3. The fiscal challenge

Reducing the fiscal deficit and securing sustainability of public finances over the medium-term has been the main macroeconomic policy priority since 2002. This is first a response to the European fiscal rules, but, more fundamentally, it reflects a political determination to ensure that Portugal's catching up will not be jeopardised by recurrent fiscal crises. A more comfortable fiscal situation would support growth by: *i*) allowing automatic stabilisers to operate fully during downturns; *ii*) improving confidence; *iii*) putting the public sector in a better position to respond to the long-term development needs of Portugal (for instance in education); and *iv*) contributing to a friendlier business environment by improving the efficiency and speed of public services. In turn, stronger growth in the long-term should help contain fiscal imbalances. This chapter assesses the strategy developed by the authorities to address this fiscal challenge. The first section reviews progress in fiscal consolidation in the short term, while the two other sections focus on longer term sustainability issues, including reforms to improve the public administration and how to respond to spending pressures related to an ageing population.

Fiscal consolidation in the short run

The programme of progressive fiscal consolidation weakened over time, ending in 2000, when the budget deficit had reached 2.8 per cent of GDP. In 2001, the deficit increased sharply to 4.4 per cent of GDP, in part reflecting changes in recording practices and definitions, breaking the 3 per cent ceiling set by the Maastricht Treaty. As a result, the European Commission launched an excessive deficit procedure against Portugal (Box 3.1). While reflecting some temporary circumstances (activity slowdown, expenditure slippage ahead of the 2002 elections), this deterioration of the fiscal accounts reflected more fundamental problems.

The consolidation efforts during the previous upturn were much too limited to leave any room for manoeuvre in a downturn. As discussed in Chapter 1, the cycle and lower interest rates explained most of the deficit reduction over the late 1990s, and there was no discretionary retrenchment (as measured by a reduction

Box 3.1. The 2001 slippage and the excessive deficit procedure

The fiscal situation deteriorated markedly in 2001, with the budget deficit increasing from 2.8 per cent of GDP in 2000 to 4.4 per cent of GDP. This slippage reflected: *i*) lower than expect revenue following the activity slowdown; *ii*) lower recorded tax receipts as a result of changes in methodology; *iii*) increased current spending, in particular from local governments, ahead of the parliamentary elections in March 2002, and *iv*) a pick-up in capital spending following the start of some EU co-financed projects (Community Support Framework III).

Although it was clear in spring 2002 that the 2001 deficit outturn was larger than anticipated, it was only in July 2002 that its true magnitude became evident, following the report of a special commission. Judging that cyclical factors did not explain everything, the European Commission decided in mid-October 2002 that Portugal had run an excessive deficit in 2001. The Council adopted a similar decision on 5 November 2002 and asked Portugal to remedy its excessive deficit situation as rapidly as possible.

The Stability Programme presented by the authorities at end-December 2002 included a package of measures to be adopted in 2003-06 designed to contain expenditures on a durable basis (see below). In the first quarter of 2003, the European Commission and the Council approved these measures as in line with recommendations to end the excessive deficit situation. The Stability Programme for 2004-07 was also approved by the European Commission and the Council. In April 2004, the Commission concluded that the Portuguese authorities had complied with the Council recommendation to put an end to the excessive deficit situation as rapidly as possible. In May 2004, the Council decided to abrogate the excessive deficit procedure in Portugal.

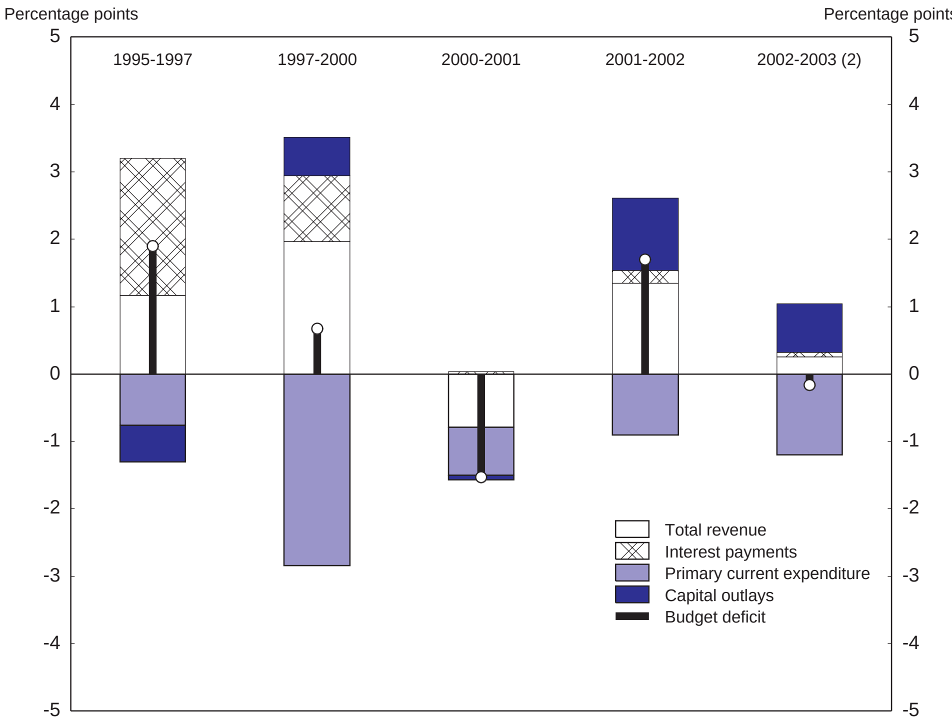
in the cyclically-adjusted deficit) in the 1997-2000 period (Figure 1.1). The resources derived from the stronger revenues and the fall in interest payments on the public debt were used to increase primary current expenditure instead of reducing the deficit (Figure 3.1). The difficulties of meeting current expenditure targets in the recent period and the 2001 slippage highlighted inefficiencies in public expenditure management that had to be addressed.

