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Portugal: Labour Market Reforms – A Summary of main problems and actions taken

- Implementation of labour markets reforms has progressed substantially since Portugal entered its EU-IMF financial assistance programme of fiscal adjustment and reform in May 2011.
- Portugal has managed to address partly one of its key problems in the labour market of strict employment protection legislation (the highest in the OECD) by reducing severance payment and relaxing the protection against individual dismissals.
- Substantial indications exist that labour market reforms have improved the competitive position of Portugal. The OECD index for the Employment protection Legislation places Portugal eight positions lower compared to 2008.
- The unemployment insurance system - among the most generous in Europe- was revised in terms of benefit level and duration.
- Working time arrangements have been eased by cutting in half additional pay for overtime and increasing the hours worked.
- Wage bargaining and working conditions have been decentralized and now collective agreements can be concluded by work councils in companies with more than 150 employees.
- Labour market reforms in the area of employment protection legislation and unemployment benefits could raise labour productivity by 1.7 percentage points and decrease unemployment rate by 1.8 p.p. over a 10-year horizon.
- In a future edition, we will describe the differences and similarities with Greek labour reforms.

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Overview

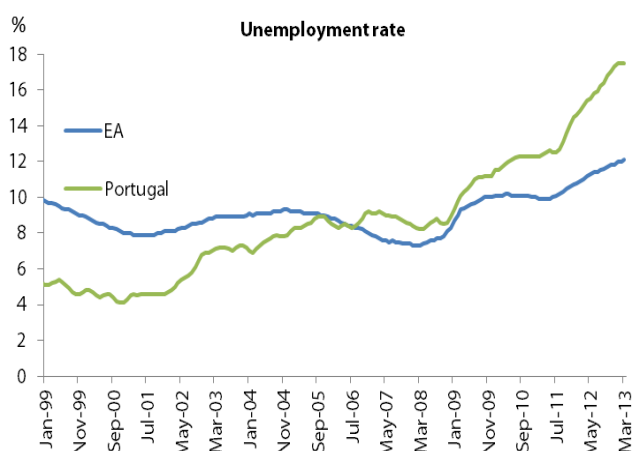
The current sovereign debt crisis has acted as a catalyst for structural reforms, particularly in the euro area in countries that asked for assistance from the European Union and the IMF. In most countries one of the main reform objectives is to improve labour market performance to help rebalance the economies and return to growth. Portugal's highly inefficient labour market has

weighted both on wage and productivity developments and, in turn, on the country's competitiveness. Therefore, under its far-reaching reform programme, Portugal aims at increasing labour market flexibility in order to stimulate employment, lower labour costs and intensify competition. In this note we assess the progress of labour market reforms in Portugal and present estimates of the effects of the structural reforms on the labour market.

Labour market conditions have deteriorated sharply since 2008

The global economic slowdown along with the recession in the euro area has triggered a marked increase in job losses in Portugal. The latter have led to soaring unemployment, exacerbating the costs of long standing labour market weaknesses. The unemployment rate for the population as a whole, at 17.5% in March 2013 (Figure 1), has more than doubled since 2008, while for those under 25 reached 38% from about 20% in 2008 (Figures 2).

Figure 1



Source: Eurostat

Figure 2

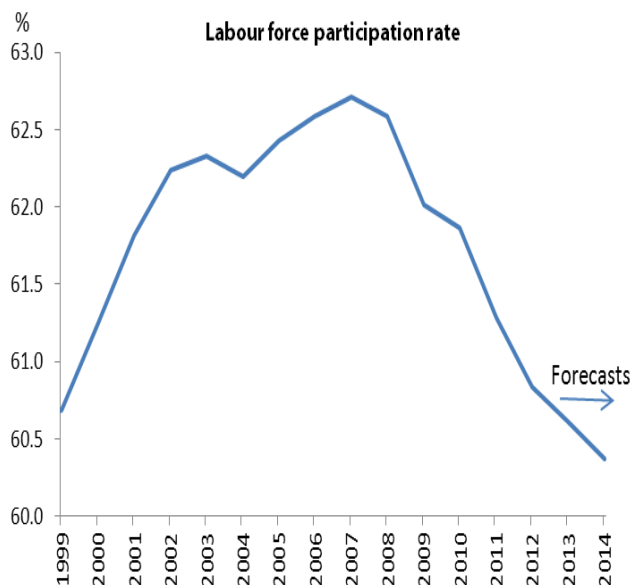


Source: Eurostat

Other key labour market indicators provide further evidence of rising distress in the labour market. Labour force participation rate continued to decline, since weak economic outlook discouraged people from staying in the labour market (Figure 3). Employment

in Portugal declined by an average of 4.5% y-o-y in 2012 (the lowest level since 1998) (Figure 4), with employment losses highly concentrated on the construction, manufacturing, public administration and defense and the wholesale & retail trade sector (Table 1).

