Portugal's Plight

The Role of Social Democracy

George Bragues

Portugal has never quite managed to regain the influence it once had on the international economic scene when it parlayed Vasco da Gama's discovery of the sea route to India into a global trading empire. Yet by late 2010 the small Iberian nation had come to be seen around the world as a crucial corridor through which, if the so-called bond vigilantes were to pass, the euro sovereign debt crisis would imperil Spain, a much bigger economy whose distress might spell the end of European currency union. If the trouble plaguing the euro zone were ever going to stop, many had come to the conclusion that it had to do so in Portugal. By the spring of 2011, that prediction was being put to the test as Portugal was compelled to follow Greece and Ireland in seeking to tap the €750 billion European Union (EU) and International Monetary Fund (IMF) bailout fund.

The immediate cause of the country's arrival at this unenviable position was escalating interest costs. Yield spreads on ten-year Portuguese bonds, steadily climbing since the onset of the 2007–2009 financial crisis, pierced the 500-basis point level in the first quarter of 2011. This increase meant that Portuguese long-term interest rates, which had begun 2010 at 4 percent, had catapulted higher than 8 percent, well beyond the threshold that market observers widely view as unsustainable for the government to finance (Wise 2011). In driving up rates, traders and investors were moved by a debt to gross domestic product (GDP) ratio that had grown to exceed 90 percent, a budget deficit to GDP ratio at 8.6 percent, and a government that, despite promises to the contrary, had not shown the discipline to

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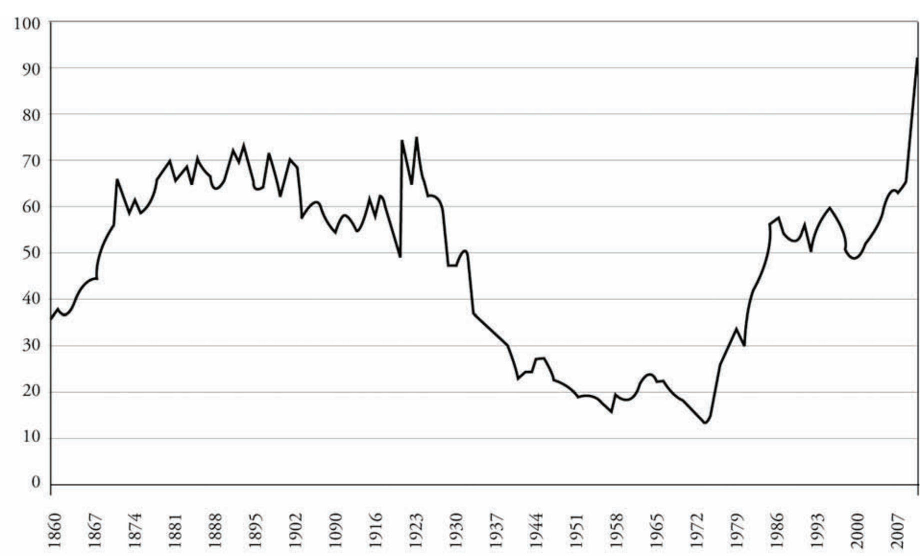
keep spending from rising in 2010. Worse yet, in view of recent experience, markets still doubt Portugal's ability to create sufficient new wealth to pay this debt: the country has recently experienced its own lost decade of anemic real GDP growth. From 2000 to 2010, the Portuguese economy grew at a mere 0.5 percent per year on average ("The Winter of Living Dangerously" 2011).

A common view of Portugal's difficulties is that it is now paying the price for having entered the euro framework without having the economic fundamentals in place to survive the rigors of a currency regime alongside nations such as Germany that have stronger histories of fiscal probity (Blanchard 2007; Krugman 2011). Although this view has a measure of truth, at least insofar as Portugal's economy was structurally vulnerable, the question remains as to how it got into this condition and why its problems were never fixed over the two decades in which it was either preparing for or already using the euro. Figure 1, which shows the historical movements in the debt/GDP ratio, provides a clue as to the underlying source of the country's problems.

What is immediately striking here is that the country's debt bottomed in 1973 at 13.6 percent of GDP. Since then, it has steadily trended upward. That year, 1973, happened to be the year before a long-standing dictatorship, ruled first by Antonio Oliveira de Salazar and then for a shorter period by Marcelo Caetano, was overthrown in the "Carnation Revolution." Out of this 1974 regime change, a social democracy was constructed. Approaching this transformation as a natural experiment to test the

Figure 1
Portugal's Public Debt as a Percentage of GDP, 1860–2010



Sources: From data in Valério 2001; European Commission 2011.

impact of a robust welfare state and democratization on economic life holds the key to understanding the country's predicament. In thus analyzing the country's history before and after the 1974 revolution, while putting into sharper relief both the political and economic variables that endured and changed, I find that social democracy is the prime culprit of Portugal's plight.

Before the Revolution

At the dawn of the twentieth century, Portugal was a poor country, largely illiterate and for all intents and purposes a vassal of its centuries-old ally, Great Britain. Soon after the ruling monarchy yielded ignominiously to a British ultimatum in 1890 concerning the drawing of boundaries in the African colonies, declining demand for Portugal's exports precipitated a financial crisis in 1892. Both of these events, combined with a political crisis fueled by republican attacks on the regime and an intellectual zeitgeist marked by pessimism and doom about the country's prospects, laid the preconditions for the 1910 overthrow of the monarchy, last personified by King Manuel II (Sardica 2008, 19–22). In his place, a republican order was instituted that lasted only sixteen years, mired as it was in political instability, public disorder, and economic chaos. To fix the country's desperate finances, the military junta that had seized the reins of power from the republicans appealed to Dr. Antonio Oliveira de Salazar, then a professor of political economy and finance at the University of Coimbra, Portugal's oldest and most hallowed university. After initially rebuffing the military and then having been granted authority over all government spending, Salazar became finance minister in 1928. More quickly than anyone had expected, Salazar brought the country's finances under control. His reputation thus made both domestically and internationally, he adroitly cemented alliances with civilian elements in the regime and neutralized opposition from military factions in ultimately winning favor from President Oscar Carmona, the head of state. Carmona appointed Salazar as prime minister in 1932 (Meneses 2009, 62–82).

A year later Salazar introduced a new constitution that established the Estado Novo (New State), the political architecture that governed Portugal until the 1974 revolution. Under Article 5 of the 1933 Constitution, Portugal's Estado Novo was defined as a "unified and corporative republic" (Nova Publicação 1971, my translation in all cases). For the economy, this republic entailed a corporativist system in which individual competition was rejected, and production was instead to be organized within and between groups deemed organic by virtue of shared characteristics, interests, and purposes. Each of these groups—the corporations—was to represent specific trades and industries. In an attempt to eliminate class conflict, employers and workers were supposed to resolve their differences in a cooperative spirit. To facilitate this resolution or at least to keep it from degenerating into antagonism, strikes and lockouts were prohibited by the Statute of National Labor (Kay 1970, 57). Although Salazar liked to emphasize the corporations' autonomy, the state reserved the right to coordinate their activity and indeed understood itself as possessing "the right and the obligation to regulate and direct economic and social life" (Nova Publicação 1971, Art. 10).

