REFORMS DRIVING RECOVERIES: SOME MISSING FOUNDATIONS

Teodora Cardoso[1]

In Portugal, the main triggers of the crisis that led to the need for the EU/IMF adjustment programme in 2011 were the weak potential growth in parallel with the rapid increase in debt. Consolidating the public finances and achieving a sustained reduction in the large external deficit had become the immediate challenges towards restoring investor confidence in the wake of the increase in differentiation in sovereign risk in Europe that followed the international financial crisis. Portugal was directly affected by these developments given the increase in public deficit and debt in conjunction with the maintenance of important structural fragilities.

The sovereign risk differentiation directly put strains on banks' liquidity situation, not only in terms of funding costs but also in their capacity to access international debt markets. The necessary transition of the Portuguese economy to a more sustainable economic and financial position over the medium term would require limiting banks' leverage and strengthening of capital ratios, but this was not a significant factor leading to the economic and financial crisis. In fact, despite the increase in non performing loans to non-financial corporations following the 2009 recession, delinquency rates remained contained, especially in the case of mortgage loans.

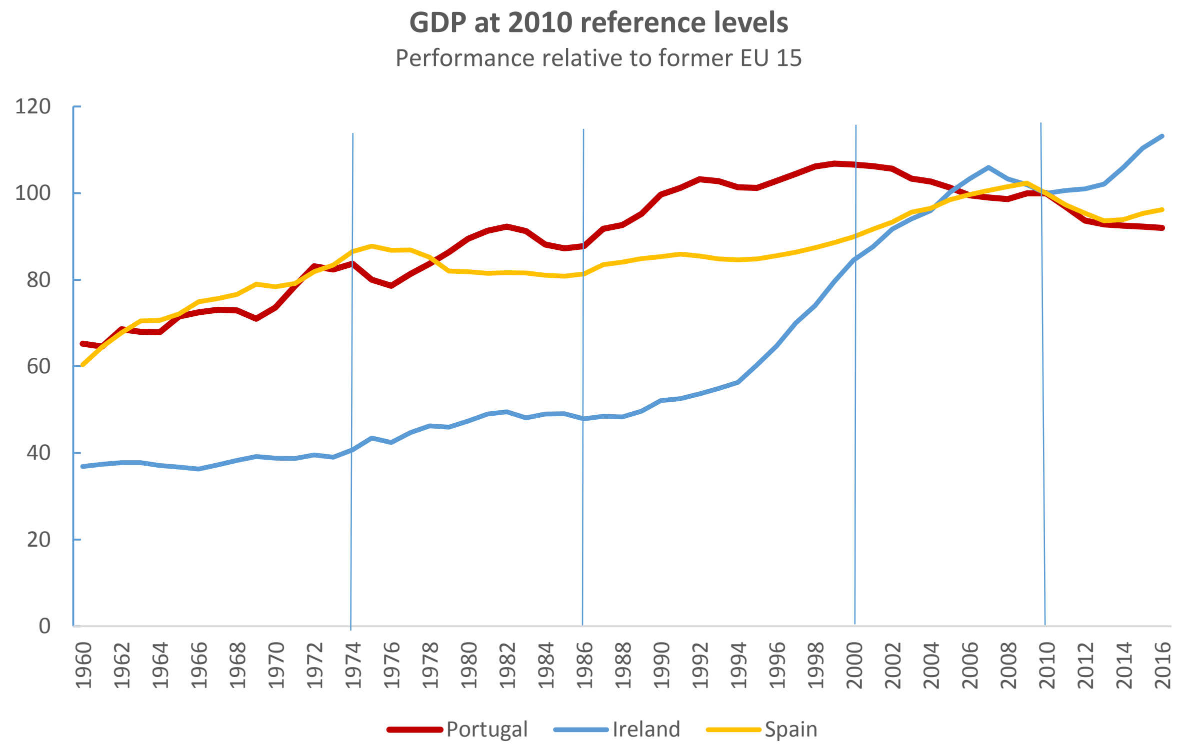
The EU/IMF adjustment programme that was in place between May 2011 and May 2014 included a fiscal consolidation strategy, an important number of structural reforms aimed at increasing potential growth, creating jobs and improving competitiveness and measures to promote a balanced and orderly deleveraging of the banking sector. The programme proved successful in achieving a significant correction of the fiscal deficit and the turnaround of the external balance within the foreseen time limits. However, both the levels of debt and the economic growth path remain disappointing, while the reversible nature of a number of measures risks bringing the economy back to the very unsatisfactory performance that characterised the decade preceding the programme.