Fiscal consolidation efforts kept the deficit below 3 per cent of GDP *in 2003…*

Fiscal consolidation has been the overriding objective of economic policy since 2002. Portugal did not let automatic stabilisers smooth the 2002-2003 slowdown in activity and fiscal tightening came on top of a contraction of private demand (both domestic and external). The Portuguese strategy to curb the fiscal deficit has included a 2 percentage points VAT rate increase (as of July 2002), on

Figure 3.1. **Contributions to fiscal consolidation 1995-2003**

Cumulative change in budget balance in percentage points of GDP[1]



1. General government, national accounts basis. A positive change contributes to a deficit reduction.
2. OECD estimates for the 2003 budget outturn.

Source: OECD, *Economic Outlook* No. 75 (June 2004).

the revenue side, and short-term and one-off emergency measures in combination with more in-depth medium-term measures, on the spending side.[1]

- *Emergency measures* taken as early as mid-2002 included spending freezes and cuts. In particular, some public investments were deferred, public wages and hiring were frozen, and operating expenditures were cut. At the same time, subsidies to interest payments on mortgages were eliminated. Most measures affecting spending were maintained in 2003. In addition, one-off operations (sale of the fixed telecommunications network, of highway tolls and a tax amnesty) were taken in 2002, amounting to about 1½ percentage points of GDP, and additional ones had to be taken again in 2003 (see below).

- Some *structural measures* were also adopted in 2002 to put the budget on a sounder path in the medium term (closing down of some government agencies, launching of a comprehensive health care reform, public administration reform, rationalisation of education services, and approval of a budgetary stability law to better control expenditure by sub-central governments and autonomous funds). These measures and their implementation are detailed below. So far, the slowdown of health expenditure in 2003 has been the only quick and clear contribution to budget consolidation, but effects of the other measures adopted should become more visible as implementation progresses.

This strategy enabled Portugal to bring its fiscal deficit back to below 3 per cent of GDP as early as 2002. In 2003, however, the contraction in economic activity hindered further reduction in the fiscal deficit, even though current expenditure was kept under control.[2] In particular, the wage bill contracted following the continuation of the freeze on hiring and on wages above 1 000 euros, and the suspension of wage and career reclassification (Box 3.2). The immediate impact of health sector reform measures also generated some saving, mainly linked to lower

Box 3.2. Emergency policy measures to contain wage bill growth

Since mid-2002, the government approved several emergency measures in order to slow public expenditure growth, especially the wage bill. The supplementary budget for 2002, approved in May 2002, froze the renewal of individual contracts and fixed-term contracts,[1] with any new hiring requiring special permission from the Minister of Finance. Careers restructuring and reclassifications were also frozen. In the two subsequent years, the recruitment of public servants, as well as career restructuring and reclassifications, continued to be suspended.[2] Wages above 1 000 euros (1 024 euros in 2004) were frozen and those below that amount were revalued by 1.5 per cent in 2003 and 2 per cent in 2004.

As a result, the number of civil servants, as measured by subscribers to the pension system (*Caixa Geral de Aposentações*, CGA), which had been rising by 4 per cent a year in 1997-2001, increased by only 1 per cent in 2002 and diminished slightly in 2003. The total wage bill diminished by 2.6 per cent, reflecting also accounting changes that followed the transformation of 34 public hospitals into 31 public corporations (see Chapter 4).

1. In the second semester of 2002, the number of fixed-term contracts was reduced by 30 per cent and the number of contracts of provision of services by 26 per cent.
2. This recruitment freeze does not apply to teaching and military staff, and recently set local administration bodies.

spending on pharmaceutical reimbursements (see Chapter 4). Savings on the wage bill and health expenditure compensated for the substantial increase in social benefits and transfers triggered by the downturn.[3] Much weaker-than-projected activity in 2003, and hence wages and profits (with GDP actually declining by 1.3 per cent instead of the budgeted growth of 1¼-2¼ per cent), were reflected in much lower than budgeted tax revenues and social contributions (by at least 1½ percentage points of GDP). As a result, the authorities had to rely again on one-off operations to keep the deficit below 3 per cent (Table 3.1). These operations, amounting to about 2.3 percentage points of GDP, included: *i*) the recording as government revenue of the transfer of unfunded pension obligations from postal services (CTT) to the General Government (0.9 per cent of GDP),[4] and *ii*) the sale of non-performing tax and social security claims to a private financial institution at close to 15 per cent of face value (amounting to 1.4 per cent of GDP). Both operations have been agreed upon by the European Commission (Eurostat). Nevertheless, the

Table 3.1. **General government financial accounts**[1]

