Social security financing: equity and sustainability issues

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Equity and Sustainability Issues

Teodora Cardoso[1]

While High Income Countries became economically rich before getting demographically old, most Low- and many Middle Income Coutries risk getting demographically old before becoming economically rich.

Robert Holzmann

[1] This text is part of a work-in-progress and was partially presented at the Conference on *"Public capitalisation of the Portuguese Social Security system: situation and perspectives"*, organised by the IDEFF at Faculty of Law of Lisbon University on 19 October 2018.

1. Historical Background

1.1. World Bank's Pioneering Study (1994)

A social protection system is a key element of any government system. In most economies social protection systems are gigantic redistribution mechanisms, and often represent 40% of the GDP of developed countries. Transfers of this size suppose robust and sound governance and management systems, requiring particular awareness of long-term trends. In this context, the financing of social security is one of the main problems that Portugal faces, only matched by the problems of demographics and the increase in productivity as the baseline conditions for the sustainability of the social protection model the country has chosen. In fact, the three problems are linked and should be jointly dealt with on the basis of a long-term analysis. This is a condition for the country – which is classified as an advanced economy but is actually close to middle income countries – to solve the dilemma that Robert Holzmann describes in the above quote.

None of the aforesaid problems is specific to Portugal, nor were they brought into being by the sovereign debt crisis. Twenty-five years ago the World Bank published a pioneering study on the problems raised by an ageing population: *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*.[2] The quality and scope of this analysis continues to deserve our attention, especially as, in the meantime, several variants and models it inspired have been tried with varying degrees of success. This experience provides a good basis for analysing the Portuguese case.

The first point to highlight is the comprehensive nature of the ageing population problem. To break it down, for instance by isolating the topic of pension funding while ignoring the other impacts of ageing – upon the economy, employment, the State Budget and society as a whole – is a sure path to not solving it.

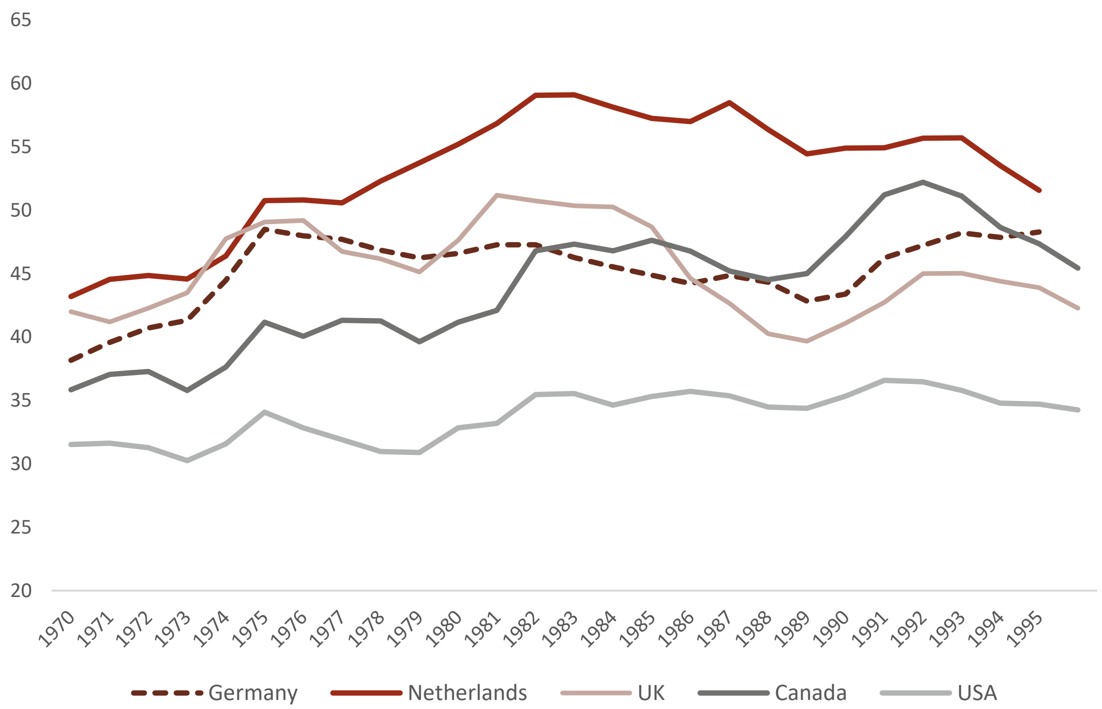
The World Bank study began by observing the decrease in the size of families and their broader dispersal, linked in part to economic developments, which entailed the weakening of informal elderly support systems, while at the same time life expectancy was increasing and the fertility rate was falling, leading to a sharp increase in the proportion of old people in the general population. At the same time the study listed a series of reasons that justify government intervention in this area: the shortsightedness that leads people to underestimate the need to save for their old age, the shortage of information suited to long-term decision making, the shortcomings of the available savings instruments, as well as insufficient income over the working life to allow for savings.

Despite this justification, experience has also shown that government interventions have created important distortions and that, even in the field of social concerns, the policies adopted in the nineteen sixties and seventies often tended to favour those with greater bargaining power, sometimes the wealthier. These concerns were joined by others linked to macroeconomic management. At the structural level they were the result of the concurrent

[2] World Bank (1994).

increase in life expectancy and slowdown in productivity growth and real salaries, observed, albeit to different degrees, in the developed economies and also in a large number of emerging and developing ones. As for cyclical economic management, the increasing weight of public expenditure in GDP, especially in countries where ageing is manifest, threatened to become an obstacle to the adoption of stabilisation policies, and has already obliged some developed countries to introduce restrictive, yet pro-cyclical, measures.[3]

Chart 1 – General Government expenditure (as % of GDP)



Source: AMECO.

The study concluded that there was an urgent need to revise the ways governments intervened in this field, even in countries which still had a young, growing population. These would also see spiralling costs relating to ageing, including, on top of pensions, spending on health and social assistance, all fields that require long-term decision-making. At the time, the dominant pension systems were pure pay-as-you-go systems, where the financing of retirement pensions is provided by the contributions of the working population. As the number of pensioners grew faster than the working population, the volume of contributions also had to grow. If prohibitive contribution rates were to be avoided, either the activity rate[4] or the wage level had to increase. As the increase in the activity rate was being countered by

[3] The chart is based on data prior to the adoption of the current European national accounts sytem (SEC 2010) available on the AMECO 2008 database.

[4] The activity rate is the ratio between the number of active persons (defined as those aged 15 to 64 years) to the corresponding total population.

the increasing trend to take early retirement, the remaining option was the increase in productivity, the only basis for the sustained increase in real wages.

The World Bank study stressed that government intervention is not restricted to the collection of taxes and the provision of transfers, but can count on other equally powerful instruments, such as the regulation and supervision of financial systems and institutions, as well as tax breaks for savings, within a context of economic stability. Therefore, the necessary reforms were not reduced to discussing pension systems and possible forms of funding but had to examine the problems stemming from ageing as a whole, including all types of government intervention, without forgetting the different roles and adjustments of the various social groups and economic agents. A fundamental concern was the need to bear in mind the implications of those reforms, not only on public accounts and the distribution of income between economic agents and between generations, but also on the functioning of the labour and capital markets. So, it was not a case of simply discussing the problem of pension financing, or even of social security, but it was also a case of framing it as an economic stability and growth instrument.

To this end the World Bank report stated that an old age security system should:

- facilitate people's efforts to shift some of their income from their active working years to old age;
- redistribute income to low-income workers, who lack the capacity to save, but avoiding intra- and intergenerational distortions;
- provide insurance against the many risks to which the old are especially vulnerable, such as the costs of health care and inflation.

