

OECD ECONOMIC SURVEY OF PORTUGAL 2004:
AGEING-RELATED PRESSURES ON PUBLIC FINANCES

*This is an excerpt from the OECD Economic Survey of Portugal, 2004,
from the section on pressure from population ageing in chapter 3*

Pressure from population ageing on the pension systems

Steps were taken, starting in 2000, to improve the general pension regime sustainability

3.24 As in almost all OECD countries, ageing is affecting the Portuguese social security system. Some political concern on this issue arose in the second half of the 1990's, leading to the appointment of a Commission of Experts. The Commission published a White Paper on Social Security (*Livro Branco da Segurança Social*, 1997), which forecasts that the social security system would move into deficit between 2010 and 2015. As a response, in 2000, the Parliament approved a new Social Security Framework Law⁷⁴ that clearly separated contributory and non-contributory schemes and defined specific and adequate financing sources for each scheme (Box 3.3). The Framework Law also established the principles of a new disability and old-age pension benefit formula, which was defined in February 2002.

3.25 The new benefit formula for disability and old-age pensions, which had been established under the 2000 Framework Law was finally defined in early 2002. The revised formula takes into account the entire contributory career (capped at 40 years), while the formula applied until then had considered the average compensation of the best 10 out of the last 15 years. The wages on which benefits are based are either re-evaluated based on the CPI (excluding housing) for the period prior to 2002, or in the case of the 2002-2011 period, based on a composite index which combines the CPI and the average increase in earnings.⁷⁵ When record of past wages do not exist, some official estimate will be made according to job category and activity sector. For beneficiaries having contributed for more than 20 years, the accrual rate is based on a progressive schedule ranging from 2 to 2.3 per cent.⁷⁶ To guarantee the protection of acquired rights, a grandfather clause has been introduced to protect all workers having already completed the vesting period -- 15 years of contributions -- at the end of 2001 and all workers who began working before 2002 and are to retire before the end of 2016. These will get the most favourable pension value out of the following three benefit formulas: *i*) old formula; *ii*) new formula; *iii*) transition formula that corresponds to a weighted average of the old and the new formula, where the weights are the number of years of contributions until and after 2001, respectively. Workers who began to work before the end of 2001 and are to retire after the beginning of 2017 will get the more favourable pension value out of the following two benefit formula: *i*) new formula; *ii*) transition formula. For workers who started to work after 2002 the new formula is the only one which is applicable.

Box 3.3. Social security under the 2000 Social Security Framework Law

In Portugal, the mandatory public scheme of social security for private workers¹ is a typical first-pillar pay-as-you-go system, which is organised in three subsystems according to their purpose and their financing source.

- The Contributory/Insurance Subsystem comprises all pensions and income-substitution benefits of contributory nature (general regime). Contributions, which are based on wages, are paid by both employees and employers.² An amount ranging from 2 to 4 percentage points of the employees contribution, as well as general regime surpluses and capital gains, should in principle be channeled to the social security reserve fund (*Fundo de Estabilização Financeira da Segurança Social*, FEFSS). Regarding minimum pensions,³ the difference between the social pension and the statutory pension (the social complement) is considered to form part of the non-contributory regime (*Regime Não Contributivo e Equiparados*, RNCE) and thus financed exclusively by the state budget.
- The Solidarity Subsystem, comprises the non-contributory or low contribution regimes -- *Regime Não Contributivo e Equiparados* (RNCE), *Regime Especial de Segurança Social das Atividades Agrícolas* (RESSAA) and the former railways workers' regime, as well as social insertion income (formerly called the minimum guaranteed income), all of which are exclusively financed by the state budget.
- The Family Protection Subsystem, comprises expenditure for family protection, active labour market policies and vocational training, as well as all other family benefits, such as the family subsidy and complements for deficiency and dependency, is financed by employers, employees and the state budget (with 50 per cent of the family protection expenditure being financed by earmarked value-added tax revenues).

Social Action, mainly run by private non-profit institutions, is also exclusively financed by the state budget.