Per cent of GDP

	2000	2001	2002[2]	2003[2]	2004 budget[3]
Current receipts	40.8	40.1	41.4	41.7	41.4
Direct taxes	10.4	9.9	9.7	9.2	8.7
Social security contributions	11.8	11.9	12.3	12.7	12.8
Indirect taxes	14.4	14.2	15.0	15.8	15.3
Other current receipts	4.2	4.0	4.3	3.9	4.6
Current disbursements	40.2	40.8	41.5	42.5	42.5
Intermediate consumption	4.4	4.3	4.3	3.8	4.1
Compensation of employees	15.0	15.1	15.4	14.9	14.5
Social security	14.0	14.4	14.9	17.0	16.7
Interest on public debt	3.3	3.2	3.0	2.9	3.0
Other current disbursements	3.5	3.8	3.9	4.0	4.2
Current balance	0.7	–0.7	–0.1	–0.8	–1.0
Capital receipts	1.4	1.8	2.0	3.3	2.8
Capital outlays	5.0	5.5	4.6	5.4	4.7
Gross investment	3.8	4.0	3.4	3.9	3.0
Capital transfers	1.2	1.5	1.2	1.4	1.7
Overall budget balance	–2.8	–4.4	–2.7	–2.8	–2.9
Memorandum items:					
Primary balance[4]	0.4	–1.1	0.3	0.1	0.1
Primary current spending[4]	36.9	37.6	38.5	39.6	39.5
One-off operations	0.3	0.0	1.6	2.3	0.8

1. National accounts basis. Ministry of Finance presentation. Rates are calculated on the basis of the new GDP levels (revised in June 2004).
2. Provisional data.
3. The budget deficit for 2004 was set at 2.8 per cent initially, as calculated on the basis of the old GDP data.
4. Excluding "interest on public debt".

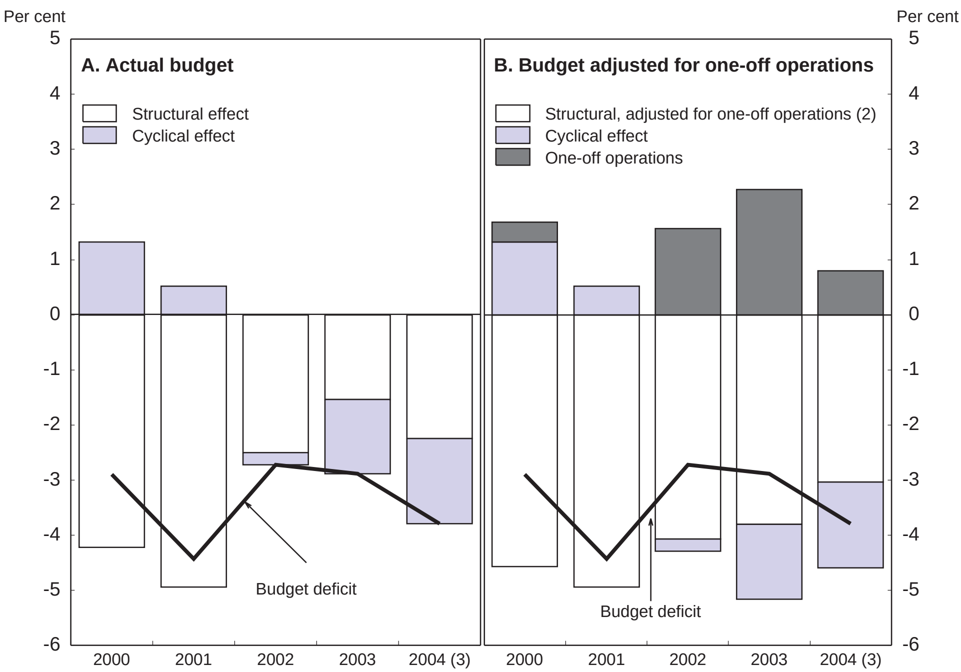
Source: Ministry of Finance.

debt-to-GDP ratio has been increasing since 2001, after reaching a low of 53.3 per cent of GDP in 2000. This reflects besides the deficit levels, the regularisation of expenditure arrears in the health sector and the weak nominal growth of GDP. The threshold value of 60 per cent of GDP set by the Maastricht Treaty was reached in 2003.

According to OECD estimates, the consolidation effort (measured by the change in the fiscal balance adjusted for the cycle) amounted to 2.5 per cent in 2002 and 1.0 per cent in 2003 (Figure 3.2 panel A). However, since a significant share of the consolidation can be imputed to one-off operations, a better idea of the consolidation effort is given by adjusting the structural deficit for the impact of these exceptional measures (Figure 3.2 Panel B). The underlying adjustment, thus

Figure 3.2. **Fiscal consolidation efforts**[1]

Per cent of GDP



1. General government financial balance. National accounts basis.
2. Excludes the cyclical effect and the impact of the non-cyclical factors that reduce the budget deficit, occurring only once in time (*e.g.* the UMTS sales in 2000).
3. Data for 2004 are OECD estimates, under the assumption that one-off measures are not higher than those budgeted.

Source: OECD, *Economic Outlook* No. 75 (June 2004).

defined, appears smaller although not negligible (½ percentage point of GDP in 2003 compared with close to 1 percentage point in 2002).

Although a more prudent fiscal policy in the late 1990s and 2000-01 would have prevented the fiscal imbalances from arising in the first place, overall the Portuguese strategy to address them thereafter has been appropriate. It has allowed for quick results in a difficult context, while also embarking on a programme of more in-depth measures to address deeply-rooted weaknesses in public finances. Some of the one-off operations, such as the 2002 sale of the fixed telecommunications network and highway tolls or the 2003 transfer of the postal services pension fund, have had the advantage of moderating the pro-cyclical stance of fiscal policy during the downturn. These measures, plus others such as freezes and cuts, have therefore been key in filling the time gap before the effects of in-depth reforms materialise. However, fiscal consolidation cannot rely on such measures for too long. Freezes in government hiring or wages as well as investment cuts, while effective in the short term, can create inefficiencies if prolonged for several years. In particular, hiring and wage freezes give distorted incentives to younger, better-educated aspirants to permanent posts in the administration and greatly complicate human resource management.[5] This could in turn slow progress towards moving to a more qualified public service, which is an essential goal of the ongoing public administration reform (see below). The repetition of cutbacks in infrastructure spending is also undesirable from a longer-term view.

