Fiscal policy and pension expenditure in Portugal

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1. Introduction

From the end of the 1990s until 2005 (with a break in 2002), there was a gradual deterioration in the structural fiscal position in Portugal. Favourable economic conditions were not used to consolidate, and few measures were implemented to curb the upward trend in expenditure, particularly on pensions. This contrasted significantly with developments in the euro area as a whole. Indeed, while in the euro area the ratio of primary expenditure to GDP almost stabilised between 1998 and 2005, in Portugal it rose by 6 percentage points. Without taking into account some structural breaks in the delimitation of the general government sector that occurred in Portugal meanwhile, as well as some other differences that may blur international comparisons, this outcome stemmed mainly from the behaviour of social payments. The fact that the social security system in Portugal is not yet very mature is a key factor in explaining these developments.

2. Fiscal policy in Portugal from 1998 to the present

After the beginning of the third stage of EMU, fiscal policy in Portugal followed a pro-cyclical expansionary stance in every year until 2000 (Chart 1). This was characterised by a strong growth in primary current expenditure, in parallel with a rise in the tax burden and a decline in interest payments, which allowed a near stabilisation of the general government deficit at a level close to the 3 per cent threshold (Charts 2 and 3). In 2001, the cyclical downturn and the continuous deterioration of the cyclically adjusted primary balance led Portugal into an excessive deficit situation. In the framework of the Maastricht Treaty and the Stability and Growth Pact, the Ecofin Council recommended that the excessive deficit be corrected by 2004.

In this context, and given the need for a swift reduction of the deficit, some fiscal policy measures were adopted by the Government from the middle of 2002 onwards. These consisted mainly of an increase in the standard VAT rate from 17 to 19 per cent, a significant cut in investment expenditure and a smaller reduction in intermediate consumption, plus some measures of a temporary nature (an extraordinary settlement of tax arrears, the sale of the fixed network for telecommunications and the sale of the toll rights for a motorway near Lisbon). Overall, the fiscal stance tightened slightly in 2002, in a period of low economic growth. In 2003 and 2004, some additional measures were implemented, such as a virtual freezing of the public employees' wage scale and of automatic career progression, tighter controls on the hiring of new public employees and an increase in taxes on oil products. These measures were likewise complemented by temporary measures: a securitisation of tax and social contribution arrears (2003); and transfers of pension funds to general government (2003 and 2004). The overall amount covered by the temporary measures reached 1.3, 2.4 and 2.1 per cent of GDP in 2002, 2003 and 2004, respectively.

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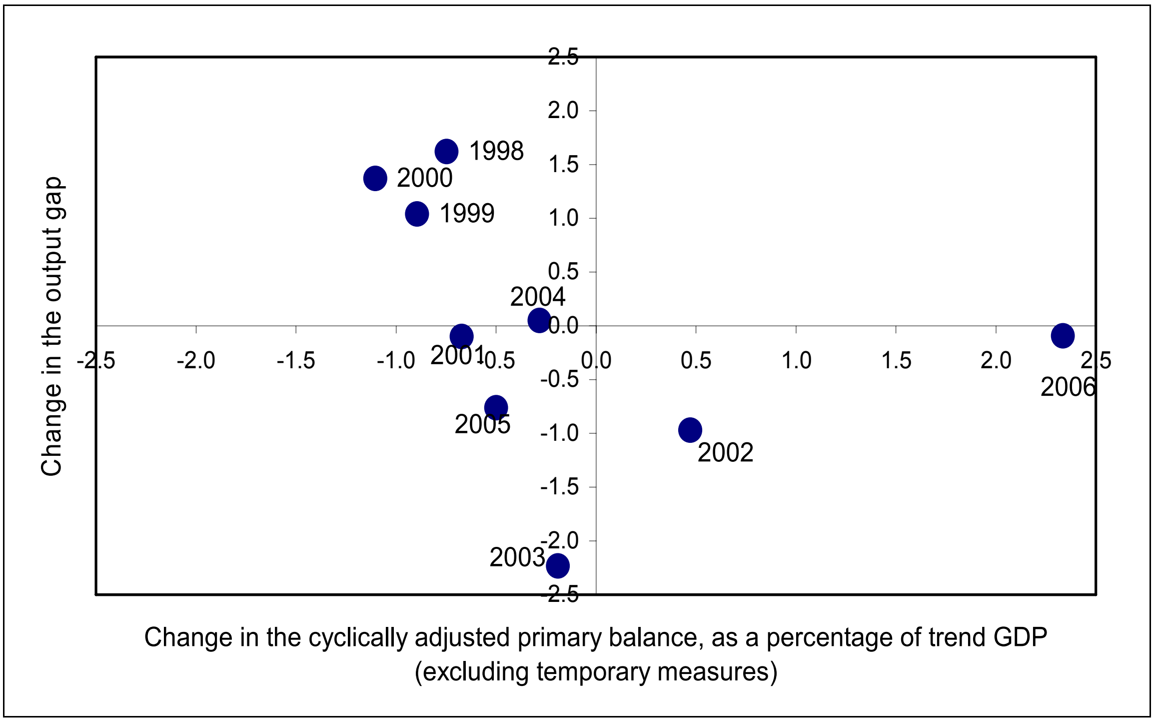
Chart 1

