

## Memorandum of Economic and Financial Policies:

# 11 Perspectives

May 2011

This document puts together the analysis of Nova faculty on different aspect of the MOU.

---

### Contents

<b>Introduction</b> – José Ferreira Machado	1
<b>Implementation</b> – Pedro Santa Clara	3
<b>Macroeconomics</b> – Francesco Franco	4
<b>Healthcare</b> – Pedro Pita Barros	6
<b>Labor Market</b> – Pedro Portugal	8
<b>Competition and Regulation</b> – Vasco Santos	9
<b>Banking</b> – Paulo Soares de Pinho	10
<b>Energy</b> – Paulo Soares de Pinho	11
<b>Telecommunications</b> – Steffen Hoernig	12
<b>Local Government</b> – Susana Peralta	13
<b>Justice</b> – Nuno Garoupa	15
<b>Economics &amp; Politics</b> – José Tavares	16

Accredited by:



Member of:



# Introduction

**José Ferreira Machado**

**Dean – Nova School of Business and Economics**

---

Leadership brings responsibility. For us, at Nova School of Business and Economics, in normal times that responsibility means producing graduates equipped to compete in the global market place and delivering research of good scientific standing and of practical relevance. But the current times are hardly normal. Portugal is plunged in a deep financial, economic and social crisis. A leading school must now be actively engaged with society, participating in the public debate and contributing to enlightened decision making by its fellow citizens.

In the midst of the crisis the Portuguese government and the main opposition parties signed and *Memorandum of Economic and Financial Policies (MOU)* with representatives of the IMF, EU and ECB that, as counterpart of a financial rescue package, lays down the deepest and widest structural reform program that Portugal as ever witnessed.

I believe that, should these reforms be carried through with earnest enthusiasm and pragmatic rigor, Portugal will change for the better. Almost all the proposed policy measure had already been advanced at one time or another. Owing to lack of courage, myopic party competition or mere capitulation before lobbies, they were never implemented. It was the depth of the crisis that forced a cooperative solution and muted the objections. But the agreement with the international troika just marks “the end of the beginning”.

This document puts together the analysis of Nova faculty on different aspect of the MOU. We ask of them to be concise and clear. Their texts represent the opinions of free women and men. They only commit their authors. The School, as such, does not have an analysis or an opinion. Its Mission is just to be the common roof that spurs, houses and spreads the intellectual contributions of its own people. ■

# Implementation

Pedro Santa Clara

---

The agreement with the IMF, ECB and EU is globally positive. It gives us a roadmap to regain lost competitiveness. But we have to ensure that we stick to the path....

Unfortunately, we have not, in our recent history, had the ability to reform our economy, and we have a state that is imprisoned by multiple and varied special interests that will predictably oppose the reforms that will affect them. It would therefore seem fundamental to discuss mechanisms that will allow us to overcome the obstacles whilst implementing the necessary changes. Here the help of the IMF is welcome, but not enough.

First of all, the financial help our country is receiving will be dispensed gradually, according to compliance with the established objectives. This is the strongest mechanism to ensure the implementation of the agreement. But this is similar to an atomic bomb: it can only be used once because the consequences are extremely dire. It would probably be more effective if the reward and punishment mechanisms were more gradual. A simple idea would be to make the interest rate charged for the loan dependent on the quarterly IMF evaluations. I am convinced that this would have a far more encouraging effect on our diligence in implementing the agreement.

An interesting measure that is included in the MOU is the creation of an independent Council of Public Finances to evaluate the performance of our fiscal strategy. Institutions of this type – such as the Office of Budget Responsibility in the United Kingdom – provide a thorough analysis of the sustainability of public accounts as well as a study of the fiscal consequences of economic policy. This institution could be an important factor in limiting the less than transparent and somewhat dishonest budget reporting we have witnessed in the past.

