions may further be made in the investment program of the EDP that was based on a higher rate of GDP growth than actually attained last year as well as on projections of electricity usage which do not take account of possible energy savings that can be attained at higher prices. In this connection, it may be noted that investment programs were revised downward to a considerable extent in the United States and in Western Europe in response to saving in the consumption of electricity.

Finally, it is recommended that the proposed investment in the steel plant manufacturing long steel products be postponed. Under the projection initially made, about one-third of the production of the plant would need to be exported in the early years of the investment; the actual ratio may exceed the projections because of lower than anticipated GDP growth in 1981. At the same time, in view of the weakness of the international steel market which is expected to continue for a number of years, and increased competition from several developing countries that have built larger plants producing at a lower cost, Portugal is not in a favorable position to export steel. And while billets can be sold to the suppliers of equipment under a long-term contract, the price is subject to negotiations and the subsequent sales of finished products have to be made on the free market.

The expected high proportion of exports also indicates the lack of urgency for the plant to provide for domestic needs, when postponing the construction at the plant would reduce the share of exports in total output. And while the postponement would entail paying penalties on signed contracts, the value of these contracts reportedly does not exceed one-sixth

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of the total construction cost of 60-70 bilion escudos, of which 17 bilion would be incurred in 1982. Moreover, a postponement would permit reviewing the original estimates that show a 10 percent internal rate of return, with the downward risk reportedly exceeding the upward risk.

III — Medium-Term Policies

*The System of Incentives*

Export incentives consist of tax benefits as well as pre-export credits (reduced from 35 percent to 25 percent of fob export value in April 1982) and post-export credits at preferential rates. The question has been raised if these incentives should be reduced following a discrete devaluation. Traditional exports to traditional markets apart, for various reasons this is not recommended.

To begin with, the proposed devaluation would only re-establish the real exchange rate of 1980, when export incentives were higher than today. Furthermore, often substantially larger export incentives are provided in other Southern European countries, including Greece, Spain, and Turkey. In fact, additional export incentives would be in order so as to bring about an increase in Portugal's export market shares that is necessary to accelerate the rate of economic growth.

Under the regulations made public in April 1982, additional incentives would be provided for the exports of selected commodities to particular markets. The desirability of introducing such a «positive» list is questionable, however, as the public authorities are not in the best position to choose among products and Portugal would need to increase its exports to all markets. A more appropriate solution would be to establish a «negative» list, excluding the exports of traditional products to traditional markets (e.g. the exports of textiles and clothing to the EEC that are subject to quantitative restrictions). This procedure may be followed in regard to pre-export credits as well.

At the same time, the example of Japan, Korea, and, more recently, Turkey shows the beneficial results of the
promotion of trading companies. In Turkey, a subsidy of 5 percent was granted on annual exports between $4 and $15 million and 10 percent above $15 million. While these subsidies may have been overly generous, and have since been reduced, they have contributed to the establishment of trading companies, which have been instrumental in doubling the dollar value of Turkish manufactured exports between 1980 and 1981. In the case of Portugal, it is recommended that the establishment of trading companies be promoted by providing preferential credits on the same terms as to direct exporters, granting a small export subsidy on fob value, and providing exemptions from the industrial tax for a 5-year period.

The multiple schemes of investment incentives presently applied in Portugal are extremely complicated and their benefits are difficult to evaluate, which fact may account for the limited number of applications for investment incentives. It would be desirable to replace the existing investment incentive schemes by a single scheme that would provide a relatively low benefit to all investors automatically. This may take the form of reductions in the rate of the industrial tax for a limited period. In view of the importance of modernizing Portuguese industry in preparation for entry into the Common Market, tax benefits should be provided to investment for modernization as well.

Export-oriented investments should receive additional incentives. These incentives may take the form of preferential credits, with the interest rate rebate actually provided varying in proportion to the share of exports in incremental output. The proposed procedure would provide a simple check and permit varying the rebate with changes in the share of exports over time.

Possibly the most important incentive to investment would be to free industrial prices by eliminating the 30 percent profit limitation on invested capital in the price calculations. This limitation discourages efficient operations and limits business savings. At the same time, with increases in the rate of inflation in recent years, and with profits being subject to tax, it has lost any rationale it may have had.

Eventually, the controls imposed on the prices of certain agricultural products and services would also need to be
lifted. While such controls may be used to limit price increases for a time, they tend to become an obstacle to the efficient allocation of resources. For the same reason, it would be desirable to ease import licensing procedures once the effects of the proposed measures on the balance of payments become apparent. At any rate, import liberalization will be necessary in conjunction with entry into the European Common Market. The policy recommendations made in the following section of the report aim at ensuring that entry occurs under favorable conditions.