1. There is also a mandatory scheme for civil servants (see below) and a special (privately-run) trust scheme for bank and insurance employees.
2. The general contribution rates are 11 per cent for the employee and 23.75 per cent for the employer; several lower contribution rates exist for: *i*) schemes with less coverage; *ii*) employers belonging to the non-profit sector; *iii*) agriculture and fisheries workers; *iv*) and as a stimulus to employment for several categories of workers. There is also a voluntary regime, for those not covered by the mandatory regime.
3. Law 17/2000 established a fixed ratio between the minimum pension and the minimum wage as from 2004; until 2003, the minimum pension was to reach the value of 40 000 escudos (around 200 euros) per month. Later, the government announced a convergence path between the minimum pension and some pre-determined fraction of the minimum wage.

3.26 National official projections on the long-term effect of ageing on social security were carried out in the context of the European Union and are included in the National Strategy Report presented in 2002.⁷⁷ According to these projections, in light of the expected ageing of the population from 2000 to 2075, social security expenditure is projected to grow by 1.8 percentage points of GDP under the 2000 Social Security Framework Law, from 9.3 per cent to 11.1 per cent (Table 3.2, Panel A). Revenues are expected to decrease by 1.5 percentage points, from 10.9 per cent to 9.4 per cent of GDP. As a result the system moves into deficit as from 2016 onwards, reaching a deficit of 1.7 per cent of GDP by 2075. The reserve fund would have a zero balance as early as 2029. A comparative projection exercise made in line with the old social security framework gave similar results: a negative balance would be registered from 2018 onwards, the deficit reaching 1.6 per cent of GDP by 2075 (Table 3.2 Panel B). The reserve fund would have a zero balance by 2032.

Table 3.2. Social security account: official projections¹

	Percentages of GDP						
	2000	2010	2020	2030	2040	2050	2075
Panel A. Social Security Framework Law 17/2000 (including the benefit formula defined in 2002)							
Pension expenditure	6.1	7.1	7.3	7.5	7.7	7.7	7.8
Soc. Sec. expenditure	9.3	10.3	10.5	10.7	10.9	10.9	11.1
Soc. Sec. Revenue	10.9	10.8	10.2	9.6	9.5	9.4	9.4
Current balance	1.6	0.5	-0.3	-1.1	-1.4	-1.5	-1.7
Reserve Fund balance	3.4	11.0	7.1	0.0	0.0	0.0	0.0
Panel B. Social Security Framework Law 28/1984							
Pension expenditure	6.1	7.0	7.2	7.4	7.7	7.8	7.7
Soc. Sec. expenditure	9.3	10.3	10.3	10.6	10.9	11.1	11.0
Soc. Sec. Revenue	10.9	10.8	10.3	9.7	9.5	9.4	9.4
Current balance	1.6	0.5	-0.1	-0.8	-1.4	-1.7	-1.6
Reserve Fund Balance	3.4	11.2	8.2	1.4	0.0	0.0	0.0

1. An average annual growth of 2.5 per cent is assumed for labour productivity over the projection period. These projections include the non-contributory pensions and minimum pensions regimes.

Source: *National Strategy Report 2002*.

... but problems have yet to be solved

3.27 The Framework Law of 2000 and the new pension benefit formula which was established in 2002 after prolonged discussions with the social partners did not result in any significant improvement to the financial sustainability of the social security system, although it introduced more complexity into the system's rules, making it more difficult for beneficiaries to understand and initially increasing administration costs. Furthermore, projections seem to have been based on rather optimistic macroeconomic assumptions, such as the growth rate of labour productivity (2.5 per cent per year, which seems high compared with past performance) and the increase in the (already high by EU standards) participation rates of the labour force. The decision to use estimated wages to compute pensions when records do not exist could be a potential source of conflict. Convergence of minimum pensions to the statutory minimum wage has been quicker than initially planned, and has proved expensive at a time of drastic budgetary consolidation, though the lowest minimum pension levels remain below the poverty line. Although the establishment of minimum pensions aims at boosting income for the poor, they are a rather blunt instrument for redistribution purposes, as only 31 per cent of people belonging to families benefiting from minimum pensions are poor, as reported in a recent study.⁷⁸