The document also provides for the introduction of a public sector accounting system in line with international standards, and the improvement of spending controls, including deferred costs. All these are good measures, which will certainly limit the ability to spend without accountability. As my grandmother used to say, “sunlight is the best disinfectant”.

One area that is covered in particular, is the thorough analysis of the PPPs and an improvement in the quality of information that is made available. This could be one area that solidifies the credibility of the agreement. If, as one supposes, there is margin to renegotiate the excessive guarantees offered by the Government, we will have a quick win which will have an encouraging effect on the rest of the program.

The agreement is lacking, however, in developing mechanisms to hold decision makers responsible for mismanagement of public resources. In this country, where blame many times is an orphan, it is fundamental to monitor, make accountable and when necessary, punish those in positions of responsibility for the public good. It is up to us to create the mechanisms of this process, for if not, we run the risk of falling back into a situation that is as disastrous as the current one, without (apparently) anyone having done anything wrong! ■

# Macroeconomics

Francesco Franco

The macroeconomic framework of the Memorandum of Economic and Financial Policies (MEFP) is sound. It integrates the necessary structural reforms in a model that takes into account the effect of aggregate activity on the economy. This approach makes the underlying macroeconomic scenario realistic. The fundamental objectives of the policies described in the MEFP are to rebalance the economy and to increase its potential growth rate. The essential targets to achieve these objectives are an improvement of external competitiveness, an implementable fiscal consolidation and measures to insure a stable financial system. The external rebalancing is the most pressing and challenging target. The structural policies to achieve the external rebalancing aim at increase productivity and attractiveness of the tradable sector by liberalizing labor markets and increase competition in the non-tradable sector. The short run policy to accelerate and sustain the external rebalancing is a fiscal devaluation: a budget neutral tax swap between VAT and the social security tax paid by the employers. The decrease in the TSU must be passed through lower prices to increase competitiveness and improve exports. The increase in the VAT will favor saving and decrease imports. The fiscal consolidation is based for two thirds in decrease in expenditures and one third in an increase in revenues. The increase in revenue is achieved with a tax mix biased towards consumption. Therefore the revenue increase policy of the fiscal consolidation complements coherently the external rebalancing policy. Finally the plan reinforces the stability and resilience of the Portuguese banks to permit the large national deleveraging implied by the rebalancing to occur in an ordinate way.

## The path to fiscal consolidation

The table below shows the recent fiscal evolution together with the consolidation path implied by the MEFP. The consolidation plan stabilizes the debt to GDP ratio and reaches the Maastricht deficit limit of three percent by 2013.

Year	Debt	Deficit	g	r	FMI r	UE/UME r
2008	71.6	-3.5	1	4.3		
2009	83	-10.1	-2.9	3.5		
2010	93	-9.1	2.8	3.26		
<b>2011</b>	<b>103</b>	<b>-5.9</b>	<b>-1.6</b>		3.25	?
<b>2012</b>	<b>111</b>	<b>-4.5</b>	<b>0</b>		3.25	?
<b>2013</b>	<b>115</b>	<b>-3</b>	<b>2.4</b>		3.25-4.25	?

Table : The fiscal consolidation path. Debt and deficit are expressed in percentage of GDP. **g** is the nominal GDP growth rate and **r** is the average interest rate. The nominal GDP (and therefore the GDP growth) is obtained dividing the deficit target in euro by the deficit target in percentage of GDP. The implied interest rate is the ratio of total interest payment on outstanding debt.

The consistency of the consolidation path is conditional on the interest rate charged on the EU-EMU tranche of the loan (the ? in the Table). The European authorities must offer an interest rate that does not jeopardize the fiscal consolidation. Furthermore, any spread above the interest rate at which the European facilities are able to finance themselves must be clearly justified. A punitive spread for accessing the bail-out facility is perfectly fine but a spread left without justification and open to interpretation is not acceptable. The frequent monitoring of the consolidation to ensure a timely and precise implementation of the fiscal measures (decrease expenditure, increase taxes) is equally crucial. Actually the plan foresees the creation of a "Portuguese

Budget Office” to monitor, assist and prepare impartial reports on the budget process. A productive strategy could be to let the new “Portuguese Budget Office” participate to the continuous monitoring of the troika for the next three years.