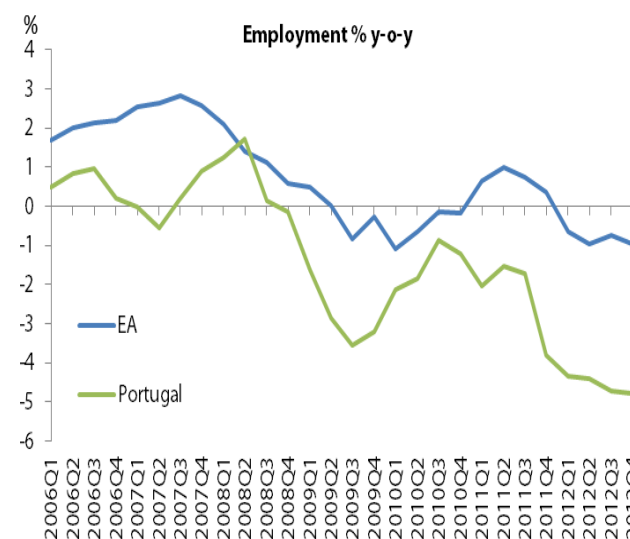
Figure 3



Source: OECD Economic Outlook Source: Eurostat

Source: Eurostat

Figure 4



Source: Eurostat

Table 1

Cumulative Employment Losses in 2012 by sector

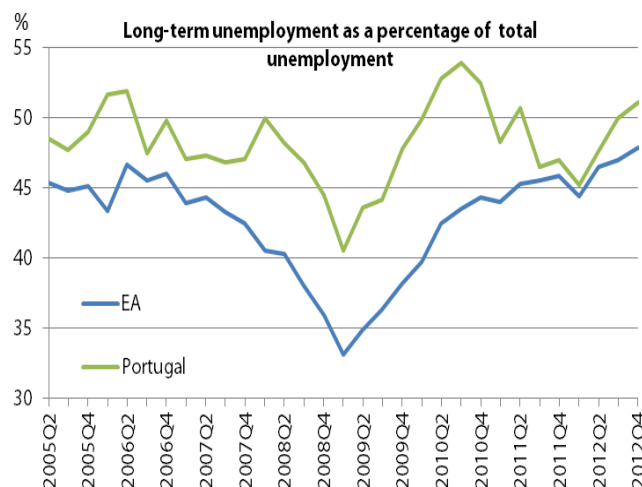
(Thousand people)	Portugal
Total	-213.1
Agriculture, forestry and fishing	11.9
Mining and quarrying	-4.6
Manufacturing	-45.2
Electricity, gas, steam and air conditioning supply	-4.5
Water supply; sewerage, waste management and remediation activities	-3.5
Construction	-106.1
Wholesale and retail trade; repair of motor vehicles and motorcycles	-28.7
Transportation and storage	8.0
Accommodation and food service activities	-9.1
Information and communication	16.2
Financial and insurance activities	-13.5
Real estate activities	1.0
Professional, scientific and technical activities	-14.6
Administrative and support service activities	10.9
Public administration and defence; compulsory social security	-30.9
Education	14.0
Human health and social work activities	-4.3
Arts, entertainment and recreation	-1.7
Other service activities	-4.7
Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use	-3.2

Source: Eurostat

Another issue of major concern is the number of people unemployed for more than a year, namely long-term unemployed, which represents more than half of the total unemployed in Portugal (Figure 5), an indication of the high inflexibility of the labour markets.

According to the European Commission's assessment of the Portuguese program, the worse-than-expected developments in Portugal's labour market are due to the stronger-than-expected contraction of economic activity and the significant adjustment in employment in the public sector. Accordingly, the IMF's latest projections suggest a further deterioration of unemployment, with the rate picking up to 18.5% in 2014 and starting to decline thereafter. The continued increase in short-term unemployment, together with the low transition rate from unemployment to employment is expected to lead to a further rise in long-term unemployment.