**Tax Policy**

The abolition of price control of industrial products, together with reductions in tax incentives to investment, would permit re-establishing a tax base for the industrial tax that has been eroded to a considerable extent in recent years. Apart from increases in revenues, this would permit the utilization of tax incentives to encourage labor training as well as research and development as suggested below.

In order to encourage work effort and personal savings, it would further be desirable to reduce marginal income tax rates from their actual level of 70 percent for married couples and 80 percent for single persons. Recognizing the adverse effects of high marginal tax rates, these rates have recently been substantially reduced in the United Kingdom and the United States. Following the example of these countries, one may reduce the marginal income tax rate to 50 percent in Portugal, with no distinction made between married and single persons.

The reform of the system of income taxes could be made part of the unification of taxes on personal incomes. Efficiency considerations would also dictate replacing existing indirect taxes by a single value added tax. At any rate, this tax would need to be adopted as Portugal becomes a member of the European Common Market.

Finally, personal savings would be encouraged by eliminating the taxation of capital that occurs under present conditions as an 18 percent tax is levied on interest receipts from
time deposits, irrespective of the rate of inflation. An appropriate procedure would be to tax only inflation-adjusted receipts.

**Financial Markets**

The double taxation of dividends in effect in Portugal also discourages savings and limits the possibilities for revitalizing the stock market. The government has in preparation new regulations providing incentives to the issuer, and to the buyer, of shares. It would be desirable to promulgate these regulations at an early date and to eliminate the double taxation of dividends.

While the stock market may play a role in industrial financing in Portugal, this role will be limited by the small size of the potential market for shares. The prospects are better for the bond market. In this connection, particular importance attaches to equalizing the tax-treatment of interest rates on government and on private bonds. The appropriate solution is to tax inflation-adjusted interest receipts as recommended in regard to time deposits.

Furthermore, the newly-established finance companies should be permitted to issue bonds on their own. These companies can be expected to play an important role in improving financial intermediation in Portugal, although they are not allowed to accept deposits. Permitting the establishment of banks by domestic private as well as by foreign interests would fill this lacuna.

On the example of Spain, foreign banks may play a particularly important role in merchant banking, thereby contributing to the investment effort in Portugal. Once the new Constitution is approved, it should be possible to enact the necessary legislation that has long been in abeyance.

**Industrial Policy**

Spain has also made a successful effort in attracting foreign direct investment to manufacturing, in particular to the automotive, mineral, and chemical industries. Despite a
favorable attitude taken towards foreign investment and a liberal Foreign Investment Code, promulgated in August 1977, Portugal has been less successful in attracting foreign capital. Thus, while direct foreign investment in 1980 was more than double that in any of the previous three years, it failed to increase further in 1981, hardly exceeding $100 million a year.

One of the major obstacles to foreign, as well as to domestic, private investment is the restrictive labor code that makes it very difficult to discharge workers, either collectively or individually. The possible reasons for collective discharges are narrowly defined and require authorization by the Ministry for Industry, Energy, and Exports. At the same time, entrepreneurs are reluctant to undertake new investments or expansions if they could not subsequently reduce their labor force should business conditions so require. Such will be the case, in particular, following entry into the European Common Market that will provide considerable opportunities but also create risks.

For these opportunities to be utilized, it would be desirable to align the Portuguese labor code with similar legislation in the Common Market countries. The same conclusion also applies to individual dismissals for cause that presently involve a complicated process and the worker’s full salary has to be paid during the period while the case is pending at the tribunals, which may take up to two years. Dismissals can thus not be effectively used as a disciplinary measure, although this would be necessary in order to raise productivity in the firm. Productivity could be increased further by modifying the existing system of collective contracts, which provide little flexibility for the firm to alter the organization of work and to reward workers for better performance.

In the European Common Market, Portugal’s comparative advantage will increasingly lie in semi-skill and skill-intensive activities, including the labor-intensive branches of engineering. This, in turn, would necessitate upgrading the Portuguese labor force. Such upgrading may be effected by taking measures at various levels.

First of all, it would be desirable to re-institute the technical middle-level schools that were abolished in the early seventies. The re-institution of such technical schools would
ensure that students who do not wish to carry their education beyond the compulsory eight years would be able to acquire basic technical skills by the end of their formal education.