The 2004 budget target will be difficult to achieve

The 2004 budget targeted a deficit of 2.8 per cent of GDP, entailing a reduction of ½ per cent of GDP in the structural balance.[6] The macroeconomic scenario underlying this budget seems reasonable, although slightly more optimistic than the OECD projections established in May 2004 (1 per cent growth in GDP compared with 0.8 per cent expected by the OECD). On the expenditure side, despite an increase in social transfers, further consolidation efforts are expected to bring savings: first, structural measures to curb expenditure in education, health and public administration are expected to start having a visible, although still limited, impact on current expenditure; second, most emergency measures decided in 2002/2003 to reduce primary spending have been maintained for 2004.[7] Moreover, one-off operations amounting to 0.8 percentage point are expected from real estate sales by the state (to be recorded as negative investment expenditure).[8]

On the tax side, the key measures are the cut in the corporate income tax rate to boost investment and competitiveness (from 30 to 25 per cent at the central government level and from 3 to 2.5 per cent at the municipal level), the creation of a fiscal reserve for investment in R&D and the reform of the taxation of assets.[9] These revenue losses are expected to be more than compensated by higher social contributions and profits following the economic recovery, better tax compliance, recovery of debt arrears to the social security system and some increases in public service prices. Current revenues are therefore expected to increase by almost one percentage point of GDP in 2004. Total revenue would still decrease because of a contraction in capital revenues, reflecting the fact that one-off operations, such as those adopted in 2003, will not be repeated.

Some options chosen in the 2004 budget can be questioned and the budget target will be difficult to achieve:

- While the tax cuts are justified to boost Portugal's international competitiveness, from a public finance point of view it would have been more appropriate to start phasing out emergency cuts and freezes as from 2004, and wait until the full impact of structural measures on the expenditure side materialised before cutting the corporate tax rate. While expenditure cuts and freezes have been effective in reducing the deficit, maintaining them for the third year in a row might prove costly in the medium term. For instance, although it is essential to avoid an excessive increase in the wage bill, the control should come from forceful rationalisation and other changes in human resource management in the public sector rather than from arbitrary freezes.
- Although the macroeconomic scenario underlying the budget is not particularly optimistic, the budget target might still be difficult to reach. On the revenue side, compliance concerning payments of taxes and social security contributions might not improve as much as expected by the authorities since the budgeted one-off revenues from securitisation were recorded in 2003 instead of 2004. According to OECD estimates, taking also into account some slippage in current expenditure, the deficit could be one point higher than budgeted.[10] The underlying consolidation effort would however remain significant (0.8 percentage point of GDP). The debt-to-GDP ratio is likely to increase slightly above 60 per cent of GDP, despite expected privatisation receipts.

Looking ahead

Looking ahead, the Stability and Growth Programme 2004-07 foresees a reduction of the deficit to 1.1 per cent of GDP by 2007, implying a structural deficit decline of about ½ percentage point of GDP each year, and a gradual reduction of the debt-to-GDP ratio to 57 percent of GDP. The reduction of the deficit will be achieved mainly through adjustments on the expenditure side, in line with OECD and EU recommendations, especially through:

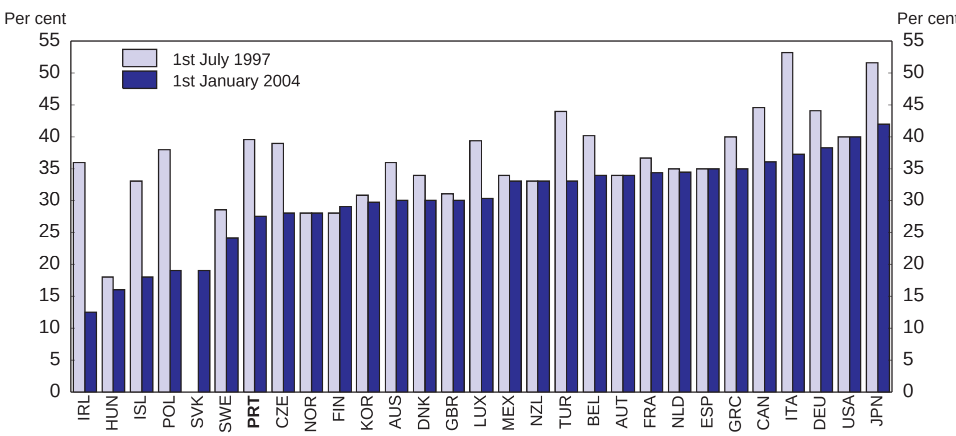
- Wage restraint and reduction in public employment.
- Ceilings on annual expenditure growth in some main spending areas.[11]

- Limits on transfers by the states to the social security system, limits on borrowing by local and regional government, requirement of balanced accounts for autonomous services.
- Forceful implementation of the structural reforms adopted since 2002.

It has been appropriately decided that these expenditure side adjustments will be independent of the economic cycle, implying that higher-than-expected revenues would accelerate the deficit reduction and lower-than-expected revenues would not stop the consolidation efforts. Given the prudent macroeconomic scenario, the risk is more on the positive side. The medium-term programme also foresees a phasing out of the recourse to one-off measures by 2007 and an additional 5 percentage points cut in the corporate tax rate in 2006, which would put the Portuguese corporate income tax rate among the lowest in the OECD (assuming that other OECD countries maintain their tax rates broadly unchanged) (Figure 3.3).