Figure 5



Source: Eurostat

Labour market rigidities also contributed to high unemployment

While the economic downturn had a severe impact on labour market conditions, labour market rigidities that intensified with the crisis have also contributed to high unemployment. In Portugal, strict employment protection legislation favored permanent job contracts, suggesting that employers were reluctant to hire new staff on a permanent basis. Consequently, most hirings were done on short-term contracts, making the labour market highly segmented. Shortcomings in wage setting mechanism and strong minimum wage increases in 2007-2010 contributed to a sharp rise in joblessness. Meanwhile, Portugal's unemployment insurance system was one of the most generous in the EU, providing disincentives for unemployed persons to seek for a job.

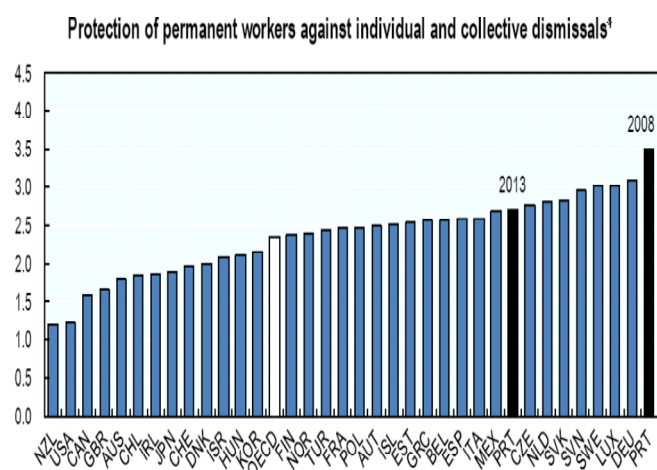
The worsening of macroeconomic and labour market conditions in Portugal forced policymakers to tackle the abovementioned structural problems. Thus, in the context of financial assistance programme by the EC and IMF, Portugal has introduced far-reaching labour market reforms to make the labour market more dynamic and efficient. Particularly, on 18 January 2012, Portugal's government and main social partners concluded a tripartite agreement which reforms the Labour Code and substantially reduces rigidities by lowering severance pay, unemployment benefits and duration, easing the definition of fair dismissals, making working hours more flexible and facilitating collective agreements at company level. In the following section, we present Portugal's labour market reforms in four key areas: employment protection legislation, unemployment insurance system, working time arrangements and wage-setting mechanisms. In each of them we describe the main characteristics before and after the reforms.

Reforming the labor market in Portugal

Employment protection legislation

In Portugal, there was a large gap in protection legislation between open-ended and temporary contracts, making the latter more attractive to the employers and, thus, hampering the creation of permanent jobs. In particular, when a firm wanted to lay off staff during a downturn, temporary workers whose contracts were coming to an end were made more easily redundant than permanent workers. Indeed, before the crisis Portugal had the highest protection legislation for regular workers in the OECD (Figure 6). In order to tackle the ensuing labour market segmentation, foster job creation and ease the transition of workers across occupations, firms and sectors, the government has taken substantial steps towards aligning the legislation with that of peer countries. These steps include the relaxation of the protection against individual dismissals and the reduction of severance pay.

Figure 6



* Weighted average of two sub-indices: protection of permanent workers against individual dismissal and specific requirements for collective dismissal. Scale from 0 (least stringent) to 6 (more restrictive)

Source: OECD, "Portugal Reforming the State to Promote Growth", May 2013

Severance payment

Portuguese employees have enjoyed one of the most generous systems in the developed world, receiving up to 30 days' pay for every year worked. The high cost of potential layoffs has discouraged companies from hiring workers. With the view of improving efficiency and reducing labor market duality, the level of severance payments for permanent contracts has been aligned to those of fixed-term contracts. The law is applied to all contracts while protecting acquired rights. Particularly, for new permanent contracts concluded after 1 November 2011, severance payment

has been reduced from 30 days salary to 20¹ days salary per year worked (approximately the EU average). For existing contracts, severance payment has been cut to 18 days for each of the first three years of the contract and 12 days for subsequent years. The maximum amount of compensation cannot exceed 12 months (previously there was a floor of 3 months). Half of the compensation is paid by the employer and half by a new employment compensation fund, exclusively financed by employers, created to pay part of the cost of dismissals.