#### **The path to external competitiveness**

The fiscal devaluation is a budget-neutral change of the tax structure that increases private saving and net exports that aim at substituting a nominal devaluation. The increase in the VAT (mostly from increasing lower rates) and the decrease in the employer’s social security contribution tax can achieve the desired outcome in the short run if only and only if they are complemented with wage moderation and the tax decrease is passed through lower prices. The fiscal devaluation can have significant effects on competitiveness only if the decrease in labor costs is substantial. A precise quantitative assessment will be defined in the next quarter but the lower bound is likely to be a decrease in the revenues generated by the labor tax of 3 to 4 percent of GDP coupled with an equal increase of the revenues generated by the tax on consumption. The increase in the consumption tax will be carefully calibrated to minimize any adverse effect on the weakest and poorest part of the population. Finally, a fiscal devaluation (and appreciation in a mirror case) appears to be one of the few adjustment mechanisms to external imbalances within the currency area. ■

# Healthcare

Pedro Pita Barros

---

The Memorandum of Understanding has several measures related to the health sector. I provide my own view on them.

The savings required are important: €550 Million. The proposed measures do aim to achieve more than just short-run expenditure savings. There is a concern for building mechanisms for future control of expenditures in the public sector. These mechanisms involve performance assessments and benchmarks, use of competition forces in public procurement, and introduction of best-practices in transparency and information on the evolution of the National Health Service.

Several of the measures are important and deserve to be implemented, even outside the current crisis setting. They must be seen as stepping stones for the future. They are not disruptive of the National Health Service, only of its culture of opacity. Curiously, some - but not all - of the measures were already present in the recommendations of a 2006 report commissioned by the Government. A good deal of the effort lies in the time horizon for implementation, forcing both technical excellence and political determination to be present.

In a quick appraisal of the main areas:

## **Moderating fees**

Not only the values but also the structure of moderating fees are to be revised. Following a revision of the values and elimination of some exemptions, the fees should be updated according to inflation. Objectively, the structure of fees should encourage better use of resources, guiding patients to primary care and away from emergency departments.

## **Pharmaceuticals**

Three relevant mechanisms are present in the area of pharmaceutical products. Margin reduction in distribution, change in margin structure making it regressive (here I believe we should implement a dispensing fee approach instead of margin as percentage of retail price), and a redefinition in the international referencing price system to the minimum of the prices in reference countries, instead of currently used average.

## **Electronic prescription and quality in prescription**

This area has been little explored as a source for savings, and the steps announced are good news for improvement. It will be essential to garner cooperation from the medical profession, and the proper technology will have to be in place (finally, I would add!!)

## **Efficiency gains**

Without mentioning specific areas, the agreement looks to produce more transparency and clear benchmark analysis to drive more efficient behavior. It calls for the continued redefinition of the supply network of the National Health Service (including closure of unnecessary or unsafe units). The major warning is about the political process of closure, to avoid unwarranted population unrest.

## **Planning of health expenditures**

The agreement calls for better and more consistent planning of health expenditures, with the development of 3 to 5 year projections. This is definitely a good idea. It was used in one specific program (continued care network) with good results and should be expanded to the whole system.

**Reduction in fiscal benefits / tax allowances**

It will mean an increase in effective copayments paid by the population, as the implicit health insurance provided is reduced. The tax allowance should not be totally removed on the account of tax evasion of providers if patients lose all interest in asking for receipts for tax purposes.

**Medical Professions**

Explicit planning and follow-up of medical profession dynamics (training, exit, retirement decisions). I would take the chance to do it with all health professions.