A slippage in the budget outturn for 2004 would require further consolidation efforts in the next years or a revision of the targets over the Programme period. More fundamentally, in the medium term it is important that the planned reduction in the corporate tax cut be accompanied by improved tax compliance by companies (so as to broaden the effective tax base) and further simplification of the tax laws (which is as important for competitiveness as the tax rates themselves).

Figure 3.3. **Statutory corporate tax rates in OECD countries**[1]
Per cent



1. Central and sub-central government corporate tax rates combined. For Portugal the municipal rate amounts to 2.5 per cent in 2004. Where a progressive rate structure applies, the top marginal rate is shown.
Source: OECD, Tax database; KPGM.

The main medium-term concerns remain: *i*) implementation of the already approved structural reforms, which has to be stepped up, with a view not only to reduce expenditure but also to improve the quality of public services; and *ii*) the need to launch additional reforms, especially regarding pensions, to lessen further spending pressure; otherwise the fiscal balance improvement expected to occur by 2007 will be short-lived.

Reforms have been launched to improve the quality and efficiency of public services

The programme of structural reforms to redress public finances includes measures to better control spending and, as importantly, to raise the quality of public services. In 2003, OECD recommended that Portugal adopt a set of measures in order to improve public spending efficiency and effectiveness, to turn input into more output and better outcomes. The public administration reform fits in that context. The government announced in 2003 a major overhaul of the country's large public administration. Increased staff mobility and managerial flexibility, along with a more accurate performance evaluation and personal accountability, are key elements in the reform. Rationalisation efforts have also started in the health and education sectors, aimed at building a more outcome-oriented public sector.

The public administration reform

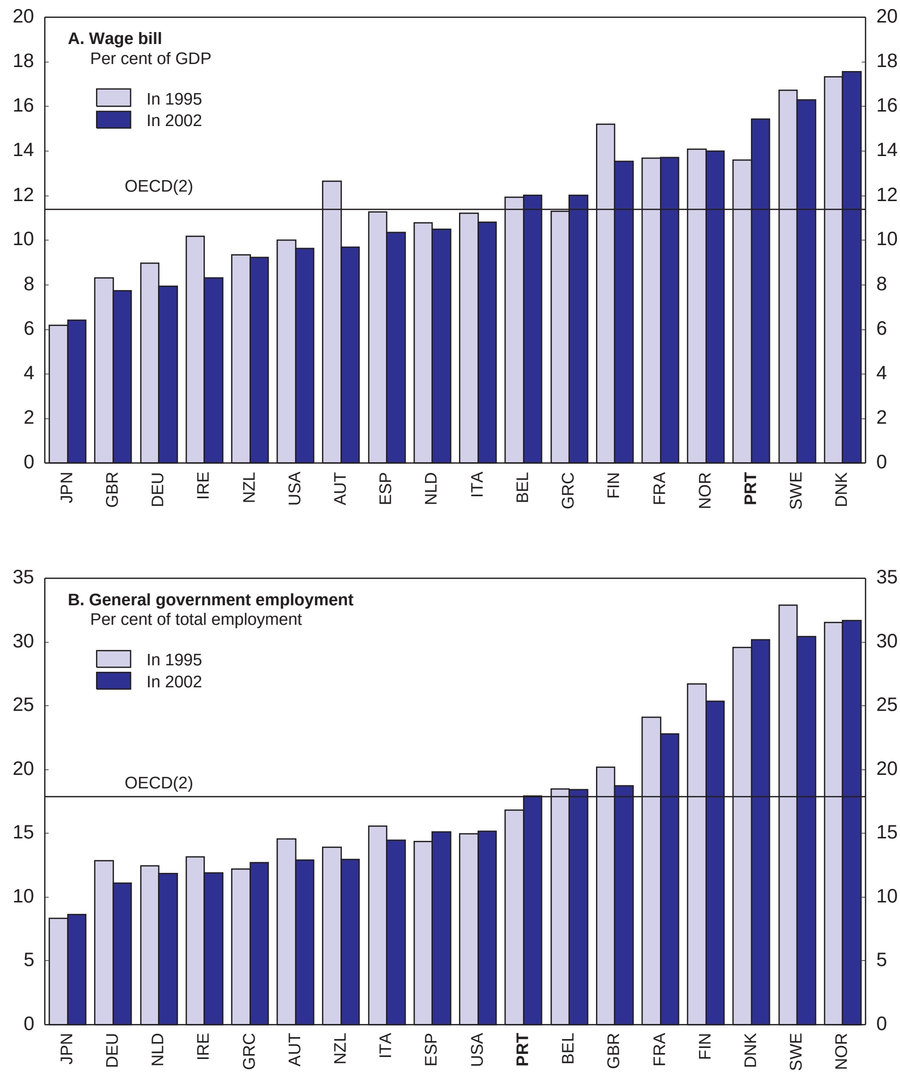
Compensation of employees in the general government increased rapidly over the late 1990s and until 2002, then reaching 15.4 per cent of GDP, well above the OECD average (Figure 3.4). The size of government, measured by employment, is close to the OECD average (Figure 3.5).[12] However, the quality of public administration services is widely considered as poor. In the last two years, the Government has adopted emergency measures to contain expenditure, especially the wage bill (see Box 3.2, above), and a vast programme of public administration reform was launched.