To favour economic stability and growth the system should:

- **minimise the factors that oppose growth,** such as misallocated capital, insufficient savings, obstacles to job creation, heavy administrative expenses and evasion, not just tax evasion but also – and in some cases mainly – regulatory evasion;
- **be sustainable,** based on long-term planning, which takes into account the expected changes in economic and demographic conditions, including those induced by the system itself;
- **be transparent,** so as to enable workers, citizens and policymakers to make informed choices, insulated from political manipulation that leads to poor economic outcomes.

The study concluded there was a need for an old age security system, including different roles for the government in accordance to the goals pursued. Furthermore, an end should be put to the myths that are often heard in discussions on this subject. One of these resulted from the conviction that the pay-as-you-go systems commonly used at the time to finance pensions were progressive and favoured the redistribution of income to less wealthy pensioners, when in fact many mechanisms tended to benefit the groups with greater influence. Others led to belief that the pay-as-you-go system, by setting down in law the way pensions were calculated, eliminated the risks of old age. In this case the myth ignored the discretionary changes to which such rules are subject, not only in response to financial emergencies, but also in the course of routine management, for example, inflation adjustments.

Perhaps the most dangerous myths were those that implied that governments are less short-sighted than private individuals when it comes to taking decisions that involve the long-term outlook and protection of future generations. In truth, as Jacques de Larosière stresses in a recent work, the long-term outlook "gives politicians a pretext to put off measures to be taken" while, at the same time, "a certain number of structural phenomena [reach] a point of no return (...) worsening at a speed that was unimaginable when we just considered them to be part of the very long-term. They have already begun to undermine our certainties, our habits, our lifestyles. They are demolishing a series of institutional equilibriums that we had grown to see as immutable." [5]

The World Bank report concluded that **an old age social security system should take into account the relative importance of the three desired outcomes – savings, redistribution and insurance – specifying a different role to be played by the State in each of them.**

- **Savings** are aimed at levelling income over a lifetime and imply foregoing some consumption during working life.
- **Redistribution** implies the shift of income between individuals, taking into account that, for low-wage earners, saving for old age would push them below the poverty line during their working lives.
- **Insurance** consists of protection against a series of risks, from those that threaten personal savings (recessions, poor investments, inflation) to those relating to life expectancy or even to the failing of public programs.

The different nature of these objectives points to the adoption of old age protection systems equipped with a range of financing and management mechanisms, which ensure the balanced sharing of responsibilities.

In particular, the experience built-up to the time the report was prepared – i.e. a quarter of a century ago – showed that it was problematic to combine these different pillars in public programs, due both to efficiency and redistribution issues. That experience showed that, before systems reach maturity, there is a great political temptation to promise generous retirement plans. However, as the population and the systems age, the level of contributions required by those plans rises. At the same time, systems that disconnect the value of the benefits from the actuarial value of the contributions lead to these being seen not as a form of retirement saving but as a simple tax, whose increase triggers distortions and evading and gaming behaviours, with adverse consequences for the sustainability of the system, as well as for the labour market and the economy. Pure pay-as-you-go systems increase these risks since, for each generation, they disconnect the value of the benefits from the value of the

[5] De Larosière (2017).

contributions. And the higher the benefits and the greater the link to declared income, the greater the distortions – and even the regressiveness – implicit in intergenerational transfers.

On the one hand, these problems lead to an increase in the system's costs larger than in its revenue and, on the other, to a tendency among the beneficiaries to neglect their savings which they assume are guaranteed by the system. Deficits in the system, even if financed by State Budget transfers, imply either the accumulation of public debt, the cutback in public spending, or an increase in taxes, all of which have an adverse impact on economic growth. At the same time, households' inadequate savings make them more vulnerable to failures in the system, worsening the attendant consequences.

As a result of the analysis discussed briefly here, the World Bank report recommended separating the savings and redistribution purposes, defining different funding and management mechanisms for each of them and assigning them to two pillars of the system, both requiring compulsory participation, one managed by the State and financed by taxes and the other fully capitalised, managed by private entities. The latter could also be supplemented by a third voluntary participation pillar.

The **first pillar**, **with its compulsory participation and defined benefits**, was responsible for reducing poverty in old age and providing insurance against a series of risks that threaten personal savings (recessions, poor investments, inflation, the winding-up of private entities). It should be a pay-as-you-go scheme that could take a number of forms but should remain modest in size so as to allow for a substantial decrease in contributions, leaving room for other pillars and avoiding the distortions and perversions linked to a high level of contributions.

The **second pillar**, managed by the private sector and fully capitalised, should also require **compulsory participation, with defined contributions** and a final benefit dependent on the return on the investments made with them. The private management was justified by the need to avoid the temptation to concentrate such investments in national public debt and the advantage of introducing competition into their management. Good quality management should reduce the pressure on the first pillar, although at the same time it would call for a strengthening of the State's role as the regulator and supervisor of the financial system and should also promote the deepening of the capital markets.

Finally, participation in the **third pillar** would be **voluntary**. The latter two pillars brought about the introduction of a significant capitalisation component to the financing of pensions.

1.2. Developments and Criticisms

The basic model put forward by the World Bank assumes that a pension system is basically a system that recognises and manages risks relating to ageing. The most systematic criticism it was subjected to, for instance by the International Labour Organization (ILO), focussed on this point. For example, an ILO position paper states:

> *It is obvious that the World Banks focus on risk management aims to minimise the income equalization effect of social transfers*, while the *ILO stresses transfers as an investment in development (inter alia through the fostering of social peace)*

> *and hence goes beyond the relatively narrow focus of minimizing the risk of falling into poverty or losing substantial parts of one's income.* ***We assume that the individual, the community or the country in question have done all they could outside social protection mechanisms to avoid and reduce risks – as every prudent individual, family, community or society should. We also assume that the transfers that we are dealing with are in keeping with roles that the life cycle model or any other model of social protection has assigned to them in a given society.***

However, it adds, immediately afterwards:

> *Our main concern is to help to make sure that the benefit levels - once determined by societal values – can be financed by sharing, or redistributing, income.* ***If that cannot be done in the long run, then the particular system is doomed to fail****. In relative terms, the willingness to share income does not necessarily depend on the level of income, but it depends to a critical extent on whether the system is perceived to be efficient or not. Very few people are willing to accept waste in public redistribution systems.*[6]

Later developments showed, however, that, especially in a field linked to the long-term, not only has prudence not been the norm, but the complexity of the risks surpasses even sophisticated control techniques. The insistence seen in a number of countries to lower the retirement age while demographic changes suggest the opposite illustrates the lack of prudence. As to the complexity of the risks, it is well reflected in the financial and macroeconomic developments that led to the financial and sovereign debt crises, despite the sophistication of the instruments that supposedly controlled them. In fact, as a rule the attention of societies, governments and international institutions remained essentially focussed on the short-term, even when environmental, demographic, technological and geopolitical challenges required the opposite approach.

So, it is not surprising that the social security systems continue to face risks due, to a large extent, to the excessive optimism as to nations' capabilities to continue to finance simple pay-as-you-go systems, even as the demographics become unfavourable, while in other cases the optimism relates to the capacity to manage capitalisation systems that assume high levels of financial market sophistication, supervision and regulation. The important difference between the World Bank approach and a simple pay-as-you-go system, subject to successive changes in parameters, resides in the attention paid to the risks the World Bank stresses. These imply the need to take into account not only the system's parameters (such as the level of contributions and pensions or the retirement age), but also its macroeconomic context and all the associated constraints.

Simple examples illustrate the point. The most common changes to the parameters – and the easiest to implement – in pay-as-you-go systems consist, in the short-term, of allowing inflation to lower the real value of pensions and, in the medium and long-terms, of reducing

[6] Cichon, M. et al. (2004). Author's emphasis.