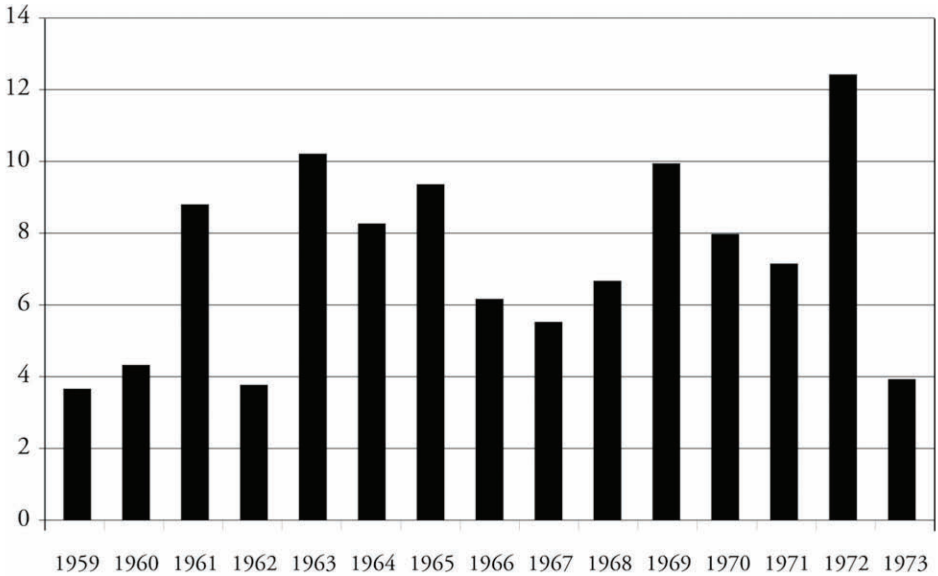
The economic system that actually evolved over the following decades bore only a slight resemblance to the corporativist ideal. This difference was not surprising. Under the prevailing economic system, each corporation, precisely because it was free to determine the conditions of its respective trade or industry, did not need to conform to consumer preferences. Even if a corporation wished to do so, the lack of prices in a system where production decisions depended on negotiations among the plethora of groups meant it would be impossible to ascertain what consumers wanted. A corporation then would ineluctably opt for policies that benefited its own members to the detriment of outsiders. Because every corporation acted in this way, the economic damage inflicted on society would be enormous. The government is thus forced to step in and direct the various socioeconomic groupings to bring about a modicum of order (for more on this type of situation, see Mises 1996, 816–20). What ended up being installed in Salazar's Estado Novo was therefore a form of interventionism insofar as private property was retained, but the government sought to hinder and modify what market forces, left to themselves, would otherwise beget.

The Estado Novo maintained, publicly at least, that the higher spirituality of Catholicism and the nationalistic objective of enhancing Portugal's economic independence guided the intervention's constraints on economic materialism. Although these motives cannot be discounted entirely, the government's interference was significantly driven by the need to remain in power because the Estado Novo's policies aimed to foster controlled growth so as not to disturb the balance of socioeconomic interests, while simultaneously favoring a narrow commercial elite that consisted of forty or so families who supported the regime (Corkill 1993, 20–21). The features of the interventionist regime that produced this result involved a system of industrial conditioning in which entry into a given area of the economy required government approval. Cross-border trade was channeled to the colonies, principally Angola and Mozambique, which were treated as captive sources of raw materials and markets for the mother country's manufactured goods. Protectionist measures, too, served to promote industrialization by domestic firms via import substitution (Meneses 2009, 336–41).

Such intervention did not conduce to economic prosperity. Although Portugal survived the Great Depression relatively unscathed and successfully maintained neutrality during World War II, in 1950 it was in the same position relative to its wealthier European counterparts that it had occupied at the founding of the Estado Novo in 1933. Its GDP per capita remained at 42 percent of the GDP per capita of twelve developed western European nations (Maddison 2010).[1] However,

1. The twelve countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.

Figure 2
Portugal's Golden Years: Annual Real GDP Growth, 1959–1973



Source: From data in Maddison 2010.

in the 1950s the industrial-conditioning regime began to be reformed, and foreign investment and tourism were encouraged (Corkill 1993, 13–17; Neves 1996, 339).

This liberalizing trend accelerated in the 1960s with Portugal's entry into the European Free Trade Association in 1960, the World Bank and the IMF in the same year, and the General Agreement on Tariffs and Trade in 1962 (Meneses 2009, 356–57). To deal with simmering insurgencies, the Portuguese government granted its colonies a measure of political sovereignty and trade freedom. This array of market-freeing policies gave rise to the highest growth rates in Portugal's history (see figure 2): real GDP increased by 6.2 percent per year from 1959 to 1965 and by 7.5 percent per year from 1966 to 1973 (Neves 1996, 337). By 1973, on the eve of the Carnation Revolution, GDP per capita had reached 58 percent of the GDP per capita among its developed western European peers, up 16 percentage points from 1950 (Maddison 2010).

The "Social" Aspect in the Move toward Social Democracy

War often begets revolution. It certainly did in Portugal, which had defied international opinion since the early 1960s in waging an ultimately quixotic struggle against independence movements in its colonies. Marcelo Caetano, who had taken over as prime minister in 1968 after Salazar suffered a stroke, initially sparked hopes among junior army officers of a negotiated settlement to the colonial wars. When these hopes were eventually dashed, a group of army captains, known as the Movimento das Forcas Armadas (MFA, Movement of Armed Forces), launched a coup d'état on April 25, 1974. Over the ensuing two years, the country suffered the economic costs of regime uncertainty as radical leftist elements of the MFA in alliance with the Communist Party vied for power against a pro-democratic coalition made up mainly of the Socialist Party, the Popular Democratic Party, and moderates within the MFA (Manuel 1995). Portugal's GDP fell by 0.3 percent in 1974 and crumbled by a stunning 9 percent in 1975 before regaining its footing somewhat in 1976 in dropping only 0.2 percent (Amaral 2010, 28). Helping account for the 1975 collapse was the radicals' initial gain of ascendancy—at one point, Henry Kissinger, then the U.S. secretary of state, resigned himself to losing Portugal to communism (Garthoff 1994, 539)—at the same time that a significant swath of Portuguese industry was nationalized, including the petrochemical, chemical, steel, insurance, and banking sectors. After a failed radical left-wing putsch in November 1975, the pro-democratic forces gained the upper hand, subsequently advancing their cause with the 1976 promulgation of a new constitution that established a parliamentary system checked and balanced by an elected president serving as head of state.

More so than the 1933 Constitution, whose corporative vision was not really carried through, the 1976 document is critical in understanding the economic system that was built after the revolution. Key features of Portugal's social democracy were codified in the 1976 Constitution and subsequently enacted to bring government policy into line with its provisions. To this day, the prospect of market reforms often raises the cry that the changes would run afoul of the Constitution. On a number of occasions, this inconsistency has been sufficiently manifest as to require amendments. These modifications notwithstanding, the Louis Hartz (1955) thesis—according to which America's ideological landscape was determined by the political ideas dominant at its founding—can be adapted to Portugal, where the socialist worldviews prevalent in the immediate aftermath of the revolution have been kept alive since then.

That set of worldviews figures prominently in the preamble to the Constitution, which enjoins the government to "open a path to a socialist society." Article 2, though subsequently revised, continues to describe Portugal's state as being founded on the rule of law, "with a view to achieving economic, social . . . democracy" (Constitution of the Portuguese Republic 2005). To this end, Portugal's fundamental law recognizes a panoply of positive rights, rather than being limited to the provision of negative rights. Instead of merely enjoying the protection of individual freedoms from government action, Portuguese citizens are promised various goods and services that require government action. The emphasis on positive rights initially went hand in hand with the more traditional socialist approach of relying on state ownership of the economy; the 1975 nationalizations were constitutionally entrenched in 1976. During the 1980s, however, Portugal's political classes generally came to recognize the inefficiency of state-run firms, and in 1989 the Constitution was amended to allow the privatization of these firms. Since then, in the attempt to advance the social-democratic project or, as it is called in Portugal, the Estado Social (Social State), the focus has been on constructing a state apparatus that assures positive rights rather than on government ownership of the means of production.