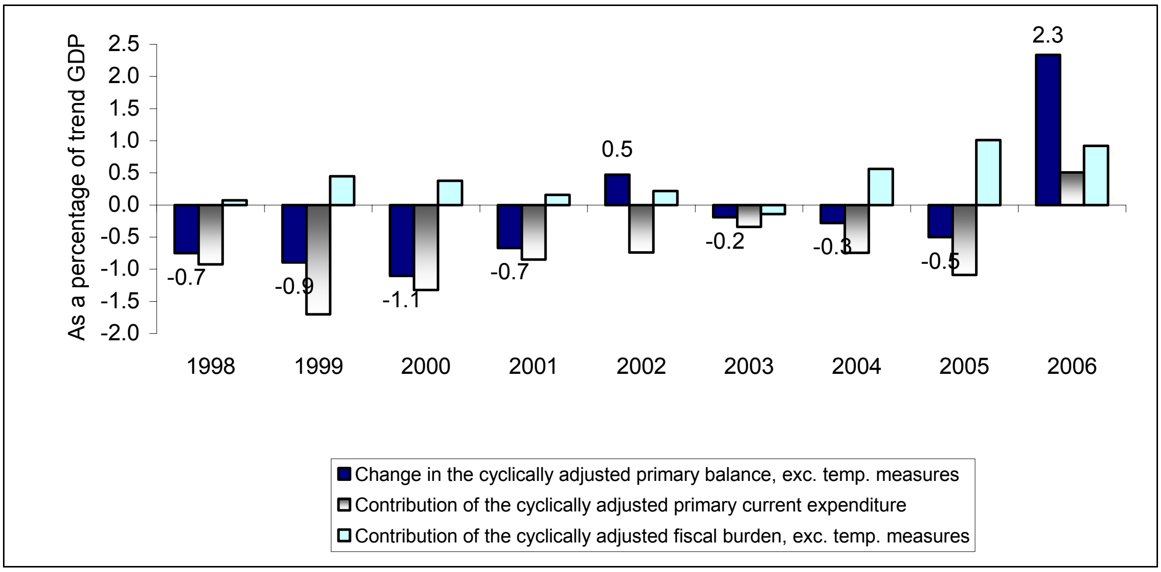
Fiscal stance and cyclical conditions



Source: National Statistical Institute and author calculations.