This paper focuses on some areas underlying these risks, where important structural and institutional reforms still remain a challenge.

1. Portuguese economic performance leading to the crisis

Until 2000, despite higher volatility than either Spain or Ireland, Portugal performed well relative to the EU15:

[1] Text presented to the European Commission Seminar "Reforms driving Recoveries – Learning from the experiences of Portugal, Ireland, Latvia and Spain", Lisbon, 15 April 2016.



Source: AMECO, February 2016 update.

However, this good performance hid important structural fragilities that had been temporarily offset by expansionary fiscal and credit policies while accumulating macroeconomic imbalances.

Prior to EU accession, the economy had specialised on low value-added highly labour-intensive products that, since the beginning of the 1990s, had been facing increasing competition from developing countries and from the new EU entrants. Given the huge wage gap relative to new competitors, devaluing the exchange rate was no longer a sufficient option to restore competitiveness and had to be supplanted by policies to improve productivity in both traded and nontraded sectors.

These meant the need for a comprehensive and sustained structural effort that the institutional and financial environment provided by the Euro area called for and also made feasible. Essential changes concerned the need to build up human capital and raise labour productivity; to encourage competition and the mobility of the labour force; to stimulate the adoption of new technologies; and to eliminate regulatory barriers hampering the process of resource reallocation towards firms better equipped to face the new environment.

Though identifying these needs and legislating for measures to improve performance, policies during the 1990s ended up mostly taking advantage of the so-called “low hanging fruits”. Final consumption and investment in construction benefited from these policies, but led to prioritising non-tradable sectors while neglecting competitiveness and the effort to deepen reform programmes and ensure their implementation. In the absence of an effective medium-term budgetary framework, the revenue growth arising from consumption and real estate accommodated the increase in public expenditure and disregard for efficiency concerns.

As a consequence, at the end of the decade the budget deficit had become a serious concern and the country came under the excessive deficit procedure in the context of the Stability and Growth Pact framework. Effectively complying with European rules would have required a genuine medium-term budgetary framework and an effective public expenditure management infrastructure. These, however, depended on institutional reforms and technical skills that had not so far been provided for. Instead resort to one-off operations and budget freezes to comply with the deficit rules became the option and led to a chronic problem of structurally weak public finances. In turn, this reinforced instead of smoothing cyclical fluctuations and ended up postponing the necessary public financial management (PFM) and civil service reforms. The permissive financial climate that prevailed in the period leading to the crisis also favoured off-budget transactions (particularly increasing arrears and SOEs indebtedness) that, instead of reinforcing the case for reform, allowed expenditure growth to pursue unhindered.

2. *Programme achievements and failures*

Together with the unprecedented increase in credit to the private sector, the procyclical fiscal policy allowed the build up of major imbalances. These included a large external deficit and high household and corporate indebtedness, while productivity stalled even as employment declined. Low and unstable growth and a high degree of financial vulnerability were the outcomes that eventually led to the need for an international assistance programme in 2011. This brought about a number of important reforms, but it could not act as a substitute for a comprehensive reform programme. To be successful, such a programme required national ownership and a clear understanding that what was at stake was not just conditionality on foreign financing. Its main targets should be removing obstacles to growth and fostering the country's capacity to efficiently use its resources in order to sustainably provide for the welfare of its citizens.

For this purpose, raising labour productivity and improving the allocation of capital in the context of an effective fiscal consolidation programme were essential conditions. As the pre-crisis experience had showed, just legislating a large number of measures, however appropriate their intentions, would not bring about the desired outcomes. For that to happen, the aims of the reforms, together with the analysis underlying them, had to be shared by the society and across the political spectrum. In the absence of such consensus, reforms tended to be presented and/or implemented as temporary measures, often accompanied by policies that, attempting to soften their immediate costs, ended up neutralising the effort.

3. *Effective fiscal consolidation as a missing link*

The Portuguese experience has shown that fiscal consolidation and rationalisation of public spending are necessary bases for successful reform. Their role should consist in providing the intertemporal consistency without which reforms become a succession of measures and countermeasures that end up in increased instability leading to stagnation and eventual discredit. But an effective policy of fiscal consolidation does not simply consist of cutting deficits in the hope of achieving some sort of non-Keynesian expansion. Neither is it just a matter of adopting strict rules that soon need to be made more flexible and end up being circumvented. It requires awareness of the costs of eluding it and institutional changes to make it happen.