Thus, the Constitution enshrines the right to life; freedom of conscience and religion; security of the person; liberty of expression; freedom of movement in and out of the country; the right to association; the protection of property; the right to seek a livelihood; and freedom from arbitrary detention, imprisonment, and deportation. But it also goes beyond these negative rights to guarantee job security, employment training, a living wage that reflects the amount and quality of effort, minimum-wage levels, unemployment assistance, unionization with the right to strike, limits on working hours, and paid holidays (Art. 53–59). Citizens are given a right to social security, in which the government is directed to supply insurance against sickness, old age, disability, unemployment, and loss of marital or parental support (Art. 63). To reduce the individual risks posed by illness, the Constitution specifies the provision of a universal health-care system in which medical services are to be rendered at little or no cost to individuals (Art. 64). The right to shelter, too, is recognized: the Constitution requires the state to promote low-cost and social housing and to ensure that rents are consistent with family income (Art. 65). Not restricting itself to the financial and bodily dimensions of human existence, the Constitution proceeds to foster citizens' mental faculties by proclaiming a right to education and culture (Art. 73–78). Spelling out this right, the document mandates a public system of basic education that is compulsory, free, and universally accessible. Universities are also to be open on a democratic basis, with the ultimate goal of offering higher education at zero tuition.

Portuguese politicians, regardless of which party was in power, duly complied with these constitutional obligations in erecting the Estado Social. In 1979, the Servico Nacional de Saude (National Health Service) was established. Although a minimal social-security infrastructure had already been erected during the republican period and the Estado Novo and was expanded somewhat during the Marcelo Caetano years, the most significant developments began in 1977 with the creation of various national and regional agencies, the chief bodies now consisting of the Instituto da Seguranca Social (Social Security Institute) and the Direcção Geral da Seguranca Social (General Directorate of Social Security). Together, these bodies oversee a regime that provides unemployment insurance, family and survivor benefits, assistance to those in socioeconomic need, and old-age and disability pensions (Seguranca Social 2011). No area received a greater impetus in the push for state resources in the immediate postrevolutionary phase than education—one of the principal criticisms of the Estado Novo had always been that it deliberately kept the populace illiterate and ignorant. A plethora of schools was built, and a battalion of professors hired; the compulsory length of education was extended from six years at the end of the Estado Novo to nine and subsequently twelve (Amaral 2010, 52–53, 76).

Employment increased significantly not only in the educational sector, but across the entire state apparatus, which ended up being raised to give substance to all the constitutionally mandated positive rights. Since 1974, the number of public-sector workers has increased from 200,000 to about 800,000 today (Amaral 2010, 55).

Also reflecting the 1976 Constitution, these workers, along with their counterparts in the private sector, have been empowered by one of the developed world's most rigorous sets of labor laws. In stipulating job security as a right, Portugal's highest law explicitly restricts work dismissals to situations with just cause, effectively ruling out employment at will (Art. 53). Indeed, the government had already defined "just cause" more specifically in 1975 under Legal Decree 372-A/75, according to which that standard embraces only circumstances in which it is "absolutely and definitively impossible, in the present and in the future, for the worker to perform his/her job or for the firm to take the worker's labor" (Art. 8, qtd. in Martins 2009, 260). Besides having to meet these exacting conditions, a firm seeking to dismiss an employee is required to undergo a time-consuming administrative process that involves, among other things, the submission of a written document stating the reasons for dismissal and the collection of evidence gleaned from interviews with anyone the employee identifies as being relevant to the case. If the firm is taken to court to defend the employee's discharge and loses, it is obligated to reinstate the worker and pay back wages for the period from the dismissal notice date onward. Even if the firm wins the case or the employee does not challenge the firing, the company is still required to pay a hefty severance package. In 1989, after much acrimony that included a general strike and a reference to the Portuguese Constitutional Court, the labor code was revised to allow firms to lay off workers in response to structural imperatives, technological shifts, and movements in the business cycle. Small businesses, too, were exempted from all but four of the twelve administrative requirements (Martins 2009, 260). At the same time, the rules surrounding limited-term contracts—all the strictures just noted apply only to permanent staff—were tightened in the 1989 revisions, though their usage persisted and actually became more frequent. So widespread are the *recibo verdes* ("green receipts," as the most widely used temporary contracts are known in Portugal) that Portugal has the third-highest proportion of temporary employment among Organization for Economic Cooperation and Development (OECD) nations, behind only Spain and Poland (Pereira 2011).

Like the Estado Novo, therefore, the Estado Social represents a system of intervention. Since 1974, the Portuguese state has continued to rely heavily on its coercive powers to supplant the free play of supply and demand in the context of private property and a market order. Hence, what fundamentally distinguishes the two regimes is not so much the means chosen by policymakers in the pursuit of economic and political goals, but rather the goals' content. If Salazar's Estado Novo, at the outset at least, aimed to foster nationalist loyalties in tandem with an economy that reflected spiritual values, the Estado Social seeks to create a secular and materially affluent society in which each person is economically accorded equal concern and respect. In an evaluation of their relative merits, it would be natural to focus on their respective ends, especially because the economic means they adopted were essentially similar. But then we would have to go beyond economics and enter the regions of moral philosophy inasmuch as the ultimate ends of human action involve claims regarding the way the world ought to be. Because such claims are beyond scientific adjudication, it is more prudent here to limit the discussion to an assessment of the fitness of the chosen means to attain the goals pursued.

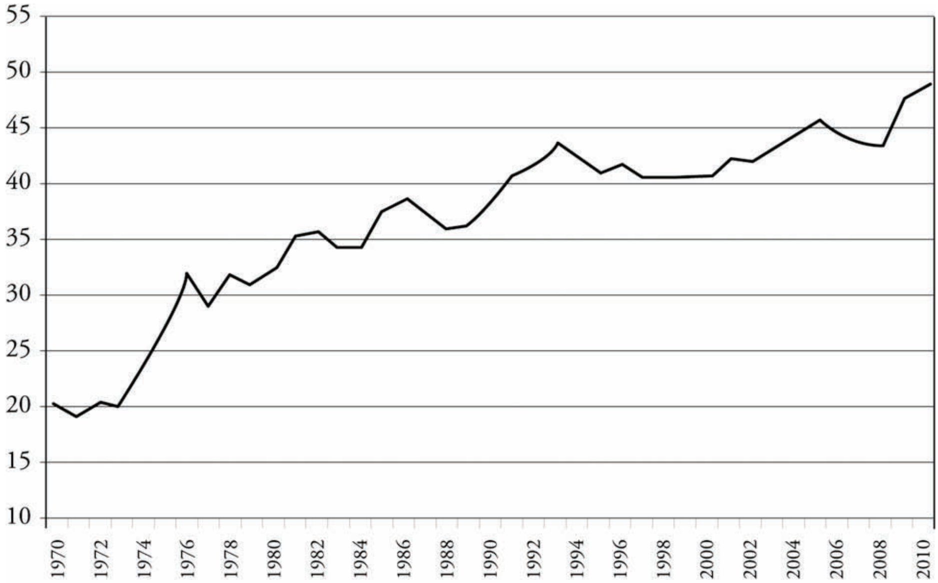
On purely economic grounds, the Estado Novo would not fare poorly by this test. If a community in which the maximization of citizen attachments to the nation is the objective, an interventionist policy that cuts people's ties to the international division of labor is a plausible means. If the goal is to limit the provision of material goods for the sake of more valuable immaterial goods, then surely there is no more effective method of curtailing economic plenty than systematic interference in the marketplace. Even when the Estado Novo, from the late 1950s forward, shifted to a more pro-growth stance in order to maintain popular support and finance the colonial wars, reducing the degree of intervention as it did was the correct approach. The same cannot be said for the Estado Social, however, because it commits the mistake of emphasizing intervention in order to bring about prosperity.