Chart 2

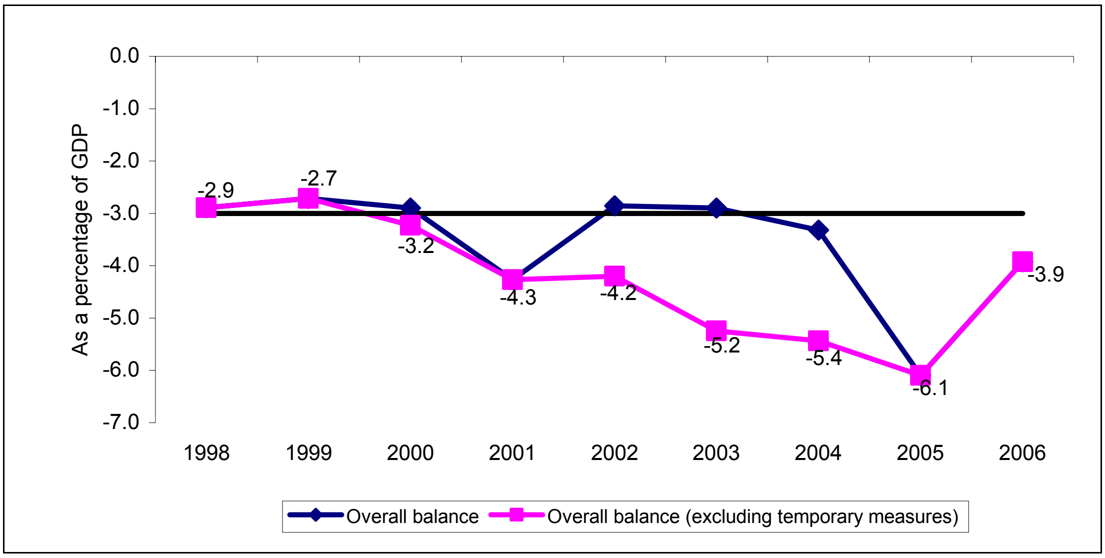
Contributions to the fiscal stance



Source: National Statistical Institute and author calculations.

Chart 3

Overall general government balance



Source: National Statistical Institute and author calculations.

In 2004, based on the data then available, the Council abrogated the decision on the existence of an excessive deficit in Portugal. However, the underlying fiscal imbalances were not eliminated durably. Indeed, from 2002 to 2004, primary current expenditure continued to increase markedly, in spite of the measures adopted. This was largely the result of the sustained strong growth in pension expenditure. In 2005, the deficit reached a peak of 6.1 per cent of GDP and Portugal returned to an excessive deficit position, which the Council recommended be corrected by 2008. The absence of temporary measures, the lagged effect of the 5 percentage point (p.p.) cut in corporate income tax in the 2004 budget, the decline in dividends received by the State and the increase in pension expenditure were crucial to this outcome. However, if the 2005 outturn had not benefited from a new hike in the standard VAT rate to 21 per cent and the considerable gains in the effectiveness of tax collection, estimated at around 1 per cent of GDP, the deterioration in the budget balance would have been much greater.

From 1998 to 2005, cyclically adjusted primary current expenditure increased by 7.7 p.p. of trend GDP, of which 5.3 p.p. were for social payments (2.5 p.p. for pension expenditure) and 1.3 p.p. stemmed from compensation of employees (1.0 p.p. related to employers' actual social contributions – for more details on the recording of social contributions for the public employees' social security system in Portugal on a national accounts basis, see section 3). It is worth highlighting that the composition of primary current expenditure was affected in 2003 by the transformation of some public hospitals into corporations, which led to an increase in social payments in kind and a decline in both compensation of employees and intermediate consumption.

By the middle of 2005 there was already a consensus that a structural curbing of primary current expenditure, in particular pension expenditure and compensation of employees, was crucial for the correction of the Portuguese public finances imbalance. The updated stability programme sent to the European Commission in June 2005 set the fiscal consolidation strategy, which aimed at reducing the general government deficit in Portugal to below 3 per cent of GDP by 2008. In the first stage, consolidation was focused more on the revenue side – the rise in the standard VAT rate mentioned above, the increase in taxes on oil products and the impact of the improvement in the effectiveness of tax collection. But it also aimed at reducing expenditure on a permanent basis, through a broad set of measures that included the reforms of both the public employees' and the general pension systems (for more details, see section 3), and of the public administration.