Against such a background, the need for a consistent programme of structural reforms soon becomes clear as the basis for economic competitiveness and stable economic growth, i.e. growth consistent with financial stability. Reforms become means to improve resource allocation and enhance consumer and investor confidence instead of being seen as inherently unstable redistribution mechanisms.

In order to be successful fiscal consolidation must be set in the context of a medium-term budgetary framework. Again this is not just a matter of prescribing it in law, but will need to be rooted in a new understanding of the role of the State in the economy and to be complemented by deep PFM reforms. Where existing arrangements have long been in place this involves rebuilding the PFM infrastructure, a process that cannot be rushed as it demands new skills and even a different culture from the civil service. Information requirements involve the complete overhaul of accounting systems and IT infrastructure. Sequencing therefore becomes an essential part of the reform, the same being true of communication and the analysis underlying the proposals.

The new budget framework law of September 2015 can provide the cornerstone for reform in this area. As usual, the implementation of the law is now at stake. It will take time, require adjustments and improvements in several areas but, above all, it will demand political ownership and close monitoring that has not yet been provided for.

4. *Need for interaction between the Stability Programme and the National Reform Programme*

The critical priority of reforming the national fiscal framework is not enhanced by the way the Stability Programme and the National Reform Programme account for the impact of reforms. Indeed it may even be weakened by the practices they accommodate that, at least in the Portuguese case, mean that the Stability Programme ignores the economic impact of measures and only takes into account direct budgetary impacts and the expected effect on aggregate demand of the increase in investment spending. This problem is reinforced by the relaxed approach to the medium-term fiscal targets the Stability Programme is supposed to enforce. In fact the Stability Programme may even turn into an obstacle to reform in cases, like the PFM measures, requiring upfront investment that must be integrated into a medium-term programme with well defined and strictly monitored outcomes and expenditure targets.

While the European rules do not prevent such programmes from being approved, neither do they uphold their adoption. In practice they treat fiscal consolidation merely in the context of rules that, by their very nature, neglect its institutional constraints and impact. By concentrating the attention on short-term compliance with numerical rules, they not only divert the Ministry of Finance's scarce resources from concerns with reform issues, but they also allow these to remain outside the specific Ministry's remit. As a consequence, the consistency of reforms with financial constraints and their role in easing (or reinforcing) such constraints is easily neglected. Implementing reforms then becomes at best a matter of passing laws, the enforcement and economic impact of which is not overseen and even less evaluated. In the end reforms only become a political priority during a financial crisis, which this framework is supposed to prevent.

5. *Approaches to compliance*

These are not problems that uniformly applied results-oriented numerical rules can solve. If member states are to retain fiscal policy sovereignty, a procedural-oriented approach is needed that requires each country to adopt a combination of rules and institutional arrangements appropriate to its own political circumstances. Making these consistent with the European framework requires evaluation and approval by European institutions of the existing or planned national arrangements aimed at dealing with the deficit bias that, in their absence, is the natural consequence of the common pool problem faced by democracies.[2]

In the Portuguese case this implies reinforcing the authority of the Minister of Finance where macroeconomic responsibility for fiscal consolidation is concerned. As this entails budgetary as well as structural measures, both set in a medium-term framework, it requires full consistency at the macroeconomic level between the Stability Programme and the National Reform Programme. The macroeconomic scenario underlying the Stability Programme must take fully into account the foreseeable effects of the National Reform Programme while the latter must be clear about the design, timing and financial requirements of the measures it endorses. Given the need for expenditure control, the Ministry of Finance should then fix the corresponding spending ceilings. Accountability for the execution of the measures and the

[2]"All democracies face the common pool problem that financing public policies from general tax funds creates an externality. Those who enjoy the marginal benefit of more spending are not the same as those who bear the marginal cost. The same argument applies to tax cuts."… "In addition to the usual national common pool problem, the Eurozone suffers from an international common pool problem whereby individual countries may be led to expect support from others, including through bailouts." Eichengreen, B. et al. (2011), *Public Debts: Nuts, Bolts and Worries*, Geneva Reports on the World Economy 13.

management of expenditures under the ceilings should then be delegated to each line ministry, as foreseen in the new budget framework law.

The implementation of such a system still requires important adjustments at the national level. It also entails close monitoring, both domestically and at the European level, and recognition that compliance with programme outcomes and evaluation is as important as numerical rules and helps qualify their achievement. A relevant point in this area concerns the difficulty in evaluating the short- or even medium-term impact of reforms on observed – or even potential – economic performance. But ignoring this complication easily leads to a preference for measures that appear favourable in the short-term while accumulating intractable problems for the future. Solving the dilemma is not easy, but ignoring it is no longer an option.