Upjohn Institute Press

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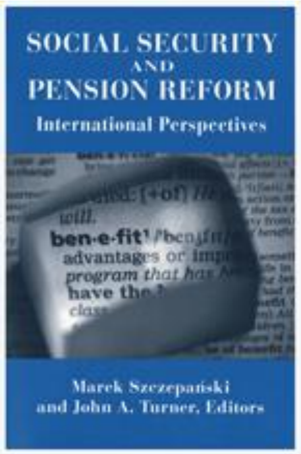

Chapter 5 (pp. 101-128) in:
Social Security and Pension Reform: International Perspectives
Marek Szczepański and John A. Turner, eds.
Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2014
DOI: 10.17848/9780880994705.ch5

Social Security and Pension Reform

International Perspectives

Marek Szczepański
John A. Turner
Editors

2014

W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

Social security and pension reform international perspectives / Marek Szczepanski, John A. Turner, editors.
pages cm
"This book is based largely on the 2012 conference of the European Network for Research on Supplementary Pensions (ENRSP), held at Poznan University of Technology, Poznan, Poland, on September 13-14, 2012"—Preface.
Includes index.
ISBN 978-0-88099-467-5 (pbk. : alk. paper) — ISBN 0-88099-467-3 (pbk. : alk. paper) — ISBN 978-0-88099-468-2 (hardcover : alk. paper) — ISBN 0-88099-468-1 (hardcover : alk. paper)
1. Social security. 2. Pensions. 3. Pensions—Government policy. I. Szczepanski, Marek, 1959- II. Turner, John A. (John Andrew), 1949 July 9-
HD7091.S5865 2014
331.25'22—dc23
2013043011

W.E. Upjohn Institute for Employment Research
300 S. Westnedge Avenue
Kalamazoo, Michigan 49007-4686

Cover design by Alcorn Publication Design.
Index prepared by Diane Worden.
Printed in the United States of America.
Printed on recycled paper.

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The Reform of Social Security Pensions in Portugal

A Critical Assessment

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This chapter provides a critical perspective on the policy direction followed in Portugal after the reform of social security pensions in 2007. First, it examines and assesses the main legislative changes introduced in that year by the former socialist government. The reform has been presented to the public as unavoidable, intended to improve financial sustainability while preserving the overall logic of the system. The chapter argues that it did not have a limited impact in the structure of the pension system, as it has introduced a fundamental change of perspective regarding the objectives and principles of pension policy. It also tries to show how the Portuguese process of reform has been influenced by political decisions from the EU, by focusing on restrictive rules that guide economic policy and the EU strategy for pensions. Economic policies inspired by the New Classical Economics paradigm and an agenda for pensions aligned with supply-side oriented economic policies have been important features in national pension policy. A particular emphasis is attributed to the critical influence of economic performance on pension systems' budgetary equilibrium, arguing that economic failures explain, to a great extent, much of the problems identified in Portugal.

The chapter is organized as follows. The first section describes the main measures introduced by the reform program of the social security pension system introduced in 2007. The second section develops a critical analysis of that reform. It examines its adverse effects regarding pensioners' well-being and its methodological incoherence. Next, it describes the path change introduced in the objectives and principles of policy, concluding that although pay-as-you-go financing has not been replaced by funding, its overall logic has changed. The next section examines the influence of the EU on the Portuguese reform process. The supply side–oriented economic policy paradigm, dominant at the EU, helped create an economic environment since the early 1990s that has favored the introduction of pension reforms. However, the social policy agenda set at the EU aligned with that paradigm has also been an important element in the reform process. Finally, the last section emphasizes the critical relevance of economic performance on social security budgetary equilibrium, arguing that the budgetary difficulties identified in the present are mainly the result of restrictive macroeconomic policies unfavorable to employment and growth. A paradigmatic change in economic policy is a necessary condition to allow a different orientation for pension policy.

MAIN LEGISLATIVE CHANGES

In Portugal, social security is financed by a total contribution rate of 34.25 percent of earnings paid by the employee and employer. Out of this total, employees pay 11 percent and employers pay 23.25 percent. These contributions finance old-age benefits (20.21 percent, since 2010), survivors' benefits (2.44 percent), unemployment benefits (5.14 percent), and disability benefits (4.29 percent). The contributions also finance sickness, parenthood, and occupational disease. The legal age of retirement is 65, but benefits can be received at age 55 for workers with 30 years of contributions (with penalties for early retirement), though the award of early retirement benefits has been temporarily suspended from 2012 through 2014, except for the long-term unemployed.

The social security pension plan in Portugal was reformed in 2007.[1] This plan is mandatory for the employees and self-employed workers in the private sector. Civil servants are covered by a separate plan.[2] Other plans also exist but cover a limited percentage of the total active population.