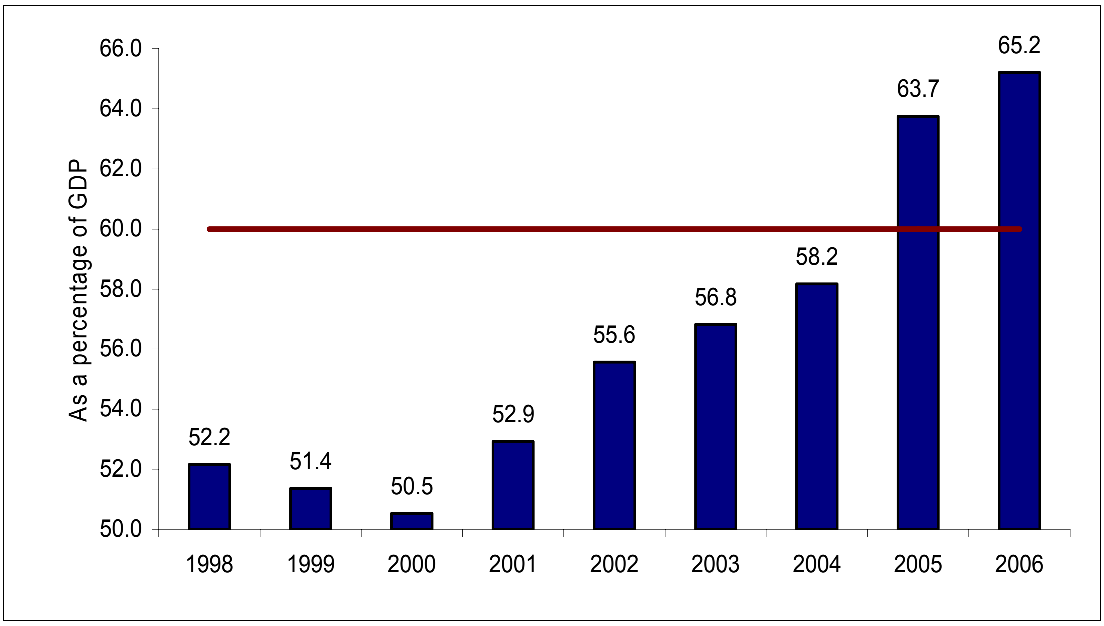
Fiscal developments in 2006 exceeded expectations: the general government deficit stood at 3.9 per cent of GDP, falling short of the 4.6 per cent target. The cyclically adjusted deficit improved by 2.3 p.p. of GDP, fulfilling by a large margin the Council recommendation to reduce the structural deficit by 1.5 p.p. of GDP. This outcome continued to result from an increase in the tax burden but, for the first time since 1997, the ratio of primary current expenditure to GDP declined. In addition, a strong decline in public investment also contributed to the improvement in the fiscal position.

Public finances in Portugal will face a major challenge in the years ahead. For 2007, the Government targets a 3.3 per cent of GDP deficit and, in the context of the Stability and Growth Pact, the excessive deficit should be corrected in 2008, as already mentioned. The medium term objective, a structural deficit of 0.5 per cent of GDP, is foreseen to be reached by 2010, according to the latest update of the stability programme. However, its attainment per se is not enough to fully contain the fiscal impact of an ageing population. In this respect, the recent reforms of the public pensions systems, if consistently implemented throughout the next decades, were a major step in ensuring the sustainability of public finances.

Concerning the public debt ratio, it is worth highlighting that there was still a decrease in the 1998–2000 period, due to the small primary surplus in each year, the impact of economic growth that more than compensated interest payments, and high negative deficit-debt adjustments in 1998, mainly related to privatisation proceeds allocated to debt redemption (Chart 4). This situation reversed in 2001, as a consequence of the primary deficit, the slowdown in economic activity and deficit-debt adjustments contributing to the increase in the debt ratio. Until 2006, the debt ratio kept its growing trend, surpassing the 60 per cent threshold in 2005 and reaching 65.2 per cent by the end of 2006. On a cumulative basis, the stock of gross public debt has increased by 14.7 p.p. of GDP in the last six years, on the basis of the contributions of the primary deficit, the net impact of interest payments and economic growth, and positive deficit-debt adjustments (Chart 5).

