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Portugal: In Economics, we call it conflict of interest!

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The fate of the Portuguese bailout program may have just been decided last Friday, April 5th, by the Portuguese Constitutional Court, whose members (as civil servants) were basically voting on the suspension of their own 13th and 14th salary payments (Christmas and holiday subsidies, as these are known in Portugal).

What has been puzzling constitutional lawyers in Portugal, however, is the fact that the same court did not reject an "extraordinary solidarity contribution", which implies progressive haircuts on pensions above €1,350 (up to 40% for the highest pension bracket). The justification cited by the Constitutional Court for approving this measure was its temporary character, which was "justified by a situation of economic and financial distress", and the fact that it was progressive... The proposed suspension of the 13th and 14th salary payment is also a temporary measure and arguably also justifiable by financial distress, although it is not progressive. In this case it has been argued that the grounds for the rejection lie in an interpretation of the Constitution that rejects the unequal treatment between the private and the public sectors (this would be a clear conflict of interest in any board meeting).

This decision by the Constitutional Court came as a blow to the Portuguese government, delivered on the eve of the informal Ecofin meetings in Dublin (April 12th and 13th), where EU Finance Ministers were slated to discuss the deteriorating economic situation of the country and a request for an extension of the schedule for loan repayment, which is seen as crucial for Portugal.

What are the next steps? Well, Portugal, where the implicit tax rate on capital is now significantly above that of the EU average, could be already close to the descending part of Laffer curve on this tax category, which means that raising capital tax rates further is unlikely to have a significant effect on, and could even lower, tax revenues.[1] Its VAT tax rates are among the highest in Europe, with the normal rate set at 23%, and labour taxation has

[1] An estimation of the implicit tax rate on capital for Portugal and a comparison with other EU countries can be found in IMF, "Portugal: Selected Issues Paper", IMF Country Report No. 13/19, 2013. Using data for 1965-2007, Trabant and Uligh find that the EU14 was already very close to the peak of its capital revenues Laffer curve, while countries like Denmark and Sweden are estimated to be already on the "slippery side": Mathias Trabant and Harald Uligh (2011), "The Laffer Curve Revisited", *Journal of Monetary Economics*, Vol. 58, pp. 305-327.

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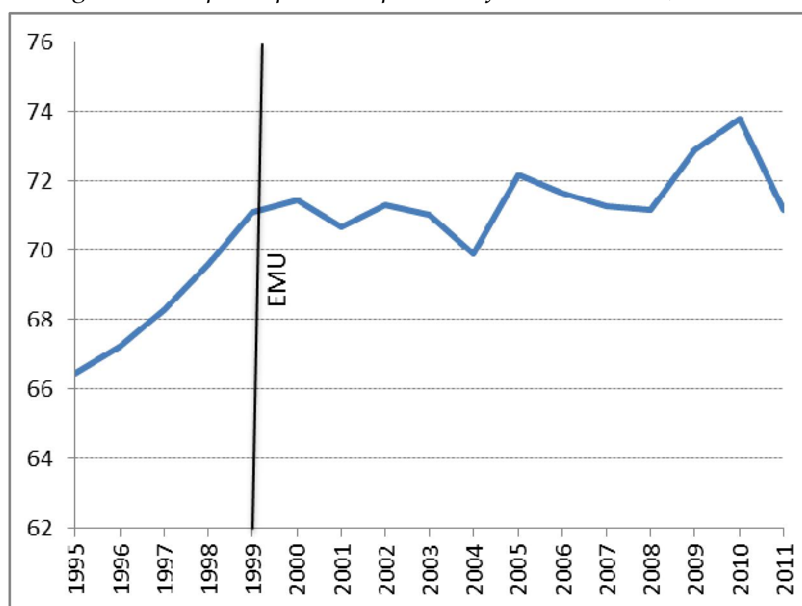
proved to be relatively difficult to increase in Portugal.[2] The government recognises this and has already pledged not to substitute expenditure cuts for higher taxes. This implies that it will have to come up with alternative cuts in expenditure amounting to roughly €1.3 billion (representing about 0.8% of GDP). The amount of savings required may not be very large, but the options are extremely limited: cuts in health, social benefits, education and state-owned companies. Excluding the cuts on social benefits, which are likely to affect the most vulnerable (so much for the equality praised by the Constitutional Court), the others are areas typically characterised by poor budgetary execution. Hence, it will not be easy to convince the Troika that planned expenditure cuts in these areas will deliver.

One remaining option is a further reduction in the number of public sector employees in combination with an increase in public sector working hours, which at 35 hours a week, constitute one of the lowest workloads in Europe. This option is likely to be very welcome to the IMF, and in fact was suggested in its latest Article IV consultation.[3] The cuts cannot come through retirement schemes, since these only shift the expenditure from payrolls to pensions; rather, they must come from an effective reduction in the number of workers in areas where current employment levels are found to be excessive. These measures will have the best long-term implications both in terms of fiscal sustainability and of labour productivity, and may finally allow the country to resume the catching-up process that has been stalled since the start of EMU (see the figure below). Depending on the response of the government, the Portuguese Constitutional Court may have decided the fate of Portugal for the better...

Portugal's GDP per capita as a percent of the euro area (12 countries, in PPS)



Source: Eurostat, Purchasing Power Standard per inhabitant.

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[2] Last year's attempt to reallocate the tax burden from social security contributions from capital to labour has resulted in social unrest and large political dissent (see "Portugal swaps pay cuts for tax rises", *Financial Times*, 24 September 2012).

[3] IMF, "Portugal Article IV Consultation and 6th Review", IMF country report 2013/18, Box 3. Growth-Friendly, Equitable, and Sustainable Fiscal Reform in Portugal, 2013.