Overall, the effect of this set of measures is crucially dependent on Government commitment . There are adjustments to be made in several points, which cumulatively have to produce the aimed savings. But the proposal attempts to reach these savings without compromising basic values of the National Health Service. A closer scrutiny needs to be in place to ensure progress is achieved. ■

# Labor Markets

Pedro Portugal

---

The initiatives dedicated to the labor market reflect a clear understanding of the current situation of Portuguese institutions. In effect, international comparisons highlight the fact that Portugal is an extreme case in what concerns job protection, unemployment protection and nominal wage rigidity. The rigidity of labor legislation has had its consequences: Portugal is the OECD country where the average unemployment period is the longest, where the arrival rate of job offers is the lowest, and where the share of temporary work is the second highest. The MOU aims to move Portuguese legislation gradually closer to the European practice.

The evolution of wages over the past decade, above what could be supported by the economy, has generated a serious problem of external competitiveness, and resulted in frightening rates of unemployment. There is, in the MOU, a general concern in containing or reducing the labor costs: reducing social security contributions (TSU), reducing overtime payments, freezing the minimum wages and public sector wages, reducing severance payments and reducing the amount and duration of unemployment benefits.

But the most critical change, however, will be of the mechanisms of wage setting, through the controls imposed on contract extensions to the whole industry, on the obligation of negotiators to reveal who they effectively represent, and on the possibility for companies to negotiate salary agreements for themselves alone. It is interesting to note the insight of this decision, showing the understanding of the legal conundrum generated by negotiators not revealing their constituency.

Highlighting the need to reduce the Labor market segmentation into “insiders” (workers with open-ended contracts) and “outsiders” (workers with temporary contracts and the unemployed) some suggestions are made to reduce firing costs. Progress is made, although timidly, in allowing more reasons to terminate individual labor contracts, but the simplification of the process, and the minimization of the legalistic processes involved is not explicitly contemplated in the MOU. What does exist is an immediate reduction in severance payments due for contract termination on new contracts. For existing workers, the reduction in severance should take into account the fact that they have already paid (as with insurance) through lower wages, the expectations of being compensated for displacement. One policy that could target this market segmentation efficiently would be the creation of a single open-ended contract, thereby eliminating contracts fixed-term contracts and other forms of temporary work. It is hoped that the fiscal devaluation will have a positive effect on job creation in the economy.

If a consensus value for the labor demand elasticity is used, then a reduction of 10% in real labor costs could, in the long run, represent a 5% employment increase. This in partial equilibrium – which is always questionable – given that the increase in consumption taxes would translate into price increases and thereby reduction in demand and consequently jobs. In any case what we do know is that an increase in taxes on labor is a weapon of mass destruction of jobs. The opposite should also hold. ■

# Competition and Regulation

Vasco Santos

---

The MOU covers competition and regulation aspects correctly. It does not, however, go far enough.

Competition between companies is a necessity for an economy to function. The MOU emphasizes a series of fundamental aspects to regulate markets in Portugal, namely:

- The need for regulators to be independent, ensuring that special interest groups, or government cannot control or influence their activities.
- The need for regulators to have guaranteed sources of financing to be able to function efficiently, ensuring that their decisions are correct from an economic perspective and legally solid (thus avoiding successful legal challenges), allowing for rapid implementation.

The document does require the production of an independent report, produced by “international specialists” that will address specific issues such as top staff selection, responsibilities, resources and level of independence, in line with international best practice.

The MOU, however, should have gone further in two aspects:

- In what concerns the “international specialists” that will be recruited and the demand that their recommendations be implemented.
- In relation to the recommendations of the national regulatory authorities on competition policy.

The choice of “international specialists” should not be left to Portugal alone. Their names should be put forward by Portugal but the IMF/EU/ECB should have veto power. This is the only way to guarantee that the report achieves its objectives. The MOU does not clarify this point.

Although implementation of the measures in the report (by Portugal) is implicit in the MOU, it would have been preferable for report recommendations to be binding except for when both Portugal and the IMF/EU/ECB agree not to do so.