Chart 4

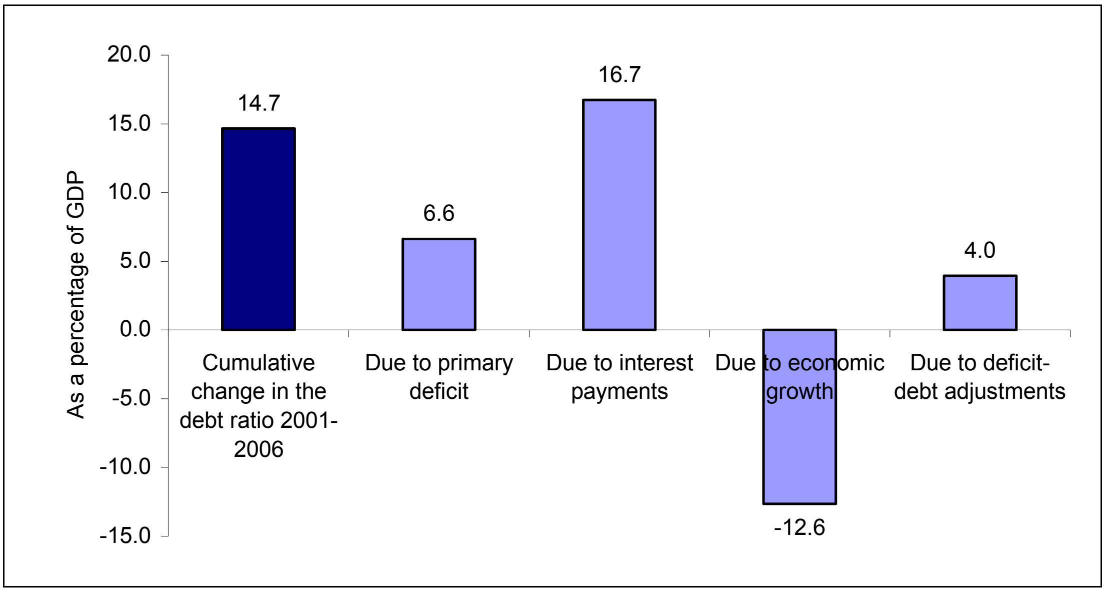
Public debt ratio, 1998–2006



Source: National Statistical Institute.

Chart 5

Cumulative change in the public debt ratio, 2001–2006



Source: National Statistical Institute and author calculations.

3. General government pension expenditure in Portugal

In Portugal, general government pension expenditure involves mainly two subsystems: the public employees' pension system and the general social security system. The rules followed in the two schemes were substantially different in the past.

3.1 The public employees' pension system

The public employees' pension system had very generous rules, in particular until the beginning of 2004; these rules applied to workers that joined general government institutions before September 1993 (for the others, the general system rules would apply). From the beginning of 2004, the initial pension of a retired public employee with at least 36 years of service was reduced from 100 per cent of the last gross wage to 90 per cent. In addition, financial penalties were introduced for those retiring before the age of 60. Still, the new rules were more favourable than the general social security system ones, and in the middle of 2005 it was decided to implement a gradual convergence. The new legislation came into force at the beginning of 2006, and essentially included a regular increase (by six months in each year) of the retirement age from 60 to 65 and of the contributory career for a full pension from 36 to 40 years. In addition, with the reform of the Retirement Statute, the system became a closed one and new public employees hired from January 2006 onwards contributed to the general social security system. These changes led to a significant rise in retirement requests and, as a consequence, pension expenditure did not decelerate in 2006, although it is expected to do so already in 2007. Very recently, additional changes in the public employees' pension system were announced, but still not legislated, in order to ensure full compatibility with the new Social Security Framework Law.

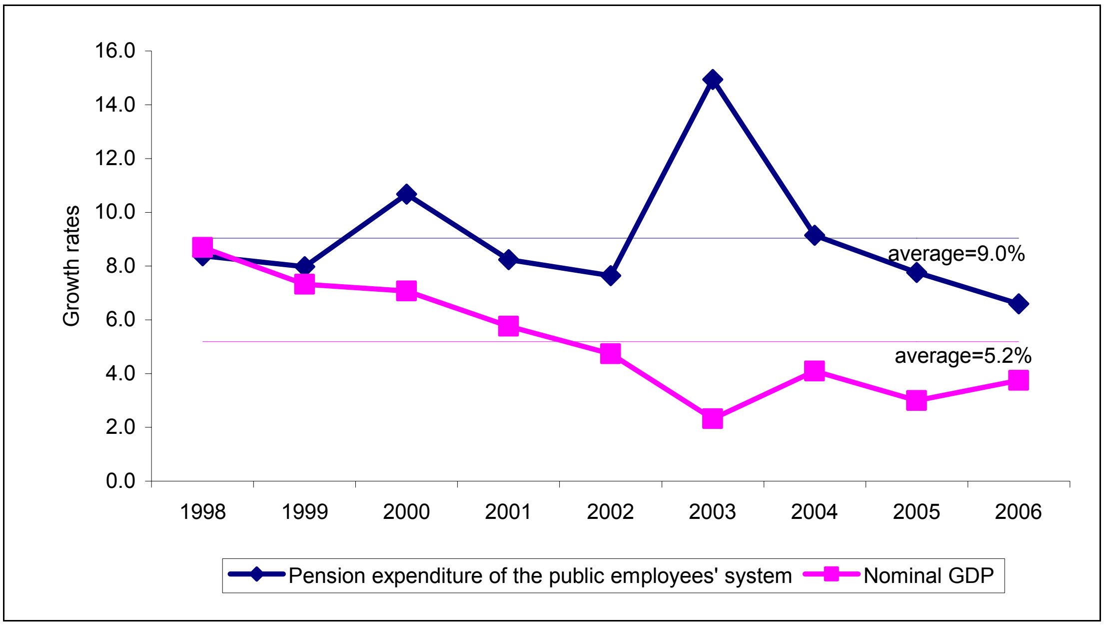
The entity that manages the public employees' pension system is *Caixa Geral de Aposentações*, which is included in the social security subsector in the national accounts. This entity pays pensions and receives, in addition to public employees' contributions, amounts paid by some general government bodies. However, no fixed rate is applied to the

State's contribution as an employer; it corresponds in each period to the amount necessary to keep the system in balance. As pension expenditure has been growing fast in the last few years, this State subsidy to *Caixa Geral de Aposentações* has also increased substantially, contributing to both the rise in social contributions, on the revenue side, and compensation of employees, on the expenditure side, but having no impact on the deficit.