It is difficult to find a stream of economic thought more adamant and unequivocal about the pitfalls of the interventionism entailed by social democracy than the Austrian school. So if that politicoeconomic framework is actually at the root of Portugal's ills, no better theoretical framework exists to reveal that fact. For Ludwig von Mises, a leading theorist of the Austrian school, the chief defect of interventionism and more broadly of the socialism that underlies it is that it constitutes a kind of acid that eats away at a society's capital stock (1981, 413–52). He worries about the moral hazards involved in the government provision of social insurance because it reduces incentives for people to maintain healthy behaviors and to work hard. The taxes required to finance the scheme lower incentives to invest (Mises 1996, 804–5). Moreover, job-protection legislation, aside from making it more difficult for companies to adjust their workforce to shifting consumer demand, effectively raises the cost of hiring workers. "In weighing the pros and cons of the hiring of workers," Mises remarks, "the employer does not ask himself what the workers gets as take-home wages. The only relevant question for him is: What is the total price I have to expend for securing the services of this worker?" (1996, 601). So government intervention in the marketplace, whether by discouraging the further accumulation of capital or by encouraging the consumption of the capital that previous generations amassed, Mises argues, leaves the community with fewer instruments with which to produce ever greater amounts of goods and services. After all, capital—assets such as factories, offices, machinery, technologies, and tools—is what makes human labor more productive in transforming the scarce resources available in ways that better fulfill people's subjective desires. A wealthy society is nothing but a group of individuals whose combined productive capacity allows them to satisfy an immense array of their subjective desires. To undermine a society's capital base is to attack its wealth-creating potential.

To this argument, social democrats will straightaway counter that interventionism has been the public policy of the advanced industrialized world since the early to mid–twentieth century, and yet these countries' economies have continued to grow into the early twenty-first century. What explains this seemingly incongruous fact, however, is that present-day welfare states have not completely suffocated market institutions and practices. A socialist system cannot exist, Mises claims, "unless it be as a fragment of socialism within an economic order resting otherwise on private property" (1981, 414). A critic of this Misesian view can still try to press the issue by noting the failure of Mises's prediction that the interventionist system would fall apart and be replaced by either capitalism or socialism. In *Human Action,* he elaborates on this forecast, arguing that the wealthy capitalists' reserve fund out of which the interventionists initially attempt to finance public expenditures will inevitably exhaust itself and that recourse will eventually have to be made to the sources of capital held by the greater populace (1996, 858–61). Once matters reach this point, the scheme becomes vulnerable to mass protest because everyone bears the cost. That this prediction has not yet come to pass can be explained by the fact that Mises did not take public debt into account. The issuance of such debt, through the sale of government bonds, offers interventionist states a ready means of tapping wealthy capitalists and keeping the funding dilemma at bay for a time. Portugal exemplifies this scenario as well as the larger claim that interventionist policies impair the capital stock. If such damage does indeed take place, as Mises insists, it will be all the more obvious in a country such as Portugal, which, compared to other social-democratic regimes, constructed its own welfare state in relatively short order on a weaker capital base. Just how swiftly Portugal did so may be seen in figure 3.

In 1973, just before the revolution, government spending as a percentage of GDP was slightly less than 20 percent, as shown in figure 3. Although social expenditures had risen slightly during the Caetano regime, the government's role was limited to the traditional, pre–welfare state functions of military defense, domestic administration, and infrastructure building. The social insurance and welfare functions had been left for the most part to family support, private charities, the Catholic Church, and a few of the Estado Novo's corporative bodies. After the revolution, driven by a ramp-up in social spending, public expenditures nearly doubled as a percentage of GDP in eleven years, reaching 37.5 percent in 1985 (figure 3). Such spending exceeded 40 percent in the early 1990s and stood at 49.3 percent in 2010. This percentage puts Portugal very close to the EU 27 average, which in 2010 was 50.6 percent (European Commission 2011). To put this percentage into comparative context, consider that France needed seventy-seven years to go from spending 17 percent of GDP to spending 49.8 percent (Tanzi and Schuknecht 2000, 6). In 1937, U.S. government expenditures were equivalent to those of the Portuguese

Figure 3
Portuguese Government Spending as a Percentage of GDP, 1970–2010



Sources: From data in Valério 2001; Bank of Portugal 2011; European Commission 2011.

state in 1973. Yet even now the United States, with government spending at approximately 40 percent of GDP, has still not reached Portuguese levels.

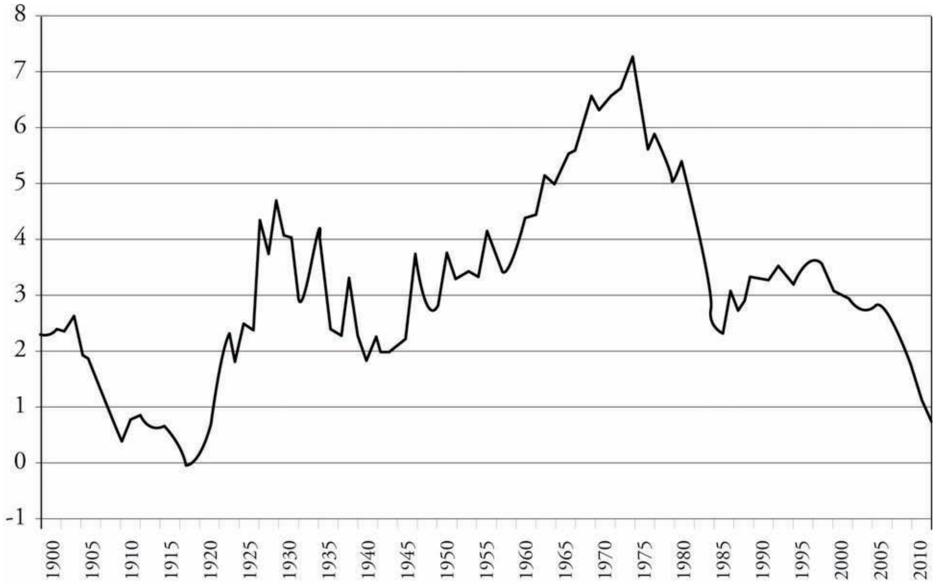
A prima facie sign that this ascension of intervention in Portugal weakened its capital base is the slowdown in economic progress after 1974. Figure 4 shows smoothed (ten-year moving average) Portuguese GDP growth rates from 1900 to 2010.

After a marked advance beginning in the late 1930s, the pace peaked in the early 1970s, and, except for a slight upward move in the late 1980s and early 1990s, the rate has steadily trended down to just higher than zero. Portugal's growth rate is astonishingly back to where it was in the late monarchical and early republican periods in the early twentieth century.