Unsuitability and extinction of work position

Until recently individual dismissals were only possible through the extinction of work position, due to the introduction of new technology. In addition, extinctions were following pre-defined seniority order. In order to increase flexibility within the companies, with a view to fight labour market segmentation and raise the use of open-ended contracts, the government eased the definition of fair individual dismissals. Under the new law, individual dismissals based on unsuitability are possible even without the need to introduce new technology. The employer, now, does not need to follow a tenure rule to proceed with dismissals based on the extinction of the job. When an individual dismissal for the above reasons takes place, the employer is not obliged to transfer the employee to another suitable position in the firm.

Unemployment benefits

Portugal's unemployment insurance system in terms of benefit level and duration was one of the most generous among the EU countries, providing disincentives for seeking re-employment. Particularly, benefit duration increased with age, while tight eligibility requirements limited the coverage of young workers and excluded the self-employed. In order to encourage earlier return to labour markets and reduce the risk of long term unemployment while strengthening social safety nets, the government reviewed the duration and the amount of unemployment benefits. In particular, the maximum duration of unemployment insurance benefits was reduced from 38 to 26 months. Unemployment benefits are now capped at 2.5 times the social support index (IAS, an amount close to the monthly minimum wage) from 3 times previously, with a 10% reduction after six months of unemployment. The necessary contributory period to have access to unemployment insurance was reduced to 12 months from 15. However, according to OECD estimates, the duration remains age-dependent, since the larger cuts of the duration of unemployment insurance for older workers are partly offset by longer provision of unemployment assistance². Furthermore, unemployment benefits have been extended to certain self-employed categories and particular to those workers

¹ In December 2012, the Portuguese government addressed to the Parliament a proposal to further reduce severance payments up to 12 days per year.

² See "OECD Economic Survey of Portugal 2012" for more details

that obtain more than 80% of their annual income from a single entity.

Working time arrangements

Overtime

In order to reduce overtime costs and increase flexibility in production cycle, additional pay for overtime has been cut in half. Whereas at present employees are paid 50 per cent extra for the first hour of overtime worked, 75 per cent extra for additional hours and 100 per cent extra for overtime on holidays and Sundays, the rates are now 25 per cent, 37.5 per cent and 50 per cent. Other amendments include the removal of the 25% compensatory time-off per hour of overtime.

Bank of Hours - Holidays and Vacations

In order to reduce unit wage costs and boost productivity, the authorities have opted for an increase in hours worked rather than employment losses. In particular, working time was made more flexible through "banks of hours" for individual workers or group of workers. The company may now directly negotiate with the worker up to 150 hours a year³ (i.e. a pool of 150 working hours per employee which is not paid as overtime), within the limit of two additional hours a day and 50 additional hours a week. Moreover, the authorities implemented an increase in working time of up to seven days per year, cutting paid annual leave entitlement from 25 days to 22 days and scrapping four national public holidays.

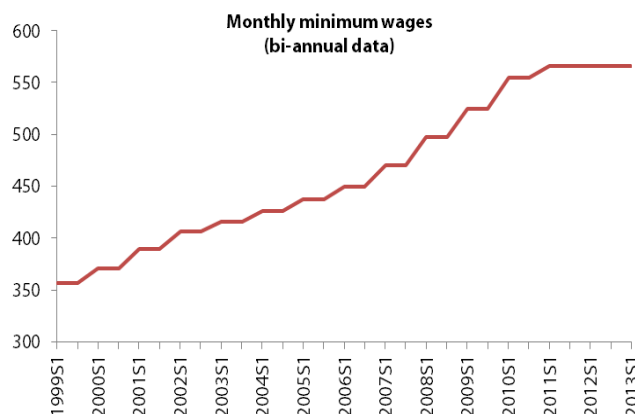
Wage Setting

Portugal's authorities introduced measures to decentralize wage determination and working conditions, so as to link wage adjustments more to firm-level productivity. Thereby companies will have more flexibility to adjust to changing market conditions. Until recently, wage bargaining was mainly taking place at the sectoral level between trade unions and employers associations. As a result, smaller companies were obliged to pay the same rates as big industrial groups. Also, trade unions were able to delegate on working councils in companies with a workforce of more than 500. In order to reinforce firm-level bargaining and promote efficiency, authorities reduced that threshold and now collective agreements can be concluded by work councils in companies with at least 150 employees. Further, any extension of collective agreement to the sector level is limited only to those agreements subscribed by employers' associations that employ more than 50 percent of workers in a sector.