This reform introduced three important changes in regard to retirement benefits. First, a "sustainability coefficient" was introduced in the formula for calculating pensions. This coefficient is a demographic adjustment factor, which reduces pensions by a certain percentage as life expectancy increases. It is equal to the ratio between life expectancy in 2006 and life expectancy in the year preceding retirement. The level of statutory pension is multiplied by the coefficient and is thus reduced as life expectancy increases. The decrease in pensions may be partially offset if workers decide to postpone retirement or if they increase their voluntary contributions to a new complementary public plan of individual accounts.

Second, the formula for calculating pensions was changed. After 2007, pension levels are calculated taking into consideration the earnings of the entire working life. Since 1994, pension levels were calculated on the basis of the average earnings of the 10 best years of the final 15.[3] A 2002 law stated that the earnings of the entire career would be taken into account for calculating the pension.[4] However, it also defined a transitional period, 2002–2016, during which the most favorable method of calculation—the former, the latter, or a weighted average of both—could be applied in order to guarantee beneficiaries the most favorable rule to determine the pension level. For that reason, the full impact of the measure was not felt. During the transitional period, only approximately 17.5 percent of pensions were calculated based on the earnings of the entire career, the method that could guarantee the most favorable pension amount (European Commission 2005, p. 2). The reform of 2007 accelerated the transition to the new method of calculation. The pension is determined by a weighted average of two terms: one is based on the best 10 years of earnings of the final 15, the other is based on the earnings of the whole career. The weight of each term depends on the moment of retirement and the length of the contributory career up to a specified moment of reference. For those who retire before 2016, the moment of reference is 2006; for those who retire after 2016, the moment of reference is 2001.

Third, new rules for indexing the benefits were approved, which came into effect in 2007.[5] The new method does not guarantee the maintenance of the real value of all benefits. Higher benefits will be indexed to prices only for higher rates of economic growth. In addition, the minimum wage is no longer used as reference for determining minimum pension levels. The process of gradual convergence of the minimum level of pension with the national minimum wage started almost 10 years before and was completed in 2005.[6] In 2006, pensioners with a career longer than 30 years were entitled to a pension equal to the minimum wage (net of employee contributions), and those with shorter careers were entitled to a certain percentage of the net minimum wage. However, immediately after, there was a reversal of this policy. A law published in the end of 2006 stated that thereafter the adjustment of the minimum levels of pensions should be dissociated from the minimum wage.[7] A new term of reference for calculating and adjusting the benefits is used, the *Indexante de Apoios Sociais* (IAS), which is defined every year by the government. As a consequence, the minimum pension level started to diverge from the net minimum wage, as Table 5.1 shows.

The reform also introduced new rules to encourage older workers to stay in the labor market such as higher penalties for early retirement and incentives to extend working life.

A CRITICAL ANALYSIS OF THE PORTUGUESE REFORM PROCESS

A Reform Focused on Cutting Spending

The reform was presented to the public as necessary to contain pressures on the social security budget and guarantee its fiscal sustainability (Ministry of Labour and Social Solidarity [MTSS] 2006a,b). The policy solution chosen was based exclusively on the reduction of benefit levels.

The option of cutting pensions is particularly adverse in the Portuguese case because, at the time the reform was introduced, the retired population had on average lower incomes and higher incidence of poverty than the rest of the population (Murteira 2008). This is explained by the late development of the Portuguese public pension system and by work histories characterized by low earnings and short contributory periods. Table 5.2 shows that more than 80 percent of old-age pensioners were entitled to an amount of pension lower than the national minimum wage. Thus, the strategy followed has placed the burden of the adjustment exclusively on pensioners, particularly on pensioners with the lowest incomes.

Table 5.1 Evolution of the Minimum Wage and the Minimum Pension Level

Years	Minimum wage (euros)	Net minimum wage (euros)	Minimum pension level (career > 30 years) (euros)	MPL/ Net MW (%)
2006	385.90	343.45	343.45	100.00
2007	403.00	358.67	354.10	98.70
2008	426.00	379.14	363.81	96.00
2009	450.00	400.50	374.36	93.50
2010	475.00	422.75	379.04	89.70
2011	485.00	431.65	379.04	78.20
2012	485.00	431.65	379.04	78.20

SOURCE: Author's calculations.

However, some analysts argue that the decrease in the benefit levels should not be a reason for concern because, up to 2007, the system could guarantee high replacement rates. Thus, the system could be considered "generous." This argument, although frequently mentioned, is not strong. It is important to understand why replacement rates were high while the majority of old-age pensioners received very low benefits. Analysis from previous research (Murteira 2008) helps to clarify this question. The average gross replacement rates were broken down by income quintile for several cohorts of men and women who retired

Table 5.2 Distribution of Old-Age Pensioners in 2005, by Pension Levels

	Old-age pensioners	
Level of pension (euros)	Number	%
<374.7	1,110,912	81.00
374.7–562.05	112,440	8.20
562.05–749.40	54,454	3.97
749.40–1124.1	53,094	3.87
1124.1–1873.5	29,553	2.15
1873.5–2997.6	8,521	0.62
frm 2997.6–3747.0	2,555	0.19
Total	1,371,529	100.00

SOURCE: Ministry of Labour and Social Solidarity (2006a).