This retrogression has been reflected in Portugal's relative GDP per capita. Figure 5 helps us to recall that during the approximately forty-year reign of the Estado Novo, Portugal's GDP per capita, relative to twelve of its more developed western European peers, rose by 16 percentage points to 58 percent. From 1974 to 2008, the Estado Social converged by only an additional 7 percentage points to 65 percent (Madison 2010), which was less than the high of 69.3 percent reached in 2001.

Measuring capital is a problematic affair, given that it is not, as orthodox economists presuppose, a homogenous lump of resources, but rather a structure of

Figure 4
Smoothed (Ten-Year Moving Average) Annual Growth Rate of GDP Portugal, 1900–2010

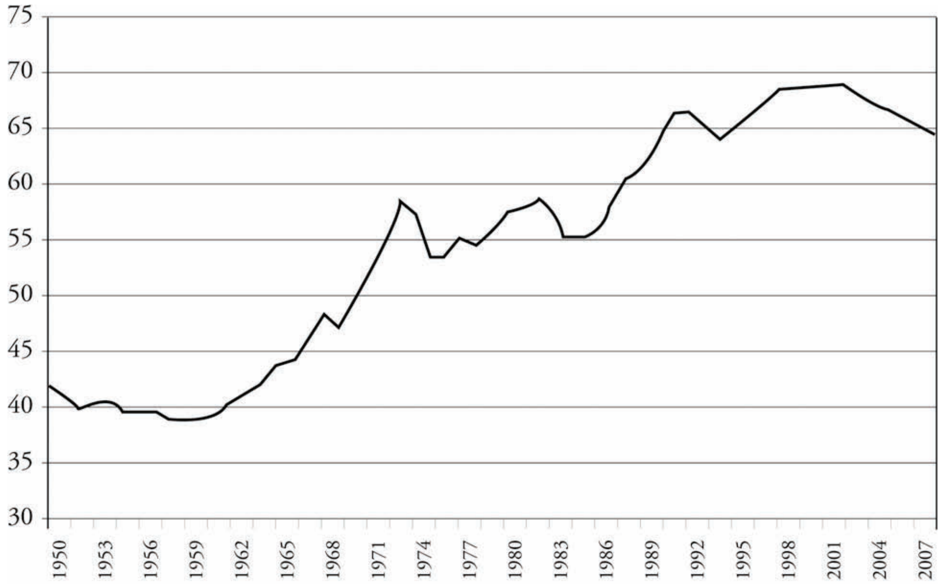


Sources: From data in Maddison 2010; European Commission 2011.

heterogeneous goods connected to different entrepreneurial plans to produce future output (Kirzner 1976). With this dilemma in mind, it is still worth noting that orthodox economists' calculations of capital accumulation and capital productivity indicate that these variables were greater in the last decades of the Estado Novo than they have been since the onset of the Estado Social (Neves 1996; Pereira and Lains 2010). Figure 6 depicts smoothed (ten-year moving average) annual growth rates in gross fixed capital formation. These rates were at double-digit levels in the early 1970s and have trended mostly downward since then. Over the past two years, this rough proxy of new capital investment has actually turned negative. With workers having relatively less additional capital at their disposal, labor productivity growth, as measured by GDP per hour, has similarly decelerated (figure 7).

Consider, too, what is uncovered when the post-1974 era is broken down into periodic segments. The period in which Portugal's economy performed best coincided with a phase in which the government took a decidedly more pro-market direction. During the mid- to late 1980s and early 1990s, when real GDP was regularly growing at annual rates higher than 3 percent and capital formation was steadily accelerating, Portugal joined the free-trade zone of the European Economic Community (1986), privatized much of what had previously been nationalized in the aftermath of the revolution, and stabilized the level of government spending.

Figure 5
Portuguese Real per Capita GDP as a Percentage of Advanced Western European Nations' per Capita GDP, 1950–2008



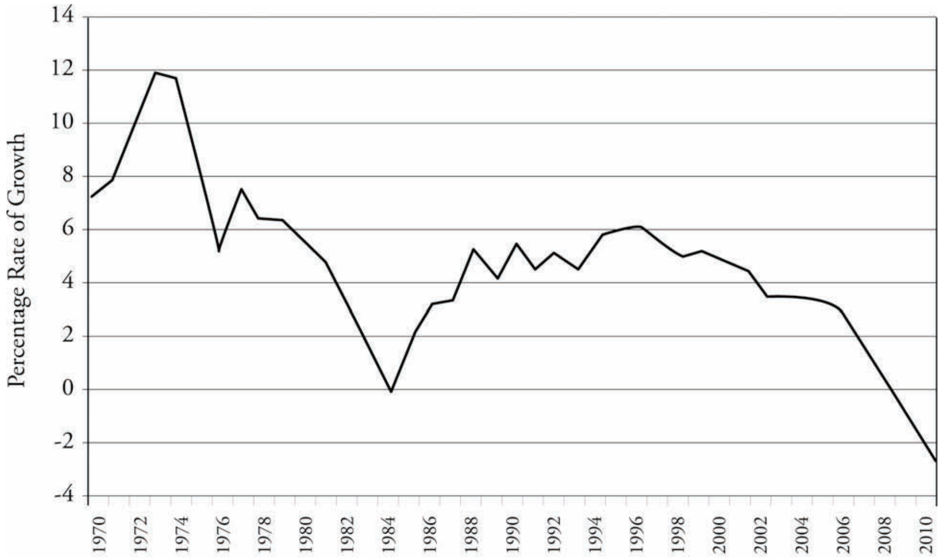
Source: From data in Maddison 2010.

By contrast, the worst subperiod since 1974, from 2000 forward, is associated with a rise in government intervention. In 2000, Portugal was ranked forty-fifth on the Heritage Foundation's Index of Economic Freedom. A little more than a decade later, in 2011, the country's position had worsened to a rank of sixty-ninth (Heritage Foundation 2011; Vasconcellos 2011).

By contrast, the standard account that zeros in on Portugal's accession to the euro cannot equally explain the country's difficulties. The strongest evidence in favor of this explanation is that Portugal's weakest economic performance in the postrevolutionary phase coincides with its use of the euro since 2002. Even earlier, in the previous decade, Portugal had to qualify for membership in the European currency union by running a tight monetary policy to contain inflation and get interest rates down to levels specified in the Maastricht Treaty. Although this period, running from 1990 through 2001, was not an especially poor one for the Portuguese economy, a noticeable slowdown occurred in economic growth, becoming more pronounced as the new millennium began. Both during this preparatory phase and thereafter, so the argument goes, Portugal lacked the ability to adjust its foreign exchange rate in order to render its exports more competitive on world markets.