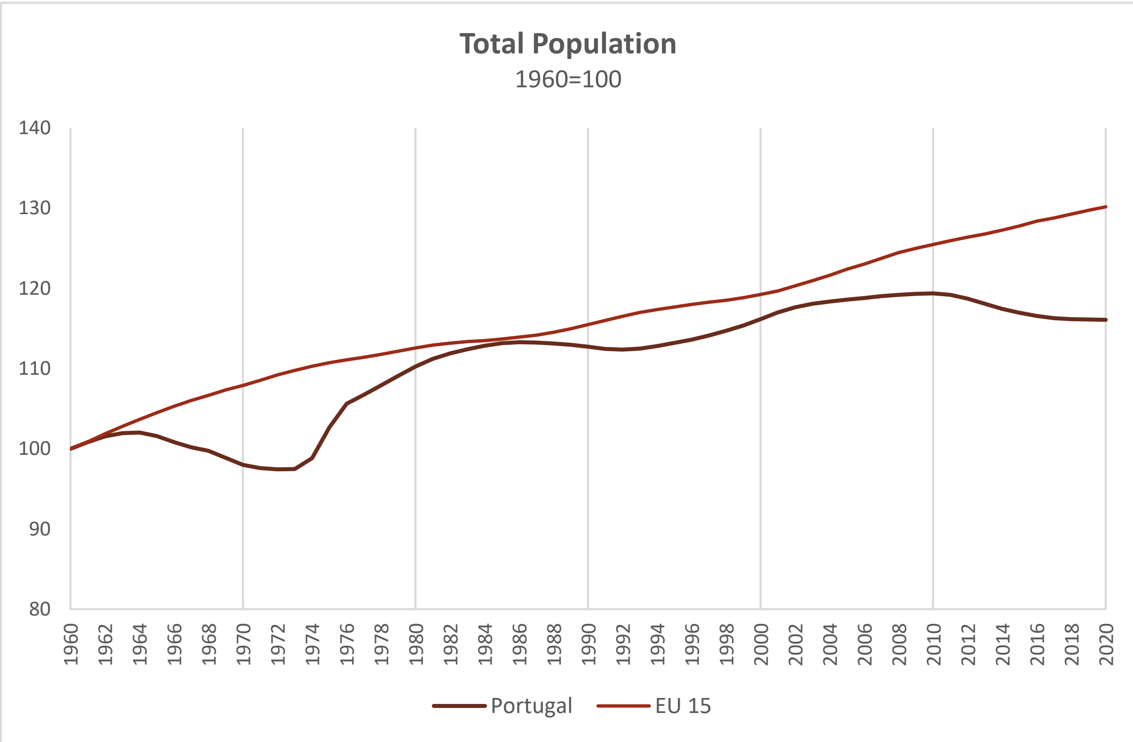
the replacement rate (that is the relationship between the first pension and the final wage). The former, despite its immediate implications for households' purchasing power – and, as a consequence, for the economy – has the advantage of deflecting the pension system's responsibility, at the same time encouraging inflationary policies. The latter has an effect that is the more perverse the less transparent the expected change in the substitution rate. The probably inevitable decline in the rate implies the strengthening of household savings in order to avoid a sudden drop in income after retirement. However, for this to take place, a number of conditions must be fulfilled: awareness of what is to come, appropriate incentives to savings, and suitable financial instruments in well-regulated markets. If the wide-ranging consequences of these changes are swept aside by successive adjustments to the parameters, the system is doomed to bankruptcy.

2. The Portuguese case

2.1. Years of confidence and demographic change

When the World Bank report was published, the Portuguese population was still benefitting from the return of emigrants in the 1970's. For this reason, even when population growth began to decline faster than in the EU15, this did not seem to be a reason for immediate concern. At the same time, economic growth compared to the EU15 average, either measured by total GDP or productivity (GDP per person employed), was also on a satisfactory path.

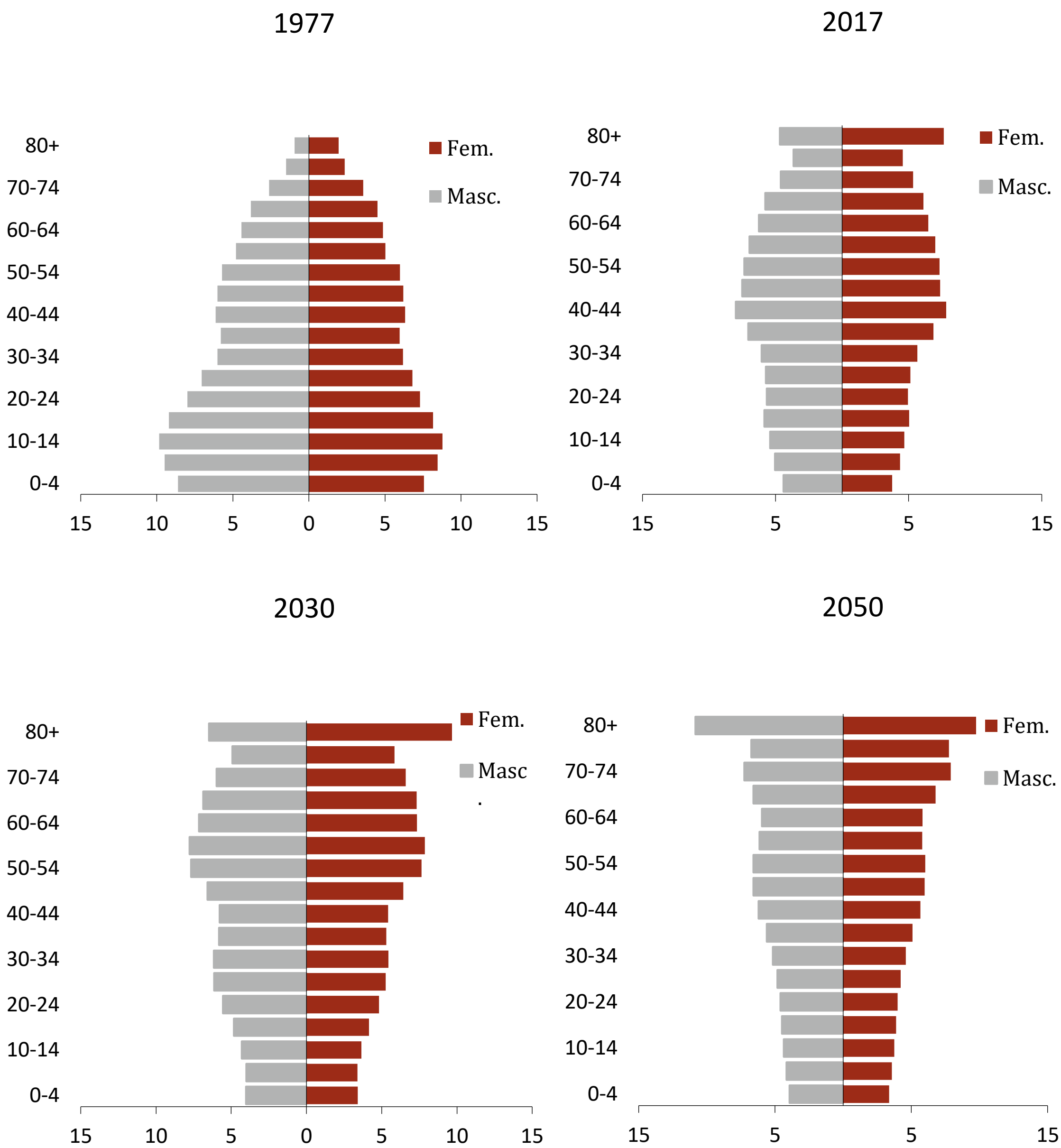
Chart 2 – Total population (1960 = 100)



Source: AMECO, November 2018.