A new Social Security Framework Law was introduced in December 2002

3.28 In December 2002, Parliament approved a new Social Security Framework Law. It implements broadly the same type of organisation as the 2000 Law, and it emphasised the relevance of creating a second-pillar complementary regime. This regime is based on a contributory ceiling on the general regime contributions, above which contributions must be channelled to private or public funds. No change was made to the benefit formula following the modifications that had been made in January that same year. And the secondary legislation approved under the previous framework law, on how each subsystem is to be financed has also been maintained. Targets and time horizons have been set for the evolution of minimum pensions.⁷⁹

3.29 Creating a second-pillar complementary regime implies setting a ceiling on general regime contributions, above which contributions have to be channelled to private or public funds. By June 2004, discussions were still going on about setting this ceiling. Various options were being considered, most notably the possibility of setting 2 thresholds: first a lower threshold (around six times the minimum wage) above which opting-out of the pay-as-you-go public pension scheme is possible; second a higher ceiling (around 10 times the minimum wage) above which contributions to the public pension scheme would not be possible. This regime would be mandatory for certain categories of beneficiaries, still to be defined. Simulation exercises are currently underway to evaluate the long-term financial impact of the various options considered. If the results are favourable, the legislation is scheduled to be completed by the end of 2004, and take effect as from January 2005. At the same time, plans are being made to increase the penalty in case of early retirement, in order to promote a higher effective retirement age.

Much remains to be done to secure the sustainability of the civil servants pension system

3.30 The civil servants' social security scheme (*Caixa Geral de Aposentações*, CGA) suffers from a similar, but deeper, problem than the general regime. First, the ratio of pensioners to contributors almost doubled since the early 1990s. Second, the Central Government does not pay its social contributions as an employer,⁸⁰ but it makes transfers to cover the deficit. Third, the CGA pension benefit formula used to be far more generous than the general regime, paying pensions with replacement rates sometimes above 100 per cent. In addition, CGA pensions, like social security pensions, have a relatively favourable treatment under the personal income tax. Recently, CGA pensions have been affected by the same quasi-freeze policy in 2003 and 2004, as they are usually revised in accordance to civil servants' wage evolution. Nevertheless, the financial transfer from the budget to CGA to finance the gap has been rising (by 15.6 per cent in 2003 and 14.1 per cent in 2004).⁸¹ In order to restrain excessive generosity of the system and to converge to the social security system, new entrants to the civil service since September 1993 have been under the same retirement conditions as private sector employees, including the benefit formula.

3.31 According to the official projections in the National Strategy Report, CGA pension expenditure is expected to grow from 3.6 per cent to 5 per cent of GDP, between 2000 and 2075. Over the same period, contributions and other revenues are expected to be roughly constant around 1½ per cent of GDP. Consequently, the balance, which is equivalent to the state budget transfer, is projected to increase by 1.5 percentage points of GDP, from 2 per cent of GDP in 2000 to 3.5 per cent by 2020, remaining close to that level in subsequent decades.

Table 3.3. The pension system for civil servants (CGA): official projections

	2000	2010	2020	2030	2040	2050	2075
Pension expenditure	3.6	4.4	5.0	5.0	4.6	4.4	5.0
Contributions and other revenues	1.6	1.5	1.5	1.5	1.5	1.6	1.6
Current balance	-2.0	-2.9	-3.5	-3.5	-3.1	-2.8	-3.4

Source: *National Strategy Report 2002*

3.32 The 2003 budget law introduced some measures that were intended to restrain CGA future pensions and which induced a large increase in retirement. However after these were considered unconstitutional by the Constitutional Court, the Government had to make a new proposal, which was approved in January 2004. Two main changes were introduced in the civil servants retirement statute (only applicable to those in the system before September 1993, since the others have now a regime similar to the private sector one): *i*) the relevant wage to be considered in pension's computation is net of social contributions; and, *ii*) in case of retirement before age of 60, even with a complete 36-year career, there will be a penalty.⁸²