Increasing staff mobility

In October 2003, a public employment pool was established in order to reduce recruitment outside the public administration and to encourage mobility within the public administration (*Bolsa de Emprego Público*). At the same time, information about the internal demand and supply of public jobs has been made available online to civil servants. In June 2004, the pool included 34 public servants made redundant as a consequence of restructuring processes, who had not yet been transferred and were available for placement. Over the nine months or so since its creation, 1 197 civil servants have put their name down asking explicitly to move to another job within the public administration.

Figure 3.4. **General government wage bill and employment in selected OECD countries**[1]

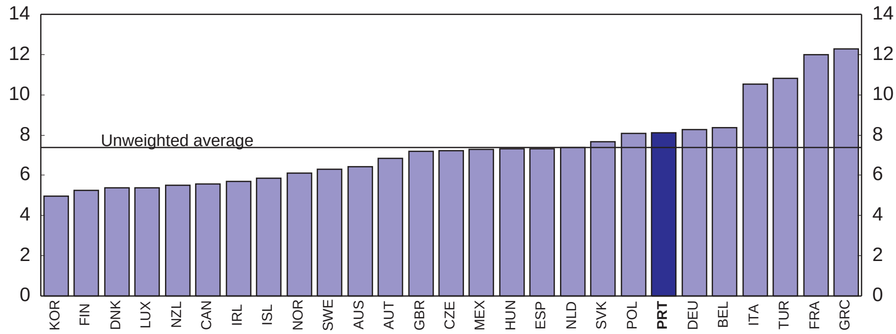
Per cent



1. OECD estimates. Excluding public enterprises, except for Japan.
2. Unweighted average.

Source: OECD, *Economic Outlook* 75 database.

Figure 3.5. **Public administration employees**[1]
As a percentage of total employees in 2002[2]



1. Corresponds to the national accounts industry branch NACE L. It includes such activities as defence, judicial services and police, foreign and economic affairs, administration of tax and social systems, regulatory and general public service activities. Public employees working in other industry branches (especially health and education) are not included.
2. 2001 for Austria; 1999 for Belgium. No data for Japan, Switzerland or the United States.

Source: OECD, *Annual Labour Force Statistics*.

Reorganising the public administration

Rationalisation of the public administration, including public institutes, was announced as a first step of a deep reform in 2002, immediately after the incoming government took office. The restructuring of the public administration has started to be implemented. So far, this process has resulted in the closing of 10 public institutes, the merging of 19 others, and it has led to the creation of 10 new bodies and the transformation of 31 into corporations. Since 2002, as well, four new public institutes were created with an integrated management of resources and improved coordination of services, so as to benefit from economies of scale.[13]

In the beginning of 2004, two new framework laws were approved, one defining the organisational model for the functioning of central administration and the other defining the purpose, principles and functioning of public institutes.[14] The new organisational and operating model for the central administration that was established sets the rules for the creation, merging and closing of services and organisations and simplifies legal formalities. Directors' autonomy concerning the design of their services' internal organisation has been increased in order to increase flexibility, and new management practices emulating private sector management models are to be introduced. Concerning public institutes, their existence will have to be economically justified. Currently, the permission to create a new institute already requires a general assessment of the existing ones under the same ministry. All existing public institutes are being reassessed according to the principles established in the new framework law. By strengthening control on the creation and functioning of institutes, the government is seeking to avoid their proliferation, to prevent the creation of additional special regimes and to avoid redundancies. Productive activities carried out by public institutes will be ruled by commercial law; alternatively these activities would be outsourced to units on public-private partnerships or even privatised. The Ministry of Economy has been pioneer in this restructuring process. It has merged several general directorates and centralised procurement, computer services, human resources and documentation centres. The Ministry of Education itself has already restructured several of its central and regional bodies.

Increasing accountability of managers

A new statute for directors has also been approved at the start of 2004 with a view to increasing managers' qualification, skills and accountability. Target-based management systems are being introduced in the public sector, whereby promotion of civil servants will be based on merit rather than seniority as has generally been the case in the past. According to the new statute, the length in office is limited to 12 years and the renewal of appointments is contingent upon performance evaluation. Furthermore, a new integrated system of performance evaluation, covering civil servants, intermediate directors and services, based on pre-defined objectives was established in March 2004, to be implemented as from the second half of 2004. The evaluation of civil servants will refer to objectives, behavioural competences and personal attitude; it will be subject to quotas (in order to guarantee merit differentiation), and will require interactions between the evaluator and the evaluated person. The purpose of the exercise is to achieve fairness and coherence in human resource management and to promote merit as a basis for career.

In order to raise managerial flexibility, it would also be important to bring the labour statute closer to private sector practices. A new law establishing individual labour contracts as a real recruitment alternative in the public administration has been approved, although it will not apply to activities directly related to authority or sovereignty functions. In the context of increased managerial autonomy, directors will be given responsibility for such recruitment. The selection and admission processes will be streamlined; non-fixed-term contracts will only be allowed in the case of vacancy under a service's legal quota for civil servants. It will not be possible to transform fixed-term contracts into permanent ones and compensation will be subject to ceilings.

Concluding remarks

Summing up, some important legislative steps have already been taken, or are expected to be in the near future, in order to reform public administration and the labour statute of its employees. Some of the measures have already been implemented, while others, such as additional de-bureaucratisation and decentralisation measures, are expected to be fully implemented during 2004. The reforms are critical to the longer-term target of increasing mobility and efficiency within the public administration, thereby reducing the growth of primary expenditure. The direction of the reforms is appropriate and there have been some important achievements. But the speed of implementation should be accelerated. Implementation of such a reform is not an easy task, because of the change of culture that is implied by some of the measures taken, and there is thus a risk that the process could lose political momentum. This is why it is particularly important to advance in this process without delay.