However, the population's age composition was moving in a less positive direction, and the decline in the birth rate and the increase in life expectancy pointed to a further deterioration. In fact, in 1977 the population aged 65 or over accounted for 10.5% of the total, while those aged 20 to 64 accounted for 54.4% and minors under 19 years of age were 35.1%. In 2017 the figures had changed to 21.3% aged 65 or over, 59.5% aged 20 to 64, while 19.2% were aged 19 or under. The total population in 2017 was 10.3 million; according to Eurostat forecasts it should be 9.1 million in 2050 and, if current trends continue, 7.6 million in 2080. The charts below illustrate this change. Its implications for the sustainability of the current pension system can neither be ignored nor offset by increases in the already high levels of contributions and/or taxes.

Chart 3 – Age pyramids

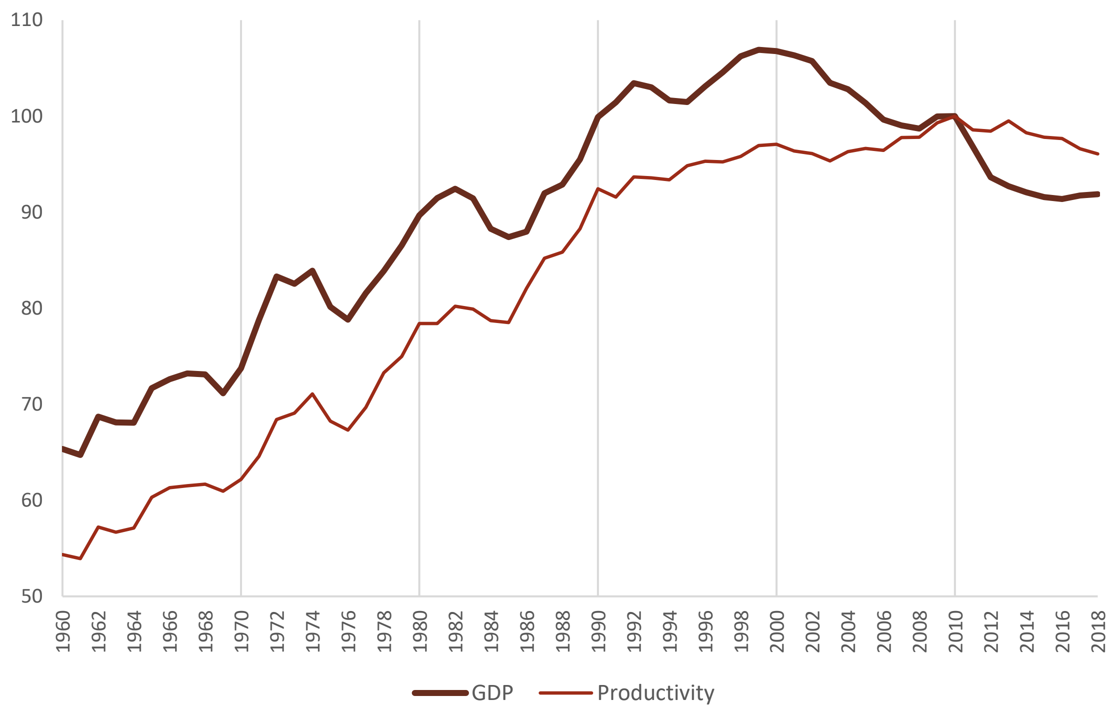


Sources: Eurostat and INE.

As a complement to the legally established pay-as-you-go system, in 1989 Portugal created the capitalisation instruments which are still the dominant option of savers in this field. These were the Retirement Savings Plan (RSP), which received favourable tax treatment, justified by the goal of encouraging private savings to supplement post-retirement earnings. At the level of policy decision-makers, however, this concern soon followed the path identified in the World Bank study, i.e., to use the financial leeway in the social security system in its early days to bolster the profligacy of the public systems, be that the size of the pensions or the retirement age. As that study also documents, later developments would soon confirm the temporary nature of the factors that gave rise to that leeway.

Besides the ageing of the population, throughout the 1990's it was clear that productivity growth was falling,[7] a trend that would become stronger and be reinforced by the fall in employment in the following decade, giving rise to a strong slowdown in GDP. On the contrary the pension commitments made earlier started to materialise, becoming one of the main sources of pressure on fiscal policy and leading to the 2007 reform of the pension system.[8]

Chart 4 – Portugal: Performance relative to the EU15 (2010 prices)



Source: AMECO November 2018.

2.2. The 2007 reform

The 2007 reform, despite the prior discussion as to the advantages and disadvantages of the pay-as-you-go system compared to capitalisation, fully retained the option for the former, albeit with important changes to parameters that strengthened the system's sustainability. These included a more flexible retirement age and the creation of incentives to extend

[7] Measured by GDP per person employed, the variable for which a sufficiently long statistical series exists. The charts which represent performance relative to the EU compare the rates of change in each of the variables in Portugal against those observed, on average, in the EU. They show that, up to 2000, GDP and productivity tended to grow faster than in the EU, although without reaching the levels recorded there. After 2000, the change was smaller than the EU average, especially GDP, as productivity grew slighlty due to the decline in employment.

[8] Social Security Framework Law, Law no. 4/2007 of 16 January and Decree-Law no. 187/2007 of 10 May.

working life, in particular through the introduction of the "sustainability factor" and stiffer penalties for taking early retirement.

The enhancing of the system's sustainability would inevitably involve some combination of prolonging working life and reducing future pensions. According to the legislation, the effect of these changes was gradual but would sharply increase over time, in particular as a result of the increased life expectancy. The impact of the lower replacement rate has enormous importance for households, because it supposes changes in their behaviour, so as to accumulate savings in order to avoid the effects of an abrupt drop in earnings on retirement. That explains the gradual introduction of the new system, so as to make this adjustment viable. This was especially pertinent in the Portuguese case as the system had initially tended to guarantee earnings in full upon retirement (sometimes even strengthening them through tax breaks and by the habit of promoting people shortly before retirement). However, for this change in behaviour to take place, households had to be aware of the implications of the new system, while stimuli to encourage savings and suitable financial instruments had to be developed.

The European Commission currently publishes a Pension Adequacy Report [9] that deals with this topic in detail and analyses the various implications of different options as to career length, contributions and gender. This is a complex study that calls the attention for the importance to the working population of being aware of the possibilities open to them in order to make decisions while being aware of the risks of each of them. However, in Portugal not only was little attention paid to this analysis, but the political debate has underestimated the sharing of responsibility with households, retaining instead the idea of the State being solely responsible and ignoring the constraint which the 2007 reform had implicitly recognised.

In fact, this contradiction was inherent in the model then defined, which differed considerably from that proposed by the World Bank, especially by continuing to concentrate funding of the system on the first pillar. The concession made in this area was limited to the setting up of a Complementary System, comprising a public capitalisation scheme, as well as complementary schemes, both public and private. Under the law,

> *The complementary system comprises a public capitalisation scheme and complementary schemes set up collectively and individually.*
>
> *The complementary schemes are recognised as significant social protection and solidarity instruments, fulfilled through the sharing of social responsiblities, and their development should be encouraged by the State through suitable incentives.*

[9] European Commision (2018).

The public capitalisation scheme is voluntary, is organised and managed by the State, and seeks to provide payments which complement those granted by the welfare system, in order to strengthen beneficiaries' social protection. [10]

However in practice, the system remained centered on the public sector and continued to call for a high level of contributions.[11] In fact, the stimuli to the Complementary System's development did not materialise and no efforts were made to rise awareness among households for the need to save, nor to strengthen the means available to achieve that end. On the contrary, the worsening economic and fiscal difficulties increased the pressure on the disposable income of working people, at the same time as it led to a decrease in the tax policy stimulus to voluntary saving, in particular the RSP's. The consequences of the international financial crisis made these problems even worse, particularly in countries such as Portugal, where the level of indebtedness reached by the economy would require an enormous deleveraging effort and the adoption of unavoidable, countercyclical restrictive policies.