The flaw in this reasoning, however, is that Portugal never lost the capacity to adapt to shifting international conditions through labor costs. As such, the standard

Figure 6
Smoothed (Ten-Year Moving Average) Annual Growth Rate of Gross Fixed Capital Formation, Portugal, 1970–2008

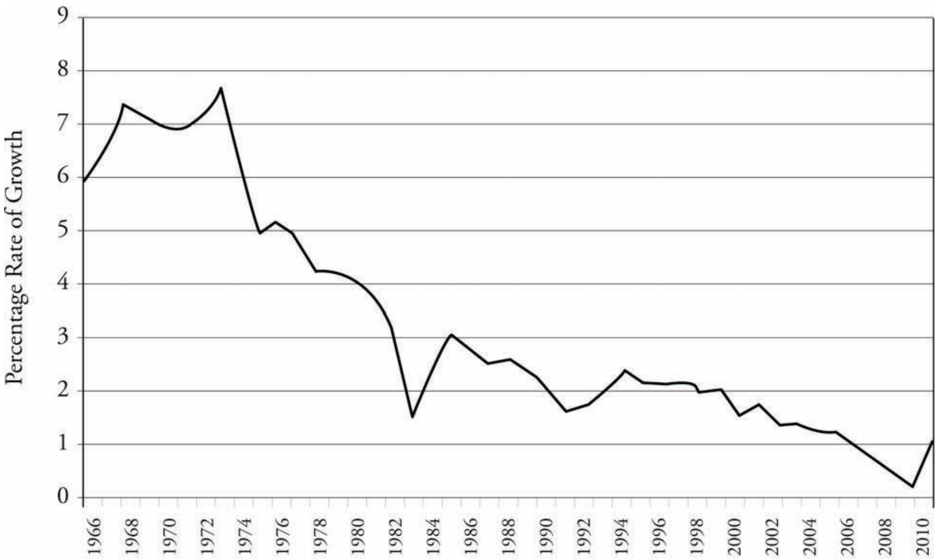


Source: From data in Pordata 2011.

appeal to the exchange-rate regime implicitly assumes that wage adjustments cannot be made. It is as if labor-market conditions are a fact of life on a par with death, which one cannot change but must simply accept. Of course, the conventional rationale for this assumption is the Keynesian story that workers do not readily accept reduced wages amid downturns in economic activity. In the Portuguese situation, though, we are not dealing simply with a matter of worker psychology common to all nations. We are confronted more specifically with a constitutional and legal order that greatly empowers labor or, to be more precise, the more organized segments of the workforce whose members have not been relegated to the more precarious situation of having to contract their services temporarily via the *recibo verdes.*

This pro-labor tilt made itself felt immediately after the 1974 revolution, when wages shot up—by 30 percent in 1975 alone—despite additions to the labor supply from the so-called *retornados* (Amaral 2010, 28), or people who had been living in the Portuguese colonies and returned to the metropole after the colonies became independent. A decade-long devaluation in the currency, which saw the escudo suffer an 87 percent drop against the U.S. dollar, brought wage rates back into line with worker productivity (Amaral 2010, 87). Bearing the brunt of this adjustment were consumers and firms that had to pay more for imported goods as well as holders of Portuguese financial and capital assets with a net long position in the escudo. According to the IMF, Portugal has the most rigid employment laws in the euro zone

Figure 7
Smoothed (Ten-Year Moving Average) Annual Growth of Real GDP per Hour, Portugal, 1966–2010



Source: From data in Conference Board 2011.

(2009, 20, 32). It is ranked 168th in the world in terms of labor freedom, dead last among developed nations (Vasconcelos 2010; Heritage Foundation 2011). Pedro S. Martins (2009) has confirmed that this rigidity has impaired firm performance. He found that small businesses partially exempted from the onerous burdens of Portugal's labor code after it was revised in 1989 subsequently outperformed larger firms that remained fully subject to the law. Nor is it any surprise, in view of this law, that the ascent in wages relative to labor productivity resumed in the 1990s and carried into the 2000s. Labor compensation per employee went up 68 percent from 1995 to 2008, whereas GDP per hour rose only 15 percent (Conference Board 2011; OECD 2011). Herein lie the roots of Portugal's competitiveness problem.

The Estado Social's investments in education have done little to correct this discrepancy by raising the productivity component implicit in the unit-labor-cost equation. The proportion of GDP devoted to education in Portugal tripled from 1.3 percent in 1974 to 5.2 percent in 2009, and the country ranks fifteenth in the world in spending per student relative to GDP per capita (Pereira and Lains 2010, 22; Pordata 2011). The notion that education is a major driver of growth has become fashionable among economists who appeal to human-capital theory (Becker 1975). Yet the evidence for a relationship between educational attainment and economic growth is more intricate than is commonly realized (Hanushek and Woessman 2008). Simply increasing the number of years attended among the country's population neglects the role played by the quality of the educational system in building cognitive skills. These skills—reflected by competency in math, reading, and science—correlate more strongly with economic performance.

The impact of education depends as well on the existing politicoeconomic structure. If this structure encourages productive activity by upholding the rule of law and private-property rights, then education will further prosperity. Otherwise, the educated classes are liable to devote their cognitive skills to rent-seeking activities. As discussed in the next section, the nature of Portugal's democratic regime suggests that a drift toward the latter scenario has developed. Moreover, Portugal's inflexible labor markets discourage the hiring of educated youth. The huge costs of dismissing workers mean that the higher productivity promised by schooling has to be all that much greater to convince employers to take a chance on recent graduates.

Education consists in large part of the socialization of youth in prevailing dogmas and values (Rothbard 2001, 827). Schools tend to prepare individuals for routine occupations; they do not generally cultivate the genius and creativity that successful entrepreneurs possess (Mises 1996, 314–15). Although education may increase people's income by equipping them with specific skills, a risk always remains that the investment will not pay off because the availability of relevant work is contingent on market demand (Mises 1996, 624–25). It is not education as such that increases productivity, but rather education that is geared ultimately to consumers' particular needs. It is doubtful that the state can fine-tune its allocation of educational funds to meet this imperative. The Portuguese state certainly has done little to allay these doubts. Youth unemployment is greater than 20 percent (Statistics Portugal 2011). Unionized teachers—the poor ones' being practically impossible to fire, given the country's labor code—have managed to capture an inordinate share of the funds invested in education. Their salaries represent 93 percent of expenditures compared to an average of 74.4 percent among OECD nations (Guichard and Larre 2006, 16). Authorities have also allocated too many resources to general education and too few to technical and vocational training (Guichard and Larre 2006, 20).

The most that can be said about Portugal's sizable investments in education is that the country's population now spends a greater number of years in school. Nevertheless, institutional shortcomings have still left Portuguese citizens lagging behind their European peers in this regard and performing around merely average levels on basic measures of reading and arithmetic (OECD 2010; Pereira and Lains 2010, 22–24). It is no wonder that businesses have been relatively leery to accumulate capital, which would enhance productivity and spur more rapid economic growth.

The Democracy Factor

Insofar as Portugal's economic troubles can be traced to government intervention, the country's issues are fundamentally political in nature. To be sure, economic problems are almost always political in that they are usually caused either by the state's interference in the market or by its effectively setting aside the price system in favor of bureaucratic diktats. But Portugal's experience allows us to probe more deeply into the political sources of subpar economic performance. After all, as I have just argued, the nation's predicament is the culmination of the policies implemented in constructing the Estado Social, which in turn originated in and evolved out of a regime change from autocracy to democracy. To what extent, then, does the democratic form of government bear responsibility for Portugal's ills?

This is a disturbing question to pose because the belief that democracy is the best type of regime is among the foundational opinions that go largely unquestioned in Western political life. The strength of this belief becomes especially obvious when opposition forces in a foreign country take up the cause of democracy in attempting to overthrow a reigning dictator or oligarchy. Western politicians and commentators with few exceptions typically support the democratization of the country at issue as a moral imperative, cautioning against it only in some instances because of the ugly necessities imposed by foreign-policy realpolitik. Even so, none of this has kept social scientists from investigating the relationship between democracy and economic growth. These cross-national inquiries, though, have not generated any firm conclusions. John F. Helliwell (1994) concludes that the impact of democracy is insignificantly negative; Robert J. Barro (1996) finds that it is somewhat negative; and a meta-analysis by Chris Doucouliagos and Mehmet Ali Ulubaşoğlu (2008) suggests that it is not detrimental. Dani Rodrik (1997) concedes the lack of a correlation between democracy and growth but argues that the economy exhibits less volatility in popularly elected regimes. One can justly question the presumption in these studies that they have disentangled democracy from myriad other factors that impinge on the economy. Because the absence and presence of democracy are so clearly marked in Portugal's recent history, Portugal offers the potential for an ideal case study that can illuminate an issue that social scientists, with their mathematical-empirical methods, have so far been unable to cut through.