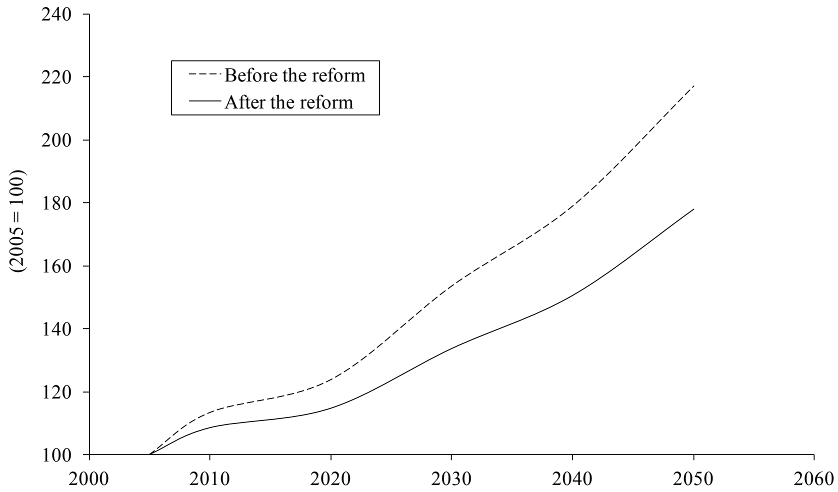
before the rule change. The disaggregate data on replacement rates helps to explain the paradox. High replacement rates did not reflect the generosity of the social security pension system. The highest replacement rates were those of pensioners, especially women, with very low wage levels who were entitled to a minimum pension level. A high percentage of women had low incomes and short working careers. These women were entitled to a minimum pension level that was higher (in many cases much higher) than their previous wages. Thus, the fact that replacement rates were high does not mean that the system provided generous benefits. High replacement rates and low pension levels were two faces of the same coin.

Moreover, the reform may also be criticized from a methodological standpoint because it has focused on the means of policy (spending on pensions) and neglected its ends (the social objectives). The objectives to attain, in regard to income security, are not reported either in the text of the law or in the document that reveals the strategic lines of the reform (MTSS 2006b). The State Budget Report (Ministry of Finance and Public Administration [MFAP] 2006) presented the estimated effects of the new rules regarding the future reduction of public spending on pensions and the future decrease of real growth of average pension, as Figure 5.1 shows. This outcome was considered positive.

This conclusion results from a biased perspective that consists of assessing policy only by its budgetary consequences, ignoring the essential purpose of pension provision. The obsession with the means of pension policy has led to the neglect of the ends. An appropriate assessment of pension policy should focus on its ends, looking at the means in view of the ends. As the purpose of pension plans is to provide retirement income security, a consistent policy design requires a clear specification of this aim. Spending on pensions should be seen as the "constraint" to face, rather than the "objective," as Barr and Diamond (2008, p. 33) have observed.

The view that motivated the reform undertaken in the field of social security pensions in Portugal, based on cutting benefits in order to alleviate fiscal problems, represents a way of approaching the welfare state that has been deeply criticized by Atkinson. In particular, the author underlined the tendency to look exclusively at costs without considering the benefits of the welfare state: "The whole purpose of welfare state provision is missing from the theoretical model" (Atkinson 1999,

Figure 5.1 Expected Real Growth Rate of Average Pension



SOURCE: Ministry of Finance and Public Administration (2006).

p. 8). In the Portuguese debate the purpose of pensions was completely absent. As a consequence, the level of benefits has been taken as the adjustment variable in a policy aimed at containing spending.

The Structural Nature of the 2007 Reform

The reform was presented to the public as merely parametric, aimed at improving financial sustainability while preserving the overall logic of the system. However, there are sound reasons to argue that this reform had an important impact in the structure of the social security pension system. Thus, it might be better defined as structural.

The first reason is that it has produced a significant decline in the level of benefits, for both present and future pensioners but mainly for the latter. The three main measures introduced reduce the benefit levels because they affect both the replacement rate and the earnings path in the retirement period.