More importantly, the recommendations on competition issues made by national regulators should automatically be subject to legislative scrutiny, forcing legislators to evaluate the recommendations and if so, turned into law. One of the functions of national regulators is to make recommendations on competition issues. But if such recommendations are not discussed in the legislative process, they will remain as recommendations with no practical implications, generating costs (of conception and production) without any benefit.

Another aspect of the MOU is the decision to maintain a legal oligopoly (Pharmacies) preferring to extract some of the profits in the sector to convert into extra revenue for the state. It is interesting to note that in this case, the concern is more about revenue generation for the public coffers than the creation of a more competitive market, liberalizing entry and generating more price competition. Even while maintaining a legal oligopoly in the short run, the MOU should have insisted on the introduction of more competition in the medium to long run.

Maybe because competition issues are still in their infancy in our country, Portugal tends to significantly underestimate the contribution of competition to wellbeing, both statically (lower prices, better quality products and services) and dynamically through efficiency gains and innovation.

It would have been good to see the MOU go further on these issues. ■

# Banking

Paulo Soares de Pinho

---

From an analysis of the MOU relative to the financial sector, one can reach one fundamental conclusion: the effort to allow Portuguese banks to regain the trust of international banks, allowing them access to interbank and bond markets. Until this happens, the document introduces loan guarantee mechanisms, which allow banks, in the short run, to reduce their dependence on the European Central Bank.

With this in mind, the MOU lays out a strengthening of demands in what concerns the solvency of national banks. By requiring a Core Tier I of 10% in 2012 it is being demanding, although it is still not clear what definition of Core Tier I will be used. Should Basel III be the reference, then national banks will have difficulty achieving it. I suspect, however, that a more lenient definition will be used.

This increase in solvency requirements for the banks is accompanied by stronger demands on the quality and intensity of the supervisory work of the Bank of Portugal. To guarantee that banks can satisfy the solvency demands, a public fund to strengthen bank capital is created. It is hoped that together, these measures will allow for a substantial improvement in the international view of Portuguese banks as they prepare for the negative consequences of the approaching recession.

The MOU foresees a continuous deleveraging of the sector, which will be accompanied by a reduction in the relationship between credit conceded and deposits captured. On the one hand, because it is fundamental to improve the liquidity of banks. On the other because there is an attempt to promote savings and limit internal credit, an originator of external debt.

All the measures are good news for savers and tax payers, that benefit from a more stable financial system. But they are bad news for those who seek credit, evermore expensive and scarce. It is very bad news for bank shareholders who will be called on to invest more capital in a sector which, in the short run, will be suffering from less activity and profitability. ■

# Energy

Paulo Soares de Pinho

---

The MOU focuses on two major issues in the energy sector: increasing competition and efficiency as a factor of competitiveness for the economy in international markets, and increasing fiscal revenue generated from the sector.

Starting from the fiscal side...the document aims for an increase in the Value Added Tax (VAT) charged on electricity from 6% to 23% as well as a special tax on energy consumption. This tax should be neutral to companies (as they deduct VAT) but will have an effect on domestic consumers. Even worse, as the energy prices implicit in the 2011 tariffs are almost half of effective market prices today, it would be reasonable to forecast a significant cost increase for domestic energy consumers in 2012.

Aiming to make the sector more competitive, the MOU seeks to accelerate the liberalization of the domestic market by eliminating regulated tariffs. It also aims to deepen the Iberian Gas Market (MIBGAS), something more difficult to achieve given the characteristics of this sector and the need to reach an agreement with a reluctant Spain.

Additionally, the document demands the transposition, before June 2011, of the Third Energy Package of the EU. This indicates a clear intention to strengthen the power of the national sector regulator. With the exception of this measure, given a sensation of regulatory limitations today, none of the others should have significant impact on consumers and the economy. The market has, in Iberian terms, a level of competitiveness that is possible. The actual tariff structure is not limiting free market behavior, except for consumers with strong export activity who benefit from cross subsidies. The elimination of regulated tariffs will not benefit them.