Under these conditions it is no surprise that the complementary system stagnated, especially as regards the capitalisation component. According to the latest figures published,[12] at the end of 2017, the public scheme (through the Retirement Certificates Fund) had 7 619 members and a portfolio valued at 43 million euros.[13] At the same time, the RSP's, despite remaining an important voluntary savings product, standing at around 14 000 million euros, went into decline due to market conditions and the lack of stimuli.

2.3. Public sector liabilities

Thus, the public sector remains almost the only guarantor of households' pension entitlements. An exercise coordinated by Eurostat, which was conducted in Portugal by Statistics Portugal and the Bank of Portugal, estimated the value of these entitlements at the end of 2015 was around 584 000 million euros (equal to 325% of GDP), a figure slightly lower than the EU average, but one where the liability is centred on the public sector, thus increasing significantly that relating to public debt of around 125% of GDP. [14]

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[10] Articles 81 and 82 of Law no. 4/2007 (text republished in Law no. 83-A/2013 of 30 December).

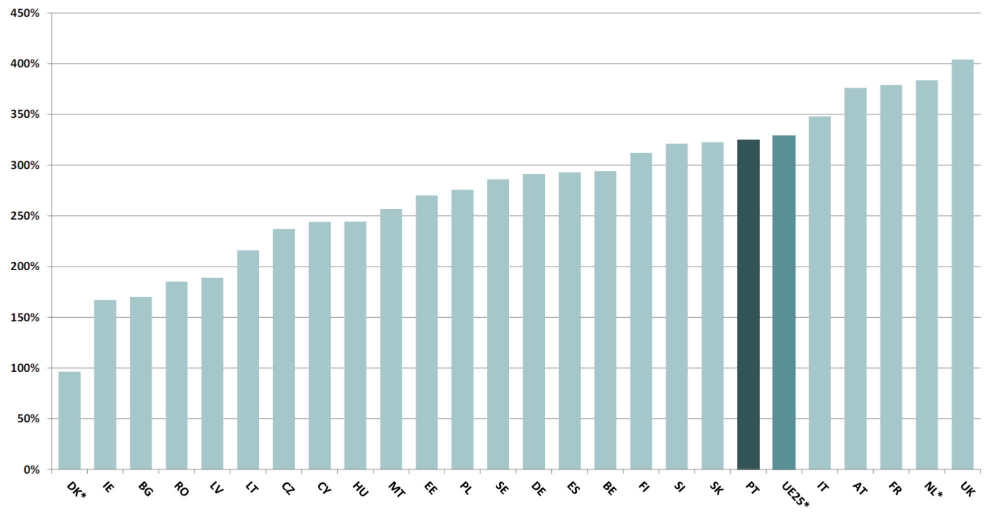
[11] Social security contributions (11% and 23.75% of gross salary to be paid by the employee and employer, respectively) also cover other liabilites such as unemployment benefit and long term care, another item that is highly sensitive to the ageing of the population. The total tax wedge (which includes personal income tax) stood at 40.6% of the cost of labour in 2018. For an international comparison see OECD (2018).

[12] IGFCSS, IP (2018).

[13] For comparison purposes, note that in 2017 total pensions paid by the social security system exceeded 16 000 million euros.

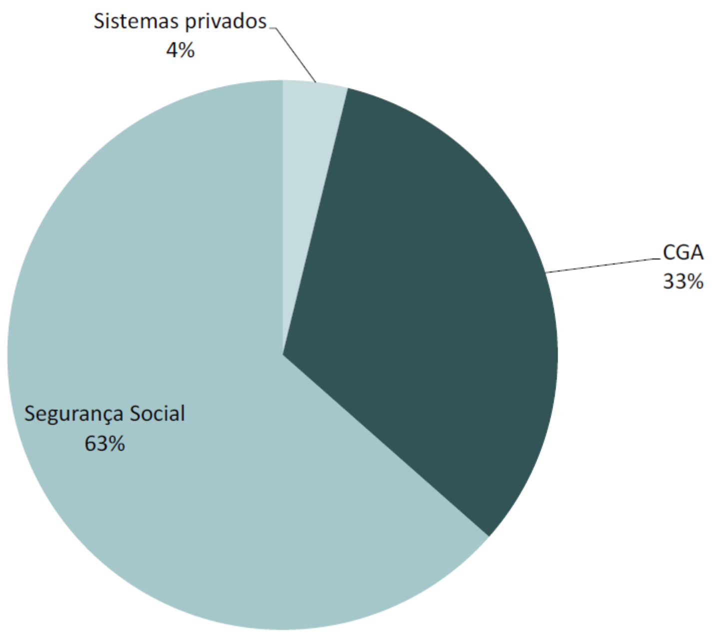
[14] Statistics Portugal (2018).

Chart 5 – Pension entitlements by EU Member-State in 2015 (as % of GDP)



Source: Statistics Portugal based on data published by Member-States. Statistics Portugal (2018).

Chart 6 – Accrued-to-date pension entitlements by system in 2015



Source: Statistics Portugal (2018). Private systems: 4%; Civil servants' system (CGA): 33%; Social Security: 63%

As Statistics Portugal stresses, we are talking about a **potential liability** (since it does not consider possible future changes to the current public systems), that is **prospective** (based on generational accounting models) **and limited** (restricted to the entitlements accrued up to 2015). Nonetheless, these features – in particular the potential nature of the liability – do not detract from its importance. Indeed, the rights granted to households determine their expectations and their behaviour concerning consumption, saving and investment. Abrupt cuts in entitlements give rise to a loss of confidence and especially hit the most fragile members of the social fabric, while at the same time, at the macroeconomic level, they divert investment to the search for immediate results, to the detriment of options that enable long-term economic growth.

As the World Bank underlined and Portuguese experience has confirmed, the gradualist approach does not allow disregarding important conditions. The first consists of the State's and Social Security's financial capacity to bear the costs which will only materialise gradually. The second requires total policy transparency, so that everyone understands and assesses the options available to them in time to adjust their behaviour accordingly.

However, the latter condition implies another: policy decision-makers trusting that, in this matter, the contribution of well-informed economic agents is a much more effective solution to the problem than successive – and sometimes contradictory – policy adjustments. These end up adding to the uncertainty, and in some cases, even create incentives that guide citizens in the wrong direction when responding rationally to the stimuli. This is particularly noticeable in relation to savings behaviour, a key element of the topic discussed here.