Following the strong minimum wage increases in 2007-2010 (5.3% per year on average) and a further rise of 2.1% in 2011 (Figure 7), minimum wage increase has effectively been frozen under the program, with the commitment that any increase will

take place only if justified by economic and labour markets developments.

Figure 7



Source: Eurostat

Impact of labour market reforms on labour productivity and unemployment

Unlike consolidation measures, structural measures require a substantial period of time to show their full impact on the economy. Several studies that have been conducted on the quantitative effects of structural reforms suggest that significant improvement started to show in the labor market after a ten-year period. Bouis and Duval (2011)⁴ link together a range of existing OECD empirical studies of the links between structural policies and productivity or employment. Particularly, they find that relaxing employment protection legislation in Portugal could yield gains of 0.7 percentage points and 1.7 p.p. of labour productivity at 5 and 10-year horizons, respectively (Table 2). Furthermore, reforms of unemployment benefit systems could yield a decline in unemployment of 0.8 p.p. and 1.8 p.p. at 5 and 10-year horizons, respectively.

Table 2
Potential Yields of Labour Market Reforms

Labour Market Reforms	Shock Variables	In 5 years	In 10 years
EPL	Labour productivity, level	0.7 p.p.	1.7 p.p.
Unemployment Benefit Reform	Unemployment rate	-0.8 p.p.	-1.8 p.p.

Source: Bouis, R. and R. Duval, 2011

⁴ Bouis, R. and R. Duval, 2011, "Raising the Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond", OECD Economic Department Working Papers No. 835

³ 200 hours previously through collective bargaining only

Conclusions

Overall, Portugal has made a good progress over the past two years to make the labour market more dynamic and efficient. Significant reforms under the adoption of a new labor code include the revision of unemployment insurance system, the revision of employment protection legislation, the easing of working time arrangements, and the promotion of labour cost developments consistent with job creation and enhanced competitiveness (Table 3). Indeed, there are some indications that labour market reforms have improved the competitive position of Portugal. The OECD index for the Employment protection Legislation (EPL) places Portugal eight positions lower compared to 2008 (Figure 8). Nevertheless employment protection still remains higher from the OECD average and, thus, it could be reduced further.

Encouragingly the outlook for labour market conditions in the next quarters has started to show some positive signs. According to the European Commission Business Survey, leading indicators of hiring intentions suggest that the rate of deterioration in the intended demand for labour might have stabilised. As Figures 9 depicts, in Portugal the intended demand for labour over the next three months shows a less dramatic contraction compared to the one occurring particularly during the last part of 2012. Employment plans worsened slightly only in the services sector.

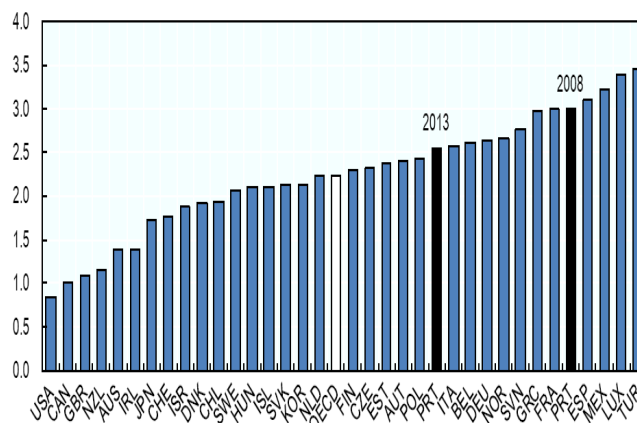
Furthermore, according to a survey, conducted by Macrometria, that reviews the progress Portugal has achieved so far in the Financial and Economic Assistance Programme, the assessment of labour market reforms improved relative to the last quarter of 2012⁵. Indeed, the survey point out that although the unemployment is expected to continue to deteriorate, labour market reforms should support a fast decline once the recovery takes hold.

All in all, labour market reforms are crucial to help rebalance Portugal's economy and promote growth. The authorities should continue with the implementation of the reforms without delay, to protect the economy and social cohesion from the threats stemming from high and persistent unemployment and a shrinking labour force.