Spending areas earmarked for rationalisation

Part of the ongoing education reform aims at improving cost-effectiveness in the sector, for instance the regrouping of very small schools, re-allocation of staff, introduction of systematic evaluation and increased autonomy of tertiary education institutions (see Chapter 2). In the health sector, an ambitious reform programme has started to be implemented to further raise the quality of health services and address equity issues, while maximising the cost-effectiveness of the system. The reform process and its assessment are discussed in Chapter 4. In the longer run, there are bound to be additional pressures on health care expenditure related to ageing. Hence, in this area as well as for pension systems, measures must be taken now to ensure long-term sustainability of public finances.

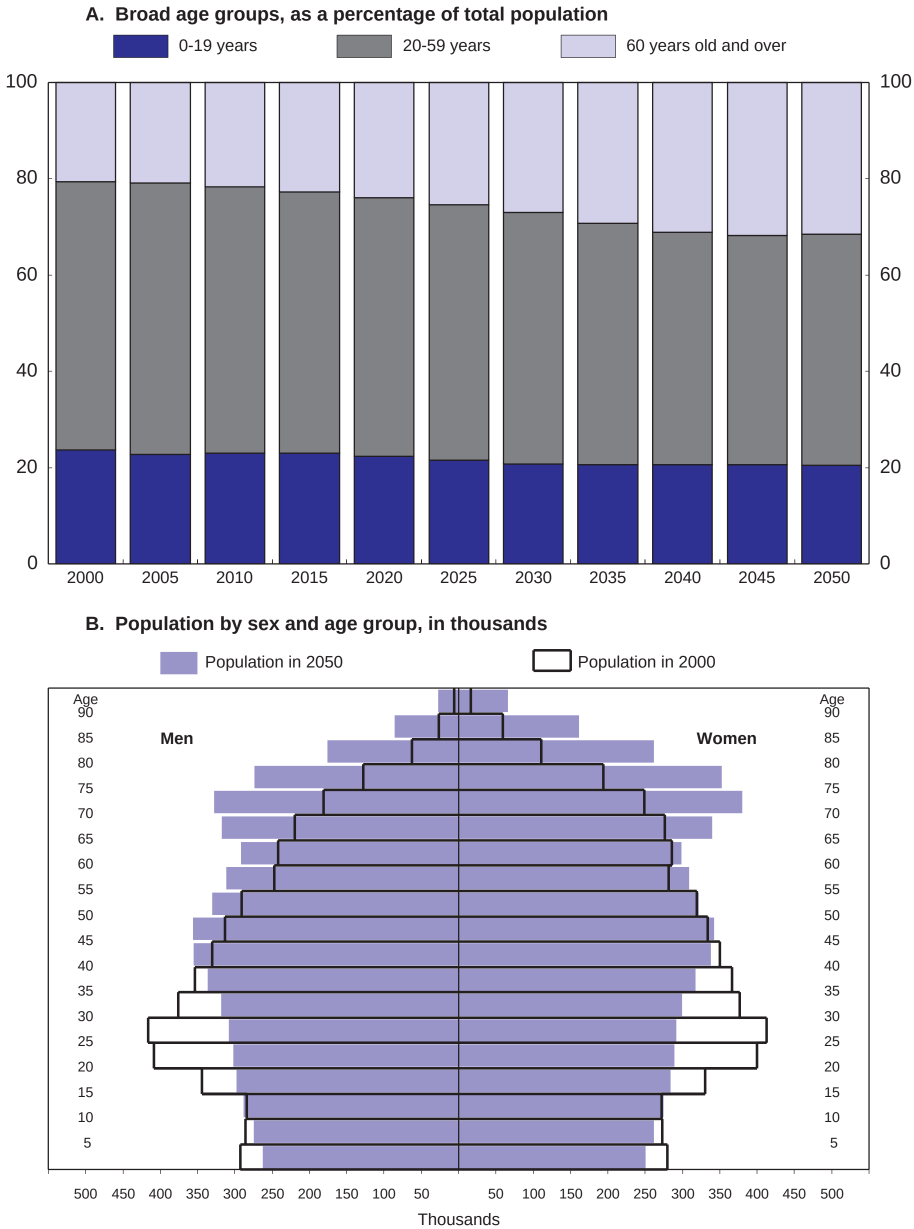
Ensuring long-term sustainability of public finances

Ageing, as a result of higher life expectancy and lower birth rates, is affecting OECD countries to various degrees. This evolution will have a large impact on public finances, especially on public pension systems and health care, since expenditure in these areas are largely age-related. Portugal is not an exception in this regard and, faced with population ageing, strong in-depth measures need to be taken now in order to ensure long-term sustainability of public finances (Figure 3.6). Deep reforms can no longer be delayed, since expenditure problems are already emerging.

Medium-term pressure on health care expenditure

Over the past twenty years or so, technology and the adjustment of relative prices were the main drivers of the steady increase of public spending on health care – from around 2.7 per cent of GDP in the 1970s to over 6 per cent of the GDP in 2000-01. By then the OECD average was just below 6 per cent (up from 4.5 per cent of GDP in the 1970s). According to empirical studies, population ageing did not significantly contribute to the increase over the past two decades.[15]

Figure 3.6. **Population by age cohorts**



Source: European Commission (Eurostat).