3. Capitalisation and savings

3.1. Income and savings

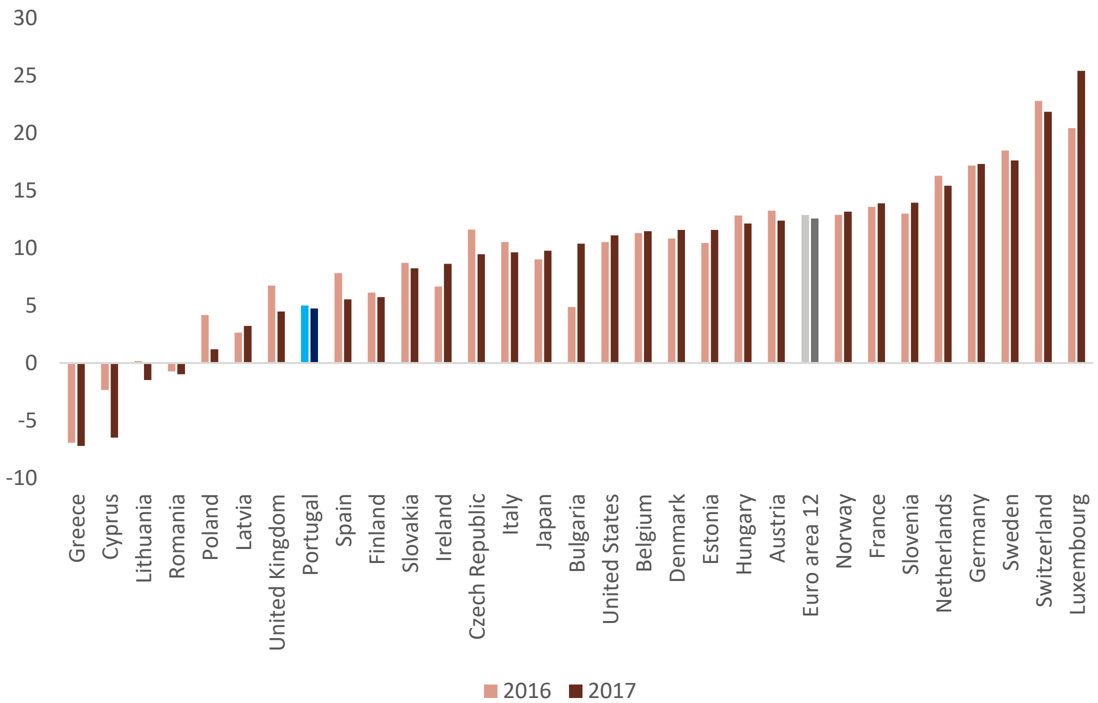
The very low saving rate in Portugal, combined with the insignificant weight of the existing capitalisation instruments, may reflect a certain apathy on the part of the main beneficiaries of the mechanisms available to mitigate the risks of a significant drop in earnings on reaching retirement age. Three explanations are commonly given for this state of affairs:

(i) insufficient income to allow for saving;

(ii) the financial illiteracy of a large number of the people concerned that does not allow them to manage their interest appropriately;

(iii) the financial crisis which lowered the return on investment and undercut confidence in financial markets.

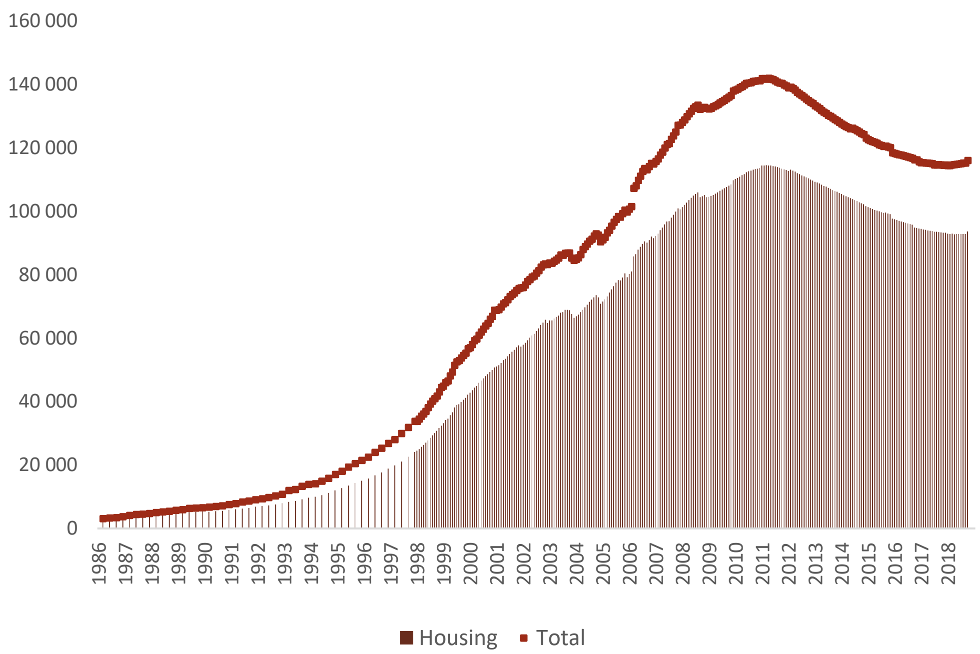
Chart 7 – Households' saving rate (as % of disposable income)



Source: AMECO, November 2018.

All three explanations carry some weight, but not enough to explain the apparent apathy. In fact, Portugal saw its households' rate of saving decline precisely when disposable income was on the rise and when the real return on financial assets grew thanks to the control over inflation.[15] So it is important to look for other reasons for these developments.

Chart 8 – Banking loans to private individuals (M€)



Source: Bank of Portugal

The first reason for the decline in savings as incomes rise is related to households' access to credit. As an immediate consequence of joining the EU, the opening up of this source of finance (previously extremely limited), together with the decrease in the level and risk associated with its cost, reinforced the highly optimistic expectations about the economy. Within this framework it made sense for households to increase consumption and investment in housing, in the expectation that the level of future earnings would enable them to service the debt, while at the same time creating important assets for old age.

So, the Portuguese households' consumption pattern underwent a profound change, mainly as regards the quality of housing, energy consumption and vehicle usage. However, from the end of the nineties, economic developments proved considerably less favourable than expected. The enlargement of the European Union to include East European countries had a great impact on the competitiveness of the Portuguese economy, requiring structural adjustments that the abundance of finance could have supported, but which only started later and remain incomplete. The results of these adjustments would have been less

[15] In 1995, the first year for which comparable data are available, Portuguese households' saving rate was 12.5% of disposable income. In 2017 it was 4.7%.

immediate, but safer, than those of the growing indebtedness of households (and the country) which fuelled the illusion of continued affluence.

However, such adjustment would have required policies and stimuli that guided households' decisions towards greater prudence as to the future. Instead, the policies adopted led to the extension and increased weight of entitlements for which the State was liable, while the State's access to finance was taken for granted and public expenditure remained crucial to economic growth. Nevertheless, the first decade of the 21st century would show that in light of the loss of competitiveness, neither economic growth, nor the State's ability to borrow were guaranteed. In this context households were faced with the worsening of job and income prospects, which made debt servicing an important factor in the pressure on their spending and ability to save. The fact that most of the debt had been incurred with very long maturities did not mitigate the problem in the short-term and prolonged its effect over time.

The problems were exacerbated by the fiscal instability and led to a decade of falling employment, near stagnation of economic growth and increasing weight of external indebtedness, a set of vulnerabilities which seriously increased the impact of the international financial crisis. This was felt simultaneously in all fields in which up to then consumer and investor confidence were founded: confidence in the economy's ability to create jobs and generate income, in the soundness of the financial system and even in the State's borrowing capacity. All of this destroyed the foundations on which household decisions were taken, while at the same time increasing the pressures they faced. These included the weight of financial charges, but also the difficulty in reducing consumption levels, which was reinforced by constraints that are not dependent on household decisions: transport and energy costs and, generally, the taxes levied on consumption. When these improve public savings, they contribute to the country's macroeconomic balance. If, however, they are used to increase public expenditure, it becomes necessary to evaluate what this consists of and what are its economic and social impacts, not forgetting the implications for consumer expectations and behaviour.

3.2. Financial illiteracy

Households' financial illiteracy is a general concern in all countries and is compounded by the enormous and growing complexity of financial markets. Therefore, assigning importance to capitalisation schemes calls for greater responsibility on the part of the financial authorities and the State, in terms both of financial stability, the quality of information, and the selection and supervision of bodies allowed to manage the savings that should be included in the second pillar of the pension systems. In fact, all these conditions are indispensable to savers and private systems managers as well as to public managers, and they increase awareness of risks, irrespective of the pension system adopted.

3.3. Effects of the financial crisis

One of the key instruments for overcoming the financial crisis was the fall in nominal interest rates to unprecedently low levels. Along with the abundant liquidity, this is a stimulus to indebtedness but not to saving. This is one of the current dilemmas of economic policy, not only in Portugal: given the high levels of indebtedness, simply incurring more debt is not a solution. As was seen in the past, debt which does not generate the income required to service it (under normal interest rate conditions) brings about an effect this country is very familiar with: an increase in the interest rates paid abroad, due to increases in the risk premiums, which ends up hitting sovereign debt once the banks have lost access to international markets.