Chart 6 shows the evolution of pension expenditure of the public employees' pension system from 1998 to 2006. As can be observed, pension expenditure in this subsystem grew every year above nominal GDP, contributing to the deterioration of the budget balance, in particular in years of low economic growth. In addition, as mentioned above, it contributed to the increase in the tax burden, on the revenue side, and in compensation of employees, on the expenditure side. The factors that explain this evolution are presented in Chart 7. The number of retirees increased every year, explaining about one third of the overall growth in pension expenditure. This effect results from the demographic structure of public employees still active, as well as from the impact of an ageing population, with longer average life expectancy. The annual update of pensions in this subsystem follows closely that for active public employees, which means that from 2003 to 2006 it was also impacted by the moderation in the update of their wage scale. The residual growth rate represents a composition effect related to the fact that, on average, the new retirees have higher pensions than those that leave the system. In the whole period, this last effect is the most important in the explanation of pension expenditure growth.

Chart 6

Pension expenditure of the public employees' subsystem and nominal GDP

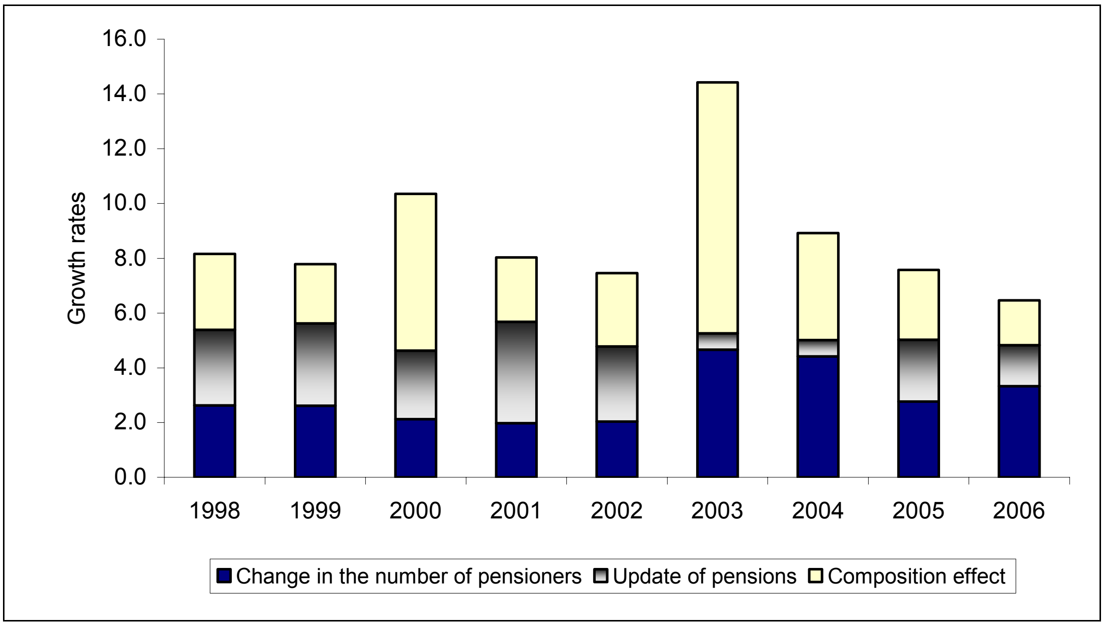


Source: Author calculations.

Chart 7

Pension expenditure of the public employees' subsystem

Growth factors



Source: Author calculations.