Where the MOU is more ambitious is in challenging the costs resulting from national energy policies paid for by all consumers – whether in the free or regulated markets – through network access tariffs. These costs represent almost 50% of the electricity bill of a domestic consumer. A careful reading of this section in the MOU reveals strong criticism of the energy policy of recent years. Investment in non-mature renewables will need to be rethought (photovoltaic, wave energy, etc.). And for the whole area of renewables – including wind and cogeneration - tariffs will need to come down for future projects, and in a courageous initiative, renegotiated for existing projects. Lets hope there is enough courage to push this through.

The MOU also states the need for renegotiating Energy Acquisition Contracts (EAC) and Contract Equilibrium Maintenance Costs (CEMC). In practice, these contracts effectively guarantee higher profitability, without risk, for a large component of ordinary electricity production, even if it is obsolete and redundant. Their existence results in higher costs for all consumers. Companies will invoke existing rights to avoid renegotiation, but given that consumers lose more existing rights with these agreements, earlier action on this point should have been taken.

We shall see if the Portuguese Government will have the wisdom to take advantage of this opportunity to stimulate competition, breaking with the “excessive profits” generated from the most archaic regulatory component of this sector: production. ■

# Telecommunications

Steffen Hoernig

---

Telecommunications are discussed in the MOU mainly because they constitute an increasingly important input for the Portuguese economy. They are mentioned not because they represent direct export opportunities (being non-tradable) or because of their weight in GDP, but because they are an instrument and cost of production for business in general and for exports in particular. The proposed measures for the sector therefore aim to increase the competitiveness of the Portuguese economy.

A first set of measures aims to guarantee the ability to act of the sectoral regulator (ICP-ANACOM), by focusing on its independence, financial autonomy and transparency of regulations regarding the dismissal of its president as described in Directive 2009/140 of the European Commission (“Better Regulation Directive”).

An independent report will be produced which will carefully review policies for nominating council members, as well as the responsibilities, independence and resources of the regulator. Although the direct nomination of directors by the Government is less transparent (and more susceptible to accusations of nepotism) than a process that involves the Parliament and/or nominations by the President of the Republic, the fact is that at European level no rules exist that impose nomination process.

The regulator’s financing is based on fees charged to the regulated companies and used to be more than sufficient (even given the contribution to the budget of the Competition Authority).

A second set of measures intends to remove barriers to competition in several segments. Some of these measures were already foreseen or to be imposed by the European Commission. Mobile termination fees, for example, have started a strong decline in Portugal as in the rest of Europe: they will reach 3.5 cents by the end of this year, and in 2011, ICP-ANACOM can be expected to recommend the continued reduction until maybe the value of 1 cent in 2015.

Also in the mobile sector, the auction for 4th generation bandwidth (LTE Broadband) is expected for this year.

The provision of universal service – at present the responsibility of Portugal Telecom – and the contract for concession of fixed services has originated disagreement between Portugal and the European Commission. In the MOU, the European Commission insists on the idea of a bidding process for the concession, underlining the need for competition for the attribution of universal service.

The only new measure in the document is the facilitation of change of operators in the fixed network, an issue that has originated many customer complaints over the years. The measure to revise barriers to entry for new operators is perhaps less relevant, given that the existence of two large networks with triple play offer makes the market less attractive to new entrants. ■

# Local Government

Susana Peralta

The MOU includes 3 measures directly impacting local government:

- First, Municipal Authorities must reduce staff by at least 15% by the end of 2012.
- Second, an administrative re-organization of the territory must be executed, aiming to reduce the number of municipalities (currently 308, including the municipalities of the autonomous regions), and parishes (currently 4259,) which should be executed by the end of 2012.
- Finally, the competencies of local government should be reviewed, aiming to eliminate the overlap of responsibilities between local and central government, and especially, the local agencies of central government. Identification of all overlaps should be completed by the end of 2011.