To recognise that indiscriminate indebtedness does not solve the problem leads us back to the original questions: how to use available funds to increase productivity and economic competitiveness. Neither the option of assigning responsibility entirely to the State and adopting a full pay-as-you-go pension system, nor the capitalisation option, solve the problem by themselves. The solutions are far more complex and wide-reaching and this is the topic that needs to be discussed.

4. Solutions?

4.1. The definition of economic policy

If we are to find solutions for a problem, we must first make a correct diagnosis. In economics there are problems that are essentially short-term, but there are also long-term issues, which take longer to develop and, though sometimes temporarily superseded by short-term developments, continue to determine the path the economy takes. For a long time, economists believed that the quick resolution of short-term crises would ensure the return to the long-term trend, the loss of revenue being only temporary. More recent analyses have shown that this is not the case and that the growth path is significantly affected, particularly in economies that experience more frequent and deeper crises.[16]

Among the developed economies, Portugal has shown a high degree of instability, as well as a downward trend in productivity, that have had a negative effect on potential economic growth. One explanation for this could be the increasing uncertainty that instability arouses, for example in regard to the return on investments, which runs contrary to the advantage that *a priori* would benefit economies that are initially less capital intensive.

Investment decisions – financial or real – must necessarily take into account the future. Economic policies designed to solve conjunctural crises tend, however, to be based on short-term stimuli, and it is taken for granted that solving the crisis will ensure favourable prospects in the medium and long-term. However, when the root of the problem is structural, the answer is not to forge ahead on the basis of vaguely Keynesian measures that increase public expenditure and indebtedness, and even less to resort to protectionist measures. Keynes did indeed defend stimulating demand as a countercyclical instrument to fight economic crises, but he never advocated uninterrupted growth in public expenditure and indebtedness over a number of decades, nor unlimited monetary expansionism. So, he is not responsible for their use in a context that he himself described as the behaviour of practical men who, believing they are free from the influence of experts, become slaves to ideas – more or less distorted – of some economist from years gone by. Therefore, the problem does not lie in Keynes's merits, which history has not refuted. But rather in economic policies able to address short-term problems without ignoring the medium and long-term trends and risks.

In the medium-term, the risk to be borne in mind is the inevitability of economic cycles. The small, open Portuguese economy, whose growth is dependent upon becoming more open, is vulnerable to its own crises, as well as those of its partners. Over time it increased that vulnerability by trying to fight it through greater indebtedness without the necessary impact on productivity. Thus, servicing the debt came to absorb a growing share of income, while indebtedness ratios worsened on every front: public and private, short and long-term, effective and potential.

[16] Cerra, Valerie, and Sweta Saxena (2017).

This placed a long-term constraint on economic policy that cannot be ignored. In the meantime, it was joined by other structural problems which, if not handled, will become irreversible conditions of impoverishment. Demographics, the environment and technological changes stand out among these and call for institutional reforms, devising of which requires different types of expertise, within a macroeconomic framework that promotes their adoption, instead of exclusive concern for the short-term. Indeed, such exclusive concern also worsens the situation in the short-term: a high level of indebtedness and low productivity levels make short-term crises more frequent and lead to growing costs, making the need for structural reform ever clearer.

4.2. The role of institutional reforms

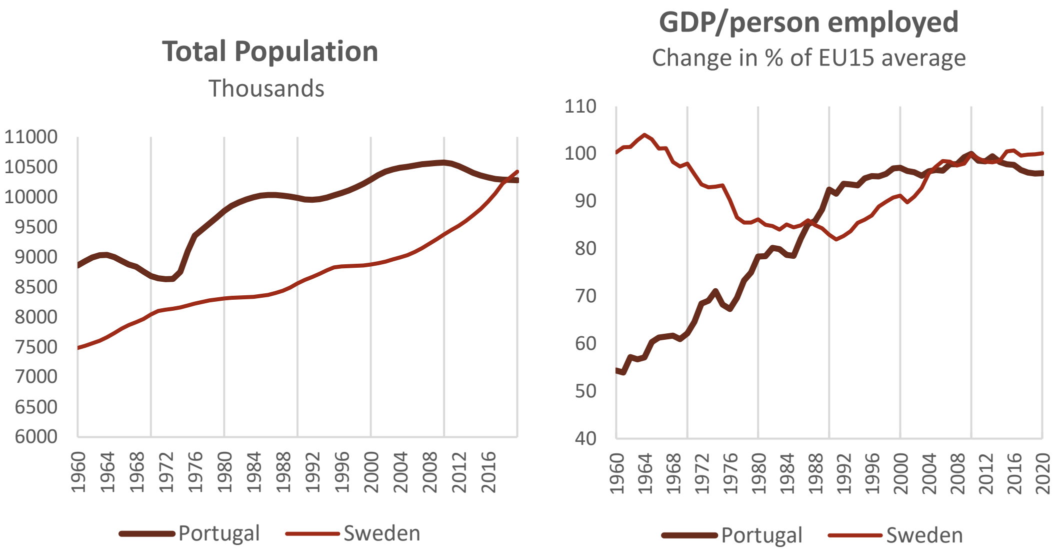
The current pension funding problem must be seen in this context. Assigning responsibility to the financial crisis and the abrupt corrections which it imposed and seeking to return to the *status quo ante* will not solve the problems of Portuguese economic growth, demographics, or indebtedness. Such reasoning will instead exacerbate the risks associated with pension funding. The solution to all these problems calls for a rethinking of the economic policy framework and tools, in particular those that relate to its main instrument: fiscal policy.

In recent decades, despite the excessive concentration on immediate results, Portugal achieved a substantial institutional transformation, through membership of the EU. This made a remarkable structural adjustment possible, especially in relation to investment in education and infrastructure. Now this needs to be completed by suitable policies aimed at the allocation of resources and involving public and private decision-making processes.

An example of how policies in these fields can have a significant effect on trends – favourable or unfavourable – is provided by the comparison between demographic changes and productivity performance in Portugal and Sweden.[17]

[17] In the 1960s, GDP/employed person in Portugal was 30% of the EU15 average, while in Sweden it exceeded that average by over 60%. The same variable at the beginning of the 1990s had risen to above 40% of the EU15 average in Portugal, while Sweden's advantage was down to between 10% to 20%. The chart shows the different relative paths.

Chart 9 – Total population (thousands) and GDP/person employed (change as % of EU15 average)



Source: AMECO, November 2018.

As a result of a serious crisis in the early 1990s, Sweden implemented a series of institutional and structural reforms, including those affecting the budget framework and the pension system, which came to closely resemble the model proposed by the World Bank. This was followed, both in terms of population growth and productivity, by a clear, positive change in the prevailing trends, while in Portugal the reigning optimism resulted in stagnation or even decline. This gives us food for thought because, despite the differences between the two countries, there are also important similarities, as both are small, open economies, which accord a major role to the State and social policies.

In the case of Portugal, the very fast favourable change that followed the 1974 revolution and membership of the EU benefitted from special circumstances that favoured decision-making processes aimed at picking the "low hanging fruits", i.e., the most accessible and politically cost-free changes. When these ran out, during the 1990s, mainly as a consequence of the enlargement of the EU and the advance of globalisation, Portugal, instead of fighting the resulting loss of economic competitiveness, chose to reinforce the short-term stimuli, taking advantage of broader access to external debt. The consequence of the preference for postponing necessary reforms was a reduction in the economy's growth potential, leading to the worsening of the vulnerability that the financial crisis revealed.