Not being disposed to a wild enthusiasm for democracy and being open to the sort of qualitative analysis that conventional economists increasingly shun, the Austrian tradition offers a suitable framework to analyze Portugal's political dynamic, just as it did in analyzing the nation's post-1974 construction of a welfare state. Mises acknowledges democracy's superiority to the alternatives (2005, 19–25), yet he does so not because democracy is morally required to give substance to individual rights of autonomy or because the populace is morally and intellectually superior to elites or because it enables all to take part in the allegedly ennobling function of overseeing public affairs. Mises's case for democracy rests on the insight that the ultimate source of political power is the masses. Although power may appear to rest with the government, the reality is that those who exercise governmental authority are invariably outnumbered by those they rule. The populace need only combine to dispatch the governing elite. Although the latter have an army and internal-security forces at their command, these forces also outnumber the rulers. In a situation where the actual enforcers of the state's coercive machinery must choose between the people and the governors, the logic of numbers favors their siding with the former, especially when popular discontent becomes intense and widespread.

The upshot for Mises, who is following David Hume's (1987) analysis here, is that the government's authority rests fundamentally on public opinion. Because this opinion is subject to change, political institutions must be framed with a view to enabling these shifts to be reflected in the government's apparatus and policies with minimal disturbance to society. Where peace prevails, the market is left unperturbed from threats to private property. By making the governing classes regularly accountable to the electorate and laying out a ready-at-hand procedure to change the occupants of political offices periodically, democracy offers the least socially disruptive solution to the transition dilemma. Portugal paid the price of not having this democratic mechanism in place when public opinion eventually turned against the Estado Novo. A revolutionary overthrow became inevitable, precipitating the steep drop in Portugal's GDP from 1974 to 1976. Any analysis of democracy's role in Portugal's postrevolutionary economic performance must assign a significant measure of the blame for that initial tumble to the previous regime.

Moreover, the constraints that the dictatorship placed on the expression of public opinion in opposition to government policies served to radicalize the zeitgeist that ended up prevailing at the time of the revolution and subsequently influenced the 1976 constitutional settlement. When the people were faced with the prospect of arrest, torture, and forced exile, only the most ideologically committed, who also tend to be the most ideologically extreme, dared to work actively in opposing the Estado Novo. Though that regime was far from being pro-market in its economic approach, its association with elite business interests meant that the ideological tone of the opposition to it would take a decidedly anticapitalistic form.

The possibility cannot be discounted, however, that the climate of opinion in favor of democratic socialism simply reflected Portugal's intellectual traditions as well as the modes of thought fashionable at the time the country's postrevolutionary path was being determined. Had the revolution occurred not in 1974, but in 1984, in the wake of the Reagan–Thatcher movement, things might have developed differently. Even so, one searches in vain for a classical-liberal stream of thought in Portugal's past. What passed for liberalism during the first republic, which overthrew the monarchy in the early twentieth century, was Jacobin in its hostility toward religion and Rousseauian in its willingness to employ the state to force people to become equal and free (Espada 2010). Only one of the significant contemporary political parties, the Democratic and Social Center–People's Party, advocates free-market policies. It is the only party to have originally voted against the 1976 Constitution

(Robinson 2002, 180). Only on occasion has it won more than 10 percent of the vote in legislative elections.

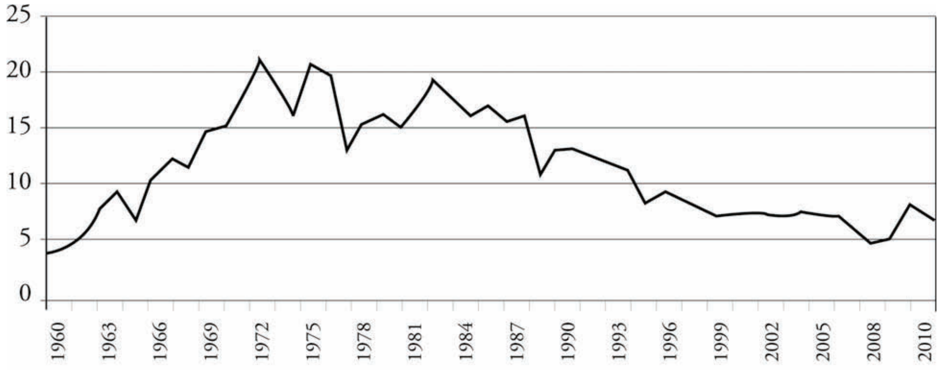
Mises's qualified support for democracy notwithstanding, he is not oblivious to such a regime's vices. Chief among them, for him, is the role political parties play (2005,121–32). Before liberalism and democracy gained ascendancy in the eighteenth and nineteenth centuries, parties did not exist. Instead, the prevailing hierarchical order meant that people almost always saw themselves instinctively as members of the caste or class into which they had been born. In this premodern world, the fundamental political divide separated the patricians and the plebeians, the nobles and the commoners, the lords and the serfs. After modern democracies institutionalized the liberal principle that everyone is free and equal before the law, individuals were liberated from the social pressure of having to identify with their initial position in a fixed social order and could instead choose their political allegiance. Political parties arose to obtain this allegiance with a view to securing the reins of democratic power.

But parties do so, Mises argues, by segmenting the people according to their special interests and offering privileges to particular groups at the expense of other groups. Such plundering flies in the face of the classical-liberal philosophy, which demands the sacrifice of one's short-term, particular interests for the greater and longer-term benefits to be gained from policies that advance the common good. To the extent that parties disregard this demand, the economy as a whole suffers from the burdens of government spending and from the various impediments and restrictions put in place to create privileges for favored groups. As one party succeeds another in providing distinct advantages to its supporters, however, matters are liable to reach a crisis stage in which each group effectively ceases to be privileged in having to fund its counterparts' benefits out of a shrunken economic pie. Much of this view prefigures Mancur Olson's (1971) thesis that in democracies small groups capture disproportionate gains at the expense of the larger community by having the costs of their privileges spread in negligible individual amounts. But in referring to the myopia that engenders this state of affairs, Mises also foreshadows the more radical critique of democracy by Hans-Hermann Hoppe (2001). On the premise that democracy socializes ownership of the state in conferring the holders of political office with a merely temporary control of societal resources, Hoppe argues that the governing classes have incentives to benefit themselves and their supporters at the expense of future generations, thus raising the society's effective time discount rate.

One way to check whether Hoppe's argument helps to explain Portugal's democratic experience is to compare savings rates before and after the 1974 revolution. Declining savings would be suggestive of people's discounting time at a higher rate.

Figure 8 illustrates that the saving rate rose throughout the 1960s as the increasing prosperity of the period enabled individuals to set aside a greater proportion of their income for the future. But after topping out in the 1970s, the saving rate has noticeably fallen with democracy's consolidation.