Given that labor costs are the main expense category for Portuguese municipalities, the first measure could result in important savings, which would allow local governments to offer a better bundle of goods and services to local residents.

The two last measures are somewhat vaguely defined. Nonetheless, they may be the first step in a change which improves the quality of life of Portuguese residents, while allowing for a more rational use of resources.

Fiscal federalist theory identifies several advantages to the existence of local government, although neither of them seems to be fully explored in the current system of local government existent in Portugal. For example, it does not allow the matching of local public good provision to the preferences of the local populations, given its excessive dependence on the central government, and

the lack of autonomy when compared to other OECD or European Union countries. On the other hand, Portuguese residents have difficulty in “voting with their feet”, in other words, moving to another local council with a preferred basket of goods, services and taxes, given the lack of comparative information on local government performance. In Portugal, it is impossible to know how much each local government spends on education, health, street lighting or municipal police. Some environmental expenses are published by the National Statistics Institute, but even here the organizational complexity of municipal firms, inter-municipal firms and municipal services make it impossible to get an exact vision on what is, in effect, spent. In some municipalities, a significant proportion of garbage is collected selectively, with reported costs of zero!

With rare exceptions, namely in garbage collection and water treatment, no performance measures are published. We miss, to mention a few examples, information on school quality, the quantity and cost of council housing, or the number of sports and cultural facilities. This is common practice in other countries – in the UK, for instance, a website, OnePlace (<http://oneplace.audit-commission.gov.uk>), allows visitors to obtain performance data on all local governments and compare it to national averages. This lack of transparency seriously hampers the accountability of local politicians, and limits the merits of local democracy.

Local politicians’ accountability is also limited by the overlapping of competencies with the central government. For example, in the area of social services, the law vaguely establishes that municipalities participate in activities to combat poverty and social exclusion in cooperation with central government.

Even in the cases where responsibilities are clearly delimited – for example, the central government is responsible for teachers and doctors, whilst the local government is responsible for the administrative staff of schools and local healthcare units - it is extremely difficult to evaluate how much each of these entities contribute to the education level or the healthcare status of the local residents.

According to the law, municipalities have competencies in 16 functional areas (from rural and urban equipment to energy, environment, security, housing, social services, health and education), all shared, at different degrees, with the central government. This results in confusion and prevents the voter from using the elections to impose discipline or hold their local government representative accountable.

Parishes are local government units with extremely limited competencies and financial resources, many with a small population and whose competencies are limited to day-to-day management without any real policy options, which raises questions as to the need for elections at this level.

The changes imposed now can be an excellent opportunity to:

- Eliminate a significant number of parishes (except those in urban areas with a sufficiently high population such that it makes sense to have a third government layer).
- Re-design the map of municipalities given the population changes that have taken place in the country so as to better distribute population numbers per municipality.
- Reduce the number of areas where the municipalities have responsibilities, whilst increasing their autonomy so as to improve their ability to act.
- Import international best practice measures in what concerns the systematic publication of performance indicators and their costs so

as to make local democracy more effective.

Is the agenda of the MOU exempt from criticism? Naturally not. Staff reductions can always result in serious social consequences in a country in crisis, and there are probably some municipalities that are more overstaffed than others – it might have been possible, for example, to make the reductions conditional on the number of staff per capita in the municipality.

The municipal election system should also have been restructured. The co-existence of legislative and executive bodies, both elected in a proportional system, does not help electors identify whom to hold responsible for policies. Finally, policy coordination between municipalities of the metropolitan areas could also have been addressed.

But this could be the beginning of changes that would allow for better quality local democracy, one that would reflect the will of the voters with better effectiveness and accountability. ■

# Justice

Nuno Garoupa

---

Many media commentators have read in the memorandum of understanding (hereafter MoU) a full scale reform of the Portuguese court system. I have a particularly different view in the sense that the MoU falls far short of what Portugal needs to do in order to get a reasonably effective court system. Moreover, I find the overall reform suggested by the MoU technically defective as explained below.