Concluding remarks

3.33 The piecemeal and gradual approach that has been followed in the pension system reforms has not so far been effective. Unavoidably, the reform plans have been subject to political changes, so that all in all what has been accomplished has been too timid, given the urgency and seriousness of the problem. Measures taken so far are not enough to solve, nor significantly postpone, the financial deficit of existing pension systems under the pressure from an ageing population. In this context, deeper and clearer reforms are urgently needed to ensure social security and CGA medium-term sustainability. The reform measures will have to include the introduction of stronger disincentives to early retirement so as to substantially raise the effective age of retirement.⁸³ Other options to be envisaged include: reducing the annual accrual rate; limiting indexation of standard pensions to inflation rather than wage developments; increasing the effective taxation of standard pensions (*i.e.* either through a flat tax rate, leaving aside minimum pensions, or subjecting pensions to a progressive scale); and adjusting replacement rates for changes in life expectancy of pension cohorts. Any combination of the above possible measures would improve the financial sustainability of the system. The implementation of the mandatory second-pillar scheme based on a contributions ceiling should be carefully evaluated to ensure that it contributes to improve the sustainability of public finance. Efforts made to decrease fraud and tighten eligibility criteria, concerning sick leaves and social insertion income⁸⁴, can also contribute and should be continued. The measures already taken in the civil service regime, CGA, are an important first step, especially the reduction of the generosity of CGA and its alignment to the private sector regime. Reducing the complexity and increasing transparency of the systems should also be given some attention in future reforms.

NOTES

74. Law 17/2000 (8th August). The previous one was Law 28/84 (14th August). .
75. The composite index used for adjusting wages includes the CPI, excluding housing, (with a weight of 75 per cent) and for the remaining 25 per cent, the average increase in earnings upon which social security contributions are levied (capped 50 basis points above CPI). The composite index will be redefined before 2011, and a revised index will be applied thereafter.
76. The old accrual rate, still applicable for beneficiaries with a contributory career equal or smaller than 20 years, is a flat 2 per cent.
77. Ministry of Social Security and Labour (2002). This report was produced following the request of the Laeken European Council. See also Rodrigues, P.G. (2002).
78. Low statutory pensions are increased with a complementary payment in order to reach defined minimum pensions. Gouveia and Rodrigues (2004).
79. By 2007, at the very latest, bracketed minimum pensions (*i.e.* pensions payable to those who have contributed for many years but have a small pension nonetheless) of the general regime as well as pensions of the RESSAA and RNCE regimes will have converged to higher predetermined fractions (between 65 per cent and 100 per cent, 60 per cent and 50 per cent, respectively) of the minimum wage, net of social security contributions. Pensions complements such as those due to dependency are then added to these values. In the beginning of 2004, the Government announced that this target will be achieved in 2006.
80. Another factor that is contributing to the financial deficit of CGA is the fact that other Government levels only pay a 10 per cent employer contribution, compared with a 23.75 per cent contribution paid by private sector employers.
81. Over the period, the Ministry of Finance' contribution to finance pensions under the government responsibility (*i.e.* pensions for survivors of civil servants and of military killed or disabled in action) rose by 18.5 per cent in 2003 and 6.1 per cent in 2004
82. The penalty will be a reduction of the pension of 4.5 per cent per year of anticipation relative to the age of 60; in the private sector, there is also a penalty, but the statutory retirement age is 65.
83. The effective average age of retirement in the social security system was 64.2 years in 2003. This retirement age is unusually high, especially given that life expectancy in Portugal is on the low side. The increase in life expectancy over future decades is projected to be among the fastest in the EU. In that context, a gradual increase in the statutory retirement age should also be considered as an option over the longer term.
84. *Rendimento Social de Inserção*, previously known as *Rendimento Mínimo Garantido*, minimum guaranteed income.