3.2 The general social security system

The old-age pension expenditure of the general system has also grown substantially in the last few years (Chart 8). As the general social security system in Portugal is of the pay-as-you-go type, this evolution is a cause for concern, especially given the ageing population. The underlying causes of these developments are represented in Chart 9. The number of old-age pensioners increased rapidly every year, with the exception of 1998 and 1999. Indeed, these years were still affected by the gradual rise in the retirement age of women from 62 to 65, which occurred between 1994 and 1999 (six months per year). Since then, the fact that the system has not yet reached maturity and the ageing population have been the main factors behind the increase in the number of old-age pensioners. These explanatory factors are also valid for the composition effect, justifying why the average pension, besides the impact of the annual update, is growing so fast. Lastly, it is worth highlighting that the average annual update of the pensions of the general system has usually been higher than expected inflation, in particular in the 2003–2006 period, when a gradual convergence of minimum pensions to a proportion of the minimum wage was implemented.

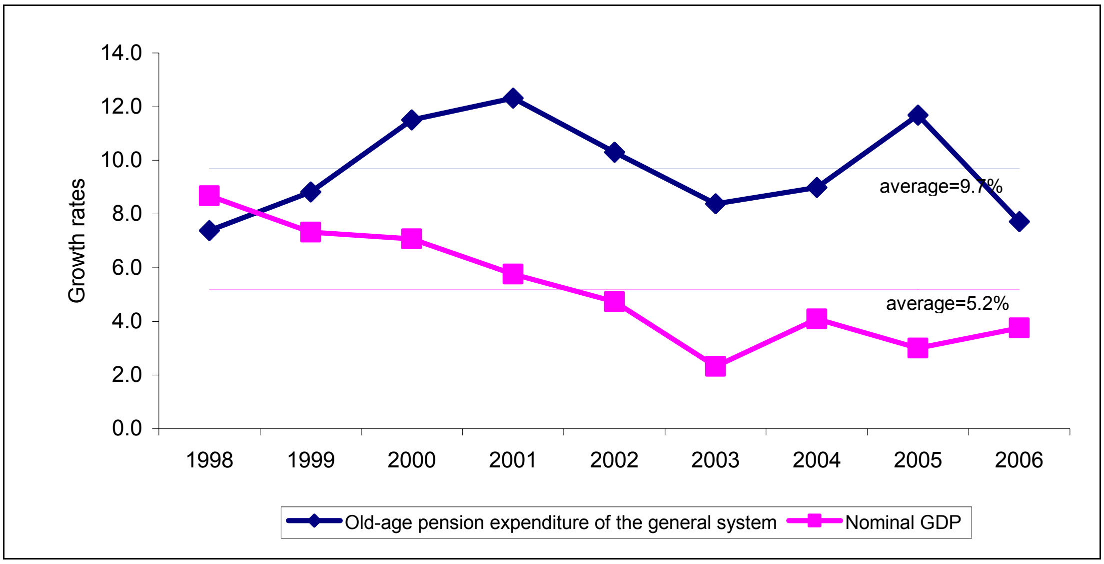
As mentioned in section 2, in mid-2005 the new Government took the view that the correction of the fiscal imbalance should be based on a sustainable reduction of expenditure, in particular pension outlays. As such, during 2006 discussions started with the social partners on a reform of the general social security system; this resulted in a new Social Security Framework Law, published at the beginning of 2007. The main changes introduced by this reform were:

New rules on the annual update of pensions as a function of inflation, real GDP growth and the amount of the pension;

Increase in the financial penalty for early old-age retirement from 4.5 to 6 per cent for each year relative to the statutory age of retirement (only possible for contributors who have at least 30 years of contributory career and are 55 years old);