It would further be desirable to increase the number of higher-level technical schools that would train technicians for industrial activities. At this level, some degree of specialization would be necessary in order to provide skills for individual industries in the manufacturing sector.

Specialization is further necessary in training labor for various occupations. Rather than duplicating the efforts of private interest groups, the government may provide financial support to courses organized by the Association of Portuguese Industrialists.

Financial support of on-the-job training carried out by private firms would also be desirable. This is because, in the absence of such support, firms underprovide training, the benefits of which partly accrue to other firms who hire away skilled labor. Governmental support may take the form of cost-sharing or tax benefits to training. These methods could also be used to encourage research and development by firms as the fruits of such activities are again enjoyed in part by others. At the same time, the government should concentrate its own efforts to a limited number of fields, where Portugal appears to have a comparative advantage.

Labor training and research and development would increase the ability of Portuguese firms to compete in the European Common Market. But economies of scale in production and in research, and the financial advantages of large size, would also necessitate industrial concentration in Portugal. In this connection, reference may be made to the experience of France that, upon joining the Common Market, gave priority to industrial concentration, resulting in mergers on a large scale. This is even more important in Portugal, whose firms are smaller in size than were firms in France at the time of entry.

On the example of France, Portugal may utilize credit as well as tax measures to encourage concentration. This would necessitate changing the present situation, under which the Banco de Fomento and the Caixa Geral do not provide credit for purposes of mergers and the commercial banks are
discouraged from doing so. Rather than extending the scope of preferential credits, the need is to provide medium — and long — term credit facilities for the purchase of firms. The revitalization of capital markets would also serve this objective.

The French government further provided tax exemptions for capital gains associated with the sale of firms. As a result of the measures applied, the movement towards concentration accelerated in France, with the value of assets of the absorbed companies rising from an annual average of 85 million francs during the 1950s to 1 billion francs in 1965 and 5 billion francs in 1970. Industrial concentration, in turn, resulted in increases in firm size and contributed to the improved competitive position of the French economy.

Industrial development in general, and increased export orientation in the framework of the European Common Market in particular, would further require improvements in infrastructure in Portugal. Such improvements, to take place over a period of several years, would primarily involve extending and modernizing port facilities in Porto and building access roads to the interior.

Agriculture and Fisheries

Infrastructural improvements would also be necessary in order to promote agricultural development in Portugal. A World Bank study, relying on an extensive survey prepared by the Gulbenkian Foundation and the World Bank, has shown that Portugal has considerable possibilities for expanding its agricultural production and improving its trade balance in agriculture. This would involve increased exports of vegetables, olive oil, and wine, as well as import substitution in wheat, with larger than average increases in incomes for small farms due to the labor-intensive character of the rising exports.

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The study has estimated the response of Portuguese agriculture to the higher prices obtainable in the European Common Market compared to the situation existing in 1978 and to the lack of barriers to Portuguese agricultural exports. One would need to establish the necessary conditions for appropriate response to occur, however. These conditions have been repeatedly stated over the years and do not need detailed discussion. They include improved credit facilities, extension services, marketing (in particular, the open auctioning of products), and the construction of slaughterhouses, refrigeration, and processing facilities.

At the same time, it would be desirable that public investment in agriculture be undertaken according to a medium-term plan, which itself should be based on estimates of Portugal’s comparative advantage. In this way, one can assure the efficient use of new facilities and avoid their undue dispersion. The establishment of refrigeration and conservation facilities will also be necessary for the expansion of fishery production in Portugal. This would further require the modernization of the fleet, so that Portuguese territorial waters could be fished more extensively. There is finally need for modifying existing labor legislation that limits the catch by keeping working hours much below those in other nations.

Concluding Remarks

This report has made recommendations for the application of a policy package for the short term and for policy improvements for the medium term. Portugal would further need to negotiate appropriate conditions for entry into the Common Market, so as to minimize the cost of adjustment.

As far as industry is concerned, it would be desirable to retain the possibility for tariff protection during the transitional period for Portugal’s infant industries. The principal contentions issue is, however, the exportation of textiles and clothing, where Portugal’s position on free access to EEC markets is entirely reasonable.

In agriculture, the objective should be to open the EEC market for Portuguese products at an early date, while post-
poning the making of a financial contribution to the EEC Agricultural Fund, as time is needed for Portugal to improve its trade balance in agricultural products. At the same time, early preparation would permit utilizing the EEC Agricultural Fund to undertake the public investments necessary for agricultural development.

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