(1) It is clear that the MoU is not intended to provide for a full reform of the Portuguese legal system since that is not a concern for the IMF or for the European Union. The measures imposed by the IMF/EU/ECB troika aim merely at solving or alleviating the fundamental aspects of court procedure and management that directly affect large corporations, foreign investors and law firms.

(2) The MoU has basically accepted the assessment provided by the current caretaker government. It proposes a set of legal policy measures that were already planned by the current government and even by previous governments. For example, it follows the planned reorganization of court districting (apparently presupposing that the new districting plan will close courtrooms around the country and concentrate them where they are needed which is clearly untrue), it considers basically the same measures already announced in March (under the PEC IV) although committing to a scheduled implementation before 2013.

(3) The measures imposed by the MoU are generally positive in terms of court management and streamlining civil procedure. Nevertheless, they require a significant budget increase for the Ministry of Justice. Almost all the measures imposed by the MoU lead to an increase in public spending in the short term,

and generate almost no savings before 2013. The short-term implementation of the new court districting as required by the MoU calls for an investment that has not been available in the past 18 months (hence the successive delays). Unfortunately, the MoU never explains how these important additional costs are going to be covered. It will therefore be interesting to see how the new government will finance these measures in a general context of cutting on public spending.

(4) The commitment to end the backlog in the second quarter of 2013 is unrealistic and irresponsible. Taking into account the number of cases filed in 2010, over 18 months ranging from January 2012 to June 2013, the Portuguese courts are expected to process two to three million disputes, broadly the same number of cases they entertained between January 2005 and December 2010. Does anyone believe that is actually possible? Even “cleaning” the court statistics (amazingly explicitly allowed by the MoU), it is just unfeasible unless further measures are imposed.

(5) An effective and noticeable improvement of the Portuguese court system requires a much deeper and comprehensive set of measures than those imposed by the MoU. They are simply insufficient. The required performance both in terms of public spending and backlog is technically inconsistent. The pessimists may say that it was either “this” or nothing. But “this” will solve very little as we will see by 2013. ■

# Economics & Politics

José Tavares

The experience of developed countries with budget adjustment programs is vast and varied. Despite similar economic structures, even in industrialized countries, the variety of political conditions present will have a fundamental role in determining the sustainability of any programs.

The extensive literature on economic policy indicates the core rules that determine the probability of success of any budget restructuring program. Amongst them are:

- Cost contention and cost cuts have a longer term effect than an increase in taxes.
- A clear distribution of costs, planned previously, favors equity and reduces resistance to the budget adjustments.
- Coalition governments are not necessarily associated to successful adjustments: if on the one hand the number of entities involved increases, on the other, the number of entities with veto power also increases.
- Governments can use their ideological identity to signal firmness in their budget intentions: this way, governments seen as left leaning that cut spending, or governments seen as right leaning that increase taxes tend to gain credibility with the voters.
- Budget adjustments do not decrease the probability of reelection of government that start them: the well known hesitation in starting the process is more associated with protecting special interests and with risk averse behavior.
- Budget cuts in “difficult times”, that is in recessionary climate, seem to induce a more positive product response.

- In situations of clear unsustainability of a budget deficit, the budget correction can in some cases generate expansionary effects.

The IMF is called to act in situations of weak economic performance and the difficulties in accessing international markets, and, it has the merit of distributing costs ex-ante and concentrates on re-establishing sustainable levels of spending.

But it is important for the IMF not to ignore the importance of political signs when presenting the recipes for budget adjustment. That they don't forget how the political identity of governments can be transformed into elements of credibility. That they don't worry excessively about losing elections. And that they don't promote, at any cost, unnatural coalitions that not only divide the responsibility for success but also the blame for failure.

A significant part of the IMF agreement is based on suspending politics to focus on the economy. It should not exaggerate on the first to the point of hurting the second. ■