Chart 8

Old-age pension expenditure of the general subsystem and nominal GDP

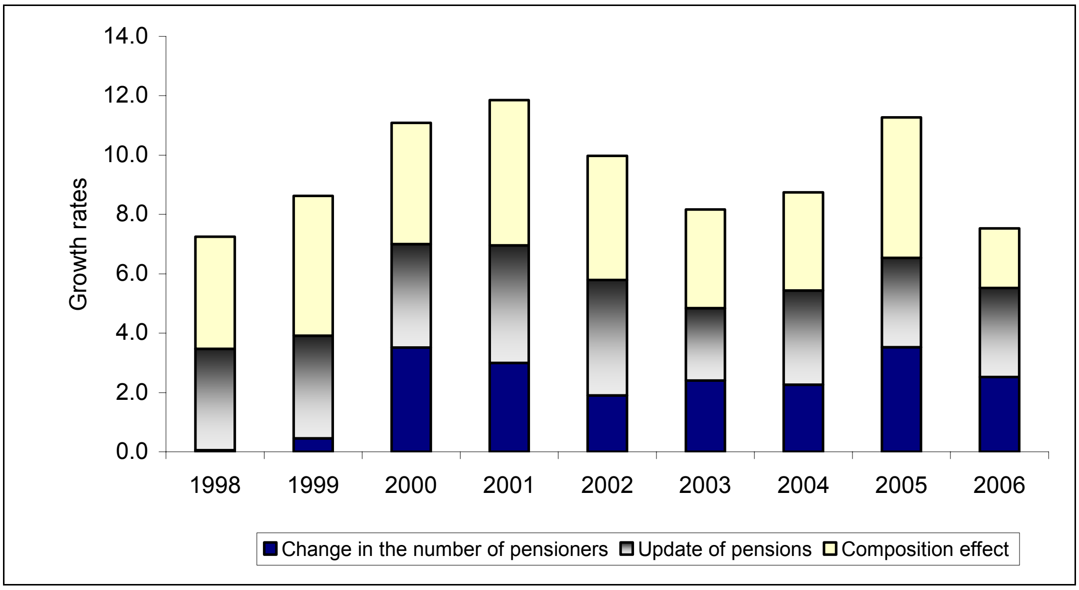


Source: Author calculations.

Chart 9

Old-age pension expenditure of the general subsystem

Growth factors



Source: Author calculations.

Introduction, from 2008 onwards, of a “sustainability factor”, which will reduce new pensions in accordance with the increase in life expectancy at 65 years old;

The transition to a new formula for the calculation of the initial pension based on the wages of all the years of contributory career, introduced in 2002, will be speeded up.

According to some recent calculations by Pinheiro and Cunha (2007), highlighted also in the next subsection, this reform, if implemented consistently, will decrease significantly the risk of unsustainability of public finances in Portugal.

3.3 Long-term projections for public pension expenditure

In the context of the Economic Policy Committee of the European Commission, the Ageing Working Group (AWG) produces long-term projections for age-related expenditure (pension, health and long-term care, unemployment benefits and education). These projections are updated on a regular basis and the last report was published in 2006 (for more details, see EPC and EC (2006)). It is worth noting that a substantial effort has been made to harmonise the underlying assumptions of the projections but the results are not yet fully comparable. The European Commission services use these results to assess the sustainability of public finances in the context of the Stability and Growth Pact.

Pension expenditure projections are essentially elaborated by national experts using their own models, under the guidance of the AWG. Regarding Portugal, taking into account the two public pension subsystems, the last AWG projections pointed to an increase of 9.3 p.p. of GDP in pension expenditure between 2005 and 2050. This result, according to the European Commission, placed Portugal in the group of high risk countries as far as the sustainability of public finances is concerned.[2] However, these projections did not consider the recent reform of the general social security system. According to a recent study by Pinheiro and Cunha (2007), using the AWG underlying assumptions, the effect of the new measures could reduce pension expenditure in the 2005–2050 period by a value between 4.1 and 7.4 p.p. of GDP, placing Portugal in the group of "medium risk" countries as regards the sustainability of public finances.[3] Nevertheless, their impact will be very limited in the short-run.

4. Conclusions

Governments may be tempted to postpone for a while the adoption of unpopular measures of a structural nature to curb public expenditure, in particular in a context of favourable economic conditions. Such measures may even be replaced by rises in taxation, temporary measures or one-off cuts in some expenditure items, in particular investment. However, the absence of measures with a lasting effect will become apparent sooner or later, as the structural trends of current expenditure prevail, and then the deficit may reach a very high level. Very briefly, this is the story behind fiscal developments in Portugal in the 1998–2005 period. The year 2006 was very likely a turning point in this evolution but the years ahead are still a huge challenge, in particular until a sustainable fiscal position is reached.

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[2] The European Commission currently bases the analysis of the sustainability of public finances on two synthetic indicators: the S1 indicator, which is the change in revenue and/or primary expenditure as a ratio to GDP required to reach a debt ratio of 60 per cent in 2050; and the S2 indicator, which is the change in revenue and/or primary expenditure as a ratio to GDP that ensures that the present discounted value of future primary balances equals the current stock of public debt.

[3] The range of results depends on the reaction of economic agents to the introduction of the "sustainability factor": they may opt for the postponement of retirement in order to avoid the financial penalty or they may choose to retire at the statutory age and have their pension reduced. The first option is more favourable in terms of the sustainability of the system.

References

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Pinheiro, M. and Cunha, V. (2007), *"MISS: A model for assessing the sustainability of public social security in Portugal"*, Banco de Portugal Occasional Papers, no.2.