Looking ahead though, ageing is expected to play a major role in boosting health care public spending, concerning acute care, as well as ambulatory care, pharmaceuticals and, a bit later on, long-term care. As a result of foreseeable demographic evolutions, public spending in health care, excluding long-term care, is expected to rise, *ceteris paribus*, by 1 to 2 percentage points of GDP between 2000 and 2050, to reach an estimated 6.4 to 7.2 per cent of GDP.[16] If factors other than population ageing, such as the development of new (more expensive) technology, are also considered, a sharper increase should be expected. Such projections, given the current and prospective fiscal situation, call for an urgent and deep reform of the health sector. Some steps in this direction have already been taken or announced and are discussed in detail and assessed in Chapter 4.

Pressure from population ageing on the pension systems

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

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 Law[17] 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.

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.[18] 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.[19] 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

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

In Portugal, the mandatory public scheme of social security for private workers[1] 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 Actividades 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.

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.

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.[20] 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.

... but problems have yet to be solved

The Framework Law of 2000 and the new pension benefit formula which was established in 2002 after prolonged discussions with the social partners did

Table 3.2. **Social security account: official projections**[1]

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.

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.[21]

A new Social Security Framework Law was introduced in December 2002

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.[22]

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

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,[23] 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).[24] 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.

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.

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

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.

(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.[25]

Concluding remarks

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.[26] 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 income[27], 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

1. See OECD *Economic Survey of Portugal* 2003, Chapter II, for more details on emergency measures and Box 5 on Budgetary Stability Law.
2. The nominal growth rate of expenditure halved compared with 2002, and in real terms expenditure was almost flat. According to data published by the Bank of Portugal in February 2004, it seems, however, that the liquid debt of local governments has increased by close to 8 per cent in 2003 despite the limits imposed by the 2002 Budgetary Stability Law.
3. Part of the slowdown in the growth of current expenditure and increase in transfers is also due to the incorporation of 34 hospitals (Box 3.2), with current expenditure taken out of the budget but compensated by an increase in transfers to households which use them – under a national account circuit – to pay for services bought from hospitals.
4. This operation creates contingent liabilities, as the improvement in the government balance observed in 2003 will be compensated by an increase in government expenditure on pensions in the medium term.
5. For instance, the quasi-freeze has resulted in a reduction of the wage differential within the public sector which reduced the attractiveness of the public sector for the most qualified workers. This could slow the progress to a more highly qualified public service.
6. Since then GDP data were revised. Calculated on the basis of the new GDP, the budget deficit amounts to 2.9 per cent (see Table 3.1).
7. Operating expenditures are set to be cut by 10 per cent, the hiring freeze and wage freeze for wages above 1 024 euros will continue. Wages below 1 024 euros will increase by 2 per cent (the expected inflation rate).
8. The budget initially expected 1.1 percentage points of GDP of one-off operations. But 0.3 percentage point of GDP were supposed to come from a second round of securitisation of non-performing tax and social security claims which was eventually registered in 2003 as the securitisation was not split into two steps.
9. Concerning the corporate tax cut and extrapolating from Oliveira, Monteiro, Santos (2003), the effect of the 2004 cut can be estimated at ½ per cent of GDP (with 20 per cent of it being recorded in 2004 and 80 per cent in 2005). The tax reserve allows companies producing tradable goods and services to put aside the 20 per cent of taxes due on 2003 and 2004 and spend them on new investment or R&D in the following two years. Its maximum impact on the 2004 tax revenues is estimated at 0.1 percentage point of GDP. The revenue impact of the reform of asset taxation will be mainly felt at the local level and its scale is still uncertain.
10. The OECD projections were prepared for OECD, *Economic Outlook*, No. 75, May 2004.

11. The ceiling on annual expenditure growth is set at 4 per cent in the health sector, 1.6 per cent in primary and secondary education, and 0 per cent in tertiary education.
12. The number of civil servants, as measured by registration in the social security institute for civil servants (*Caixa Geral de Aposentações*, CGA) increased by a cumulative 22.1 per cent from 1995 to 2003, with the following pattern: 1995-97 an average increase of 1.3 per cent per year; 1997-2001, 4.2 per cent per year and 2001-03, 0.5 per cent per year only. In 2003, the number of civil servants reached close to 780 000.
13. *Entidade Reguladora da Saúde* (Health Regulatory Entity), *Autoridades Metropolitanas de Transportes de Lisboa e do Porto* (Lisbon and Oporto Metropolitan Transport Authorities) and *Centro Hospitalar de Lisboa – Zona Central* (Lisbon Hospital Centre – Central Zone).
14. Law 3/2004 (15th January) and Law 4/2004 (15th January).
15. Oxley and MacFarlan, M. (1995).
16. See Caldas and Rodrigues (2003). Official projections on the impact of ageing on long-term care expenditure are not available. According to the EU Ageing Working Group Report, expenditure on long-term care is projected to increase by approximately 1 percentage point of GDP, between 2000 and 2050 in the OECD.
17. Law 17/2000 (8th August). The previous one was Law 28/84 (14th August).
18. 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.
19. The old accrual rate, still applicable for beneficiaries with a contributory career equal or smaller than 20 years, is a flat 2 per cent.
20. 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).
21. Low statutory pensions are increased with a complementary payment in order to reach defined minimum pensions. Gouveia and Rodrigues (2004).
22. 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.
23. 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.
24. 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
25. 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.

26. 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.
27. *Rendimento Social de Inserção*, previously known as *Rendimento Mínimo Garantido*, minimum guaranteed income.

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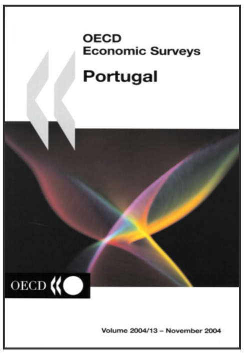

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