Figure 8
Portuguese Household Savings as a Percentage of GDP, 1960–2010



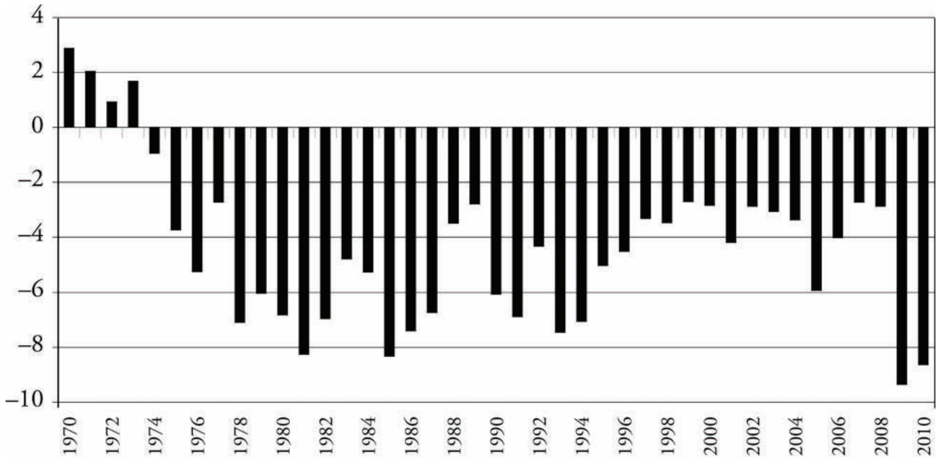
Source: From data in Pordata 2011.

Inasmuch as savings furnish the means for investments in capital goods, the shift to democracy thereby corresponds to a reduction in Portugal's growth capabilities. Besides contributing to escalating current-account deficits, steadily worsening since the late 1990s, Portugal's increasingly profligate spending has left the country's banks with relatively fewer customer deposits out of which to finance its loan portfolios. The upshot is that Portuguese banks are especially susceptible to the vagaries of the money markets for funding, a susceptibility that lately has driven them to depend on the European Central Bank ("The Winter of Living Dangerously" 2011).

The best way to determine whether the Mises–Hoppe understanding of democracy accounts for the Portuguese case, however, is to consider the government's budgetary record. If special-interest considerations are indeed driving political decision making, the resulting battle for advantage will show up in persistent budget deficits. As each interest group seeks to pass on the costs of its privileges to others and simultaneously defends itself from the impositions of opposing groups, the net effect will be to leave the least powerful players in the democratic process with the burden of payment. In a democracy, power correlates with representation, and future generations form a group deeply affected by government budgets but necessarily lacking a current vote. Hence, they are the ones most likely to be stuck with the bill for previous generations' profligacy.

As figure 9 makes abundantly clear, Portugal's government accounts since the establishment of democracy testify to a political process infected by political parties' narrow, self-serving behavior. After regularly balancing the budget and running surpluses in the Salazar and Caetano regimes prior to 1974, Portugal has not once managed in the thirty-seven subsequent years to avoid a deficit. That this situation only recently has mushroomed into a full-fledged debt crisis reflects the large borrowing capacity bequeathed by the frugality of the Estado Novo. Reinforcing the

Figure 9
Annual Portuguese Government Budget Balance as a Percentage of GDP, 1970–2010



Source: From data in Bank of Portugal 2011.

party-and-special-interest dynamic at play here is the fact that the country's system of proportional representation conduces to minority governments. Of the nineteen administrations since the 1976 Constitution, only three have held majorities in the Legislative Assembly. Coalition governments magnify the leverage of political parties and their special-interest backers by giving them veto power over proposed legislation (Pereira and Singh 2009).

Another telling sign that factionalism is bedeviling a political system is recourse to an outside entity to resolve domestic problems. Whenever the situation becomes dire and rival political players refuse to cooperate in forging a solution, resort to an external agency becomes an enticing means of breaking the deadlock. Such an agency can allow one of the sides in the domestic political struggle to impose its will under the guise that a larger power requires that imposition. Or the agency may enable all sides to follow the cooperative scheme it has laid down while permitting each side to rationalize the necessary concessions by telling its supporters that someone else forced its hand. This process has manifested itself in a number of instances during Portugal's democratic period. In both 1979 and 1983, balance-of-payments difficulties eventually led the country to seek IMF assistance. Portugal's decision to join the euro system can also arguably be seen as an appeal to an outside force in an attempt to overcome the political impetus that had previously given way to continual inflation and currency depreciation. The country's recent plea for assistance from the EU and IMF only confirms this pattern.

We need not rely simply on the machinations of special interests to account for Portugal's political failings, though. It is no coincidence that an extensive welfare state suddenly developed in Portugal after the populace was given a voice in political decisions. After all, majorities can readily be persuaded to vote for politicians who offer the full menu of social-democratic services, especially among those who expect to gain more in government services than they pay for them, with the prospect of shifting the costs to the wealthy. But as the welfare state expands and the reserve fund that can be appropriated from the rich becomes insufficient, taxes have to be raised in general in order for the budget to be balanced. Politicians have little incentive to increase taxes because by doing so they are apt to lose votes to competing parties. Even when a voter recognizes that government-provided benefits are going to have to be paid for at some point, the remoteness of that occurrence strikes his mind less vividly than the present pain of losing those benefits or of having to incur a tax now to fund them (Buchanan 1977, 101–9). The easier course to follow is to run deficits, thereby relying on the bond market to finance the social-democratic regime over the short and medium terms, leaving the resulting long-term burdens to be shouldered by the young, the unborn, or our hazy future selves. As Portugal's perpetual deficits amply attest, its governing class has been addicted to this prodigal strategy. Prior to its inclusion in the euro area, Portugal could evade hard political choices simply by having the central bank print money to pay off the continually accumulating debt. After inclusion, this option was cut off for the country's democratic rulers. It was then only a matter of time for the improvidence of the country's spending and borrowing to be exposed.

Conclusion

As I write, Portugal stands on the precipice of default. Contrary to much of the conventional wisdom, it has not come to this pass simply because of its inclusion in the euro group. Its troubles go back further, to the immediate aftermath of the country's 1974 revolution. At that time, the fateful constitutional decision was made to install a social democracy amid the remnants of the preceding dictatorship known as the "Estado Novo." In the ensuing three and a half decades, the Estado Social would grow to nearly half the size of Portugal's economy. The intervention in the marketplace entailed in this growth has undermined capital investment, leaving the economy in a moribund condition. To make matters worse, Portugal's democracy has succumbed to the regime's vulnerability to political parties' shortsighted rent seeking. The costs of the Estado Social consequently have never been fully paid by its current beneficiaries and instead have been passed on to future generations through the buildup of public debt. That future bill has now become a present reality.

Portugal's plight is a warning to other Western industrialized nations, all of which have welfare states of one extent or another to finance. The graying of the population, portending relatively fewer workers to pay escalating pension and health-care benefits, combined with the additional debt amassed by governments in dealing with the recent financial crisis, poses a monumental challenge to governments faced with the expenses of maintaining their respective welfare states. Portugal is among the first to succumb to this challenge only because it expanded its social democracy relatively quickly and had a smaller capital accumulation from which to draw resources for the delivery of public services.

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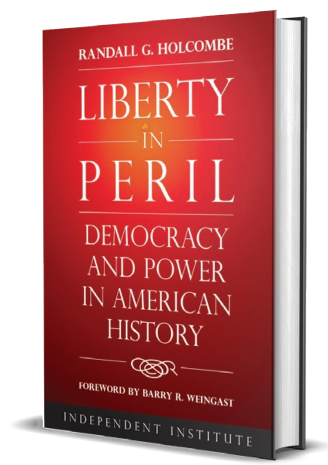

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