Figure 8

OECD employment protection overall indicator*

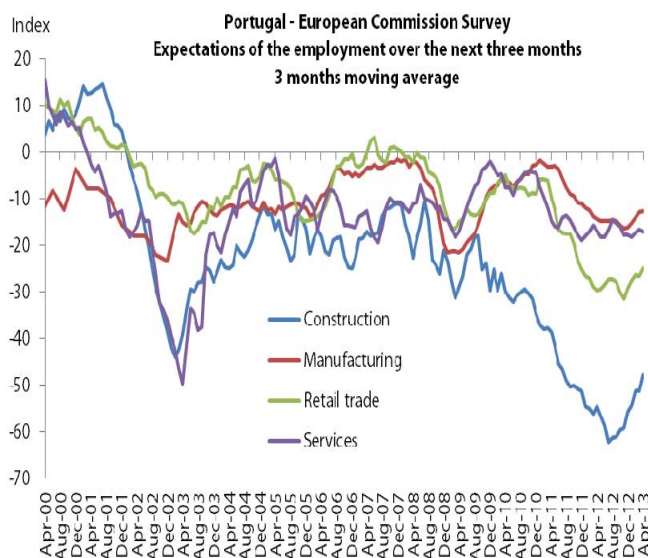
(Strictness of employment protection legislation, Scale from 0 (least stringent) to 6 (more restrictive))



* Weighted average of three sub-indices: protection of permanent workers against (individual) dismissal, regulation of temporary forms of employment and specific requirements for collective dismissal.

Source: OECD, "Portugal Reforming the State to Promote Growth", May 2013

Figure 9



Source: Ecwin, Eurobank Research

⁵ Macrometria, "Survey on the Portuguese Adjustment Programme – Q1 2013", February 2013

Table 3
Labour Market Reforms in Portugal

Area	Sub-area	Before	After	Goal
Unemployment Insurance	Unemployment Benefits	Capped at: <ul style="list-style-type: none"> • 38 months • 3xIAS • Min. contribution period 15 months 	Capped at: <ul style="list-style-type: none"> • 26 months • 2.5xIAS with 10% reduction after 6 months • Min. contribution period 12 months • Extension to self employed 	<ul style="list-style-type: none"> • Reduce risk of long term unemployment • Encourage earlier return to labour market • Reduce contribution period that gives access unemployment insurance
Employment Protection	Severance Payment	<ul style="list-style-type: none"> • 30 days per year • 36 days for fixed-term contracts 	<ul style="list-style-type: none"> • Now: 20 days per year • Nov: 8-12 days • Cap: 12 months 	<ul style="list-style-type: none"> • Improve efficiency and eliminate labour market duality
	Unsuitability and Extinction of Work Position	<ul style="list-style-type: none"> • Unsuitability only possible with introduction of new technology • Extinction follow pre-defined seniority order 	<ul style="list-style-type: none"> • Elimination of the new technology requirement • Elimination of the pre-defined seniority order 	<ul style="list-style-type: none"> • Implement flexibility on labour markets through effective mechanisms of internal flexibility within companies
Working time Arrangements	Overtime	<ul style="list-style-type: none"> • Maximum additional pay for overtime 100% • Compensatory time equal to 25% overtime 	<ul style="list-style-type: none"> • Maximum additional pay for overtime limited to 50% • Elimination of compensatory time off 	<ul style="list-style-type: none"> • Reduce overtime costs, increase flexibility in production cycle (peak periods)
	Bank of Hours	<ul style="list-style-type: none"> • Bank of hours negotiated through collective bargaining, capped at 200 hours 	<ul style="list-style-type: none"> • Introduction of individual bank of hours, capped at 150 hours • Collective bank of hours 	<ul style="list-style-type: none"> • Improve production capacity adjustment to peak periods without increasing personnel costs
	Holidays and Vacations	<ul style="list-style-type: none"> • Vacations: up to 25 days • Holidays: 13 days 	<ul style="list-style-type: none"> • Vacations: up to 22 days • Holidays: 9 days 	<ul style="list-style-type: none"> • Improve productivity
Wage Setting	Collective Agreements	<ul style="list-style-type: none"> • Bargaining made through trade unions • Work councils can negotiate in corporations with more than 500 employees 	<ul style="list-style-type: none"> • Trade unions can delegate on working councils in corporations above 150 employees 	<ul style="list-style-type: none"> • Reinforce firm-level bargaining and promote efficiency

Source: Portuguese Treasury and Debt Management Agency, Investors Presentation, "Portugal: Moving Ahead", May 2013

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