On the other hand, Sweden in the 1990s, after thirty years of rapid growth in the weight of the public sector and as a result of a serious fiscal crisis, undertook an in-depth reform of the fiscal framework, focused on the control of public expenditure and involving three-year ceilings on nominal growth of its various components, including social security. This was not, however, a case of withdrawing decision-making power from political institutions, turning them into slaves of automatic rules. Rather it provided management tools and assigned incentives and responsibilities to all participants in the process, with the conviction that this was the basis of the system's effectiveness. Other reforms accompanied or followed them, "not with a defensive nature, but a positive one, enhancing the capacity to improve public expenditure and to manage public finance better, with a view to improving economic performance and living standards". [18]

4.3. Reforms versus expenditure

In Portugal the attention paid to the State's role has predominantly focused on increasing entitlements and public expenditure. The judgement of the financial markets brought budget deficits and debt to the foreground, but lasting solutions for these problems cannot be found within the institutional framework that led to the erosion of the State's ability to implement its own decisions, not only for financial reasons but also due to information gaps, wrong incentives and, in some cases, lack of suitable skills.

A good example of this erosion is provided by the obstacles that prevent implementation of laws such as the Budgetary Framework Law approved in 2015 (BFL 2015). In general, these difficulties show the continued priority given to short-term measures, whose impact depends mainly on their announcement effect, leaving aside those needed to improve decisions and facilitate their proper implementation. That option can then be used to justify the exhaustion of resources that would be required to improve decision-making processes and the State's capabilities. In fact, the current budgetary framework focuses solely on annual outcomes, especially in terms of the headline budget deficit. In this regard responsibility is centred on the Ministry of Finance. While being indispensable to fiscal discipline, this is insufficient– and sometimes even contradictory to – when it comes to the adoption and implementation of measures that contribute to the quality of public expenditure. Indeed, almost twenty years ago an OECD paper classified annual expenditure reduction into five categories:

- Quality cuts: the year they are introduced they do not contradict other items of expenditure and in subsequent years they produce even better results;
- one-shot cuts: they have an immediate effect, but do not impact on subsequent years;
- vanishing cuts: they appear to work at the outset but involve future increases – because the need exists – or in other expenditure items;
- cosmetic cuts: they improve the appearance, but they change nothing (as when they transfer expenditure out of the budget scope or to later years);
- boomerang cuts: cuts which, over time, involve greater expense (for example, postponing maintenance costs or ignoring the risk of serious accidents).[19]

Portugal, following the one-shot cuts required by the crisis and taking into account the pressure of expenses relating to population ageing, cannot settle for vanishing, cosmetic and, even less, boomerang cuts. However, at the macroeconomic level, quality measures call for a budget time horizon that extends to the medium-term and even to the long-term, based on

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[18] MOLANDER, Per and Jörgen HOLMQUIST (2013).

[19] TARSCHYS, Daniel (2002).

consistent accounting information (which, namely, quantifies existing commitments and available resources). At the microeconomic level, it supposes that public managers have the necessary instruments and incentives to take and implement decisions within this time frame, within the context of an appropriate macroeconomic framework.

BFL 2015 seeks to create the conditions for a framework of this kind. The successive constraints that have affected its implementation are, therefore, a cause of concern, in particular when the underlying economic – and social – problems are discussed, including mainly the ability to finance the expenditure items most affected by population ageing, in particular social protection (including pensions) and health care. This concern becomes even greater given the amount of time already lost. The aforesaid OECD paper recalled, in 2002, that "the next decade or two provide a window of opportunity for adjustment of public policy before dependence ratios climb more steeply and various effects of population ageing begin to impinge more substantially on public finance. In this time-span, it is particularly important to review pension systems, examine the dynamics of health care and long-term care systems, and reconsider labour market exit rules and practices. Public debts must also be reduced in order to ensure fiscal sustainability."[20]

4.4. The financing of pensions

Portugal began well, by reforming the pension system in 2007, although the reform fell short, not only as regards the matters referred to above, but also in terms of later developments. At the same time, the continued political – and fiscal – focus on short-term results produced an effect opposite the one desired for the country's financial sustainability, while the essential questions relating to demographics and productivity continued to deteriorate.

In terms of demographics, the corrections required are related to improved household support (for example, access to nurseries), or the integration of women in the labour market, for example, through policies and practices aimed at reconciling careers and caring, especially of children, but also of the elderly. These ideas are not new, are accepted and have even been the subject of measures taken.[21] This gave rise to some progress, but the changing demographics leave no doubts as to their insufficiency, which can only be compounded as women gain access to education and by the nature of economic development.

Another key area is the stimulus to active old age, which places emphasis on life-long learning and much more effective vocational training, which is equally important in terms of improving productivity. Policies in this area need to abandon the predominant nature of subsidies or bureaucratic promotion levers, to become instruments that allow each worker to prepare for

[20] TARSCHYS, Daniel (2002).

[21] For example article 27 of Law no. 4/2007 states that "The law shall lay down special conditions to promote parenthood that help reconcile personal, professional and family life and pay special attention to support for childern who are minors." The next paragraph refers to the "development of social facilities that support early childhood" as one of those conditions.

the inevitable structural changes in the economy. In this field, it is worth looking at the reforms that France is introducing.[22]

Productivity growth depends on this and on the quality of investment and requires policies that provide for more flexible allocation of resources, respecting market mechanisms, which administrative formalities should regulate but not replace. These fall within the scope of micro- and not macroeconomics and require reforms that reconcile the two viewpoints. The quality of tax policy, the civil service skills, the quality, stability and transparency of regulations and economic information, as well as the way relations between the public and private sectors are handled,[23] are key elements to determining the role of public policies in the allocation of resources.

A lasting solution for financing pensions must involve the coherent rationalisation of the system, including a defined contribution funded pillar, which inevitably assigns a share of the risk to beneficiaries, though always safeguarding the most vulnerable. However, policies must be transparent and foreseeable, so that beneficiaries may consciously and effectively take on that risk. In addition, they must provide them with independent, easily accessible, complete and updated information on the system's prospects and the outcomes of the measures taken. Opting for frequent changes in parameters or sources of finance and for inadequately grounded intentions, together with sparse and confusing information, only exacerbates the loss of confidence and increases the risks.

On the macroeconomic front, policies aiming at an effective solution cannot ignore the uncertainties that the future inevitably entails. This requires attention to the environing realities and the recognition of changes for which we must prepare ourselves, the earlier and more carefully the least optimistic the prospects. Demographic, technologic and environmental developments are good examples. In the short-term, while everything is going well, it may be difficult to accept measures designed to deal with problems which, although present, are yet to produce all the consequences. But only this way is it possible to guard against those consequences, affecting not only future generations, but also the most fragile members of current ones.

There will be other future developments that we are unable to foresee or assess and they should also be borne in mind when taking current decisions. At the public policy level, the way to do it consists, first of all, of governments maintaining sufficient fiscal leeway to deal with them when they arise. And it consists, above all, of ensuring confidence in institutions, thanks to transparent and up-to-date information which allows individual citizens to take responsible decisions, bearing in mind what the future holds for them.

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[22] Ministère du Travail (2018). For structural reforms in general see France Stratégie and the respective specialist bodies network.

[23] These involve the judicial system, but also, more generally, what Vito Tanzi (2011) called the "market of favours", which may be legitimate or not, but whose importance tends to increase in countries more predisposed to corruption.

There are no miracle solutions, but a wealth of literature and information is available on these topics and on the experience of other economies that have long dealt with the same problems. In Portugal, we have to overcome the concept of a paternalist State which holds itself to be wise, all powerful and benevolent, and which is always able to find someone to blame for its faults. Ensuring funding of the pension system requires sharing of decisions and risks. The State cannot on its own eliminate all risks and will not fulfil its mission if it creates the illusion that this is possible. But it can – and must – create the conditions for minimising them and ensuring they are shared as equitably as possible, the sole effective means for protecting the most vulnerable.

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