The replacement rate will decrease significantly over time because of the introduction of the "sustainability factor." According to the OECD (2007, p. 68), future benefits are expected to decrease around

20 percent as a result of the link to life expectancy. The replacement rate also decreases due to the new way of determining the benefits that are now based on the earnings of the entire career rather than the final earnings. Since working careers generally present rising earnings in later years, when pensions relate to the earnings of the entire career, the replacement rate is lower. Historical experience has shown that when pensions could be calculated according to the most favorable rule, between 2002 and 2004, only 17.5 percent of the new pensions were defined according to the new rule (European Commission 2005, p. 2). As a consequence, with the new formula, the large majority of pensions became more distant from the workers' final earnings and from the level of average earnings current in society at the time of retirement, meaning that replacement rates were reduced.

Moreover, pensioners' benefit levels over the retirement period will continue to diverge from the overall earnings path in society due to the unfavorable method of adjusting the benefits over time.

Thus far, the adverse effect of the reform on pensioners' economic well being has not been entirely felt: there is a transitional period for the application of the new calculation rule; the influence of the sustainability coefficient will be felt more acutely over time; and the negative effect of the new indexation rules is cumulative. The reduction of future pensions will be significant. OECD (2007) has estimated that future benefits will be more than 30 percent below the level pensioners would have been entitled to before the reforms. However, the reduction of future pensions might be higher than expected because of the effect of the new indexation rules, which is unpredictable.

The second reason for arguing that this reform was structural is that, although not explicitly, a new perspective regarding pension policy objectives has been adopted. The objective is no longer to enable people to maintain the previous living standards, but to provide a modest income protection.

A growing divergence between pension levels and wage levels was implicitly accepted. First, the new calculation rule expresses a different choice of objectives for pensions. When the objective is to safeguard the previous living standards, the benefits should be related to the final earnings. When pensions relate to the earnings of the entire career, they will diverge from workers' final earnings and from the average earnings current in society at the time of retirement. Second, the change in the way of adjusting pensions over time allows a growing divergence between pensioners' earnings path and the overall earnings path in the society. Both the reduction of the replacement rates for the majority of the retired population and the new rules of adjusting benefits over time show that the objective of enabling people to maintain the previous living standards in retirement has been abandoned. The new objective is to provide a modest income protection in retirement. A conception of social assistance, rather than what Myles has described as "contemporary notions of social security" (Myles 2002, p. 158), inspired this move.

The strategy of lowering pensions occurred at the same time the government declared the prevention of poverty among the elderly as a political priority. However, instead of reinforcing minimum income protection, the government has decided to dissociate the minimum pension levels from the minimum wage. At the same time, it has introduced a new means-tested benefit intended to alleviate old-age poverty (*complemento solidário para idosos*).[8] In the text of the law that introduced this benefit it is stated that the previous policy of general increase in the minimum levels of benefits was not sustainable and that it should be replaced by the strategy of concentrating the benefits of those in need.

Thus, the right to a minimum pension of the earnings-related plan has been questioned as a work-related right and started to be replaced by national solidarity mechanisms justified in case of need.

Furthermore, another profound change has occurred: the nature of pay-as-you-go (PAYG). The idea that it is possible to maintain in retirement the living standards achieved in the working period, which inspired the previous policy, was questioned.

The initial PAYG plans organized a mechanism of solidarity through work. Retirement pensions, like other social benefits, were guaranteed by the collectivization of a share of the total wages. In such a plan, the amount of contributions is immediately redistributed in the form of social benefits (pensions, unemployment benefits, sickness benefits, etc). In the original conception, a PAYG plan is contributory—benefits are defined on a commutative basis; since they are related to the employment status, their purpose is to replace earnings and require previous contributions—but it may involve a certain degree of redistribution in order to realize a set of social objectives. Therefore, benefits do not need to be strictly linked to contributions. A PAYG plan may include redistributive mechanisms such as the rules that establish minimum pension levels, the rules that guarantee higher replacement rates for the lowest incomes, or a calculation formula that takes into account the earnings of the final working years instead of the earnings of the whole career.

When the purpose is to safeguard in retirement the living standards achieved in the working period, pension levels should be close to the final wages. In this case, the pension may be seen as a "continued salary" (Castel 2009a,b; Friot 2010). This logic requires high replacement rates and indexation rules that guarantee a similar growth of pensions and wages over time.

Recently, PAYG plans in some countries have abandoned the previous logic, which based the right to resources on work and made pension levels dependent on the previous wage levels. In some cases, these plans have moved to a savings logic. Accordingly, each individual should be entitled to a sum of benefits closely related to what he has paid during his working period. Thus, the link between lifetime contributions and expected benefits should strengthen at the individual level. In this view, pensions are justified by the existence of "previous savings" (the contributions) and seen as an individual deferred income (Castel 2009a,b; Friot 2010).

In Portugal, the transition to a savings logic has already started. The logic of work-related rights is vanishing as the link between pensions and wages weakens. The reduction of the replacement rates, caused by the new pension formula and the introduction of the sustainability coefficient, increases the gap between the first pension and the final wages. These new rules contribute to strengthen the contributory nature of the plan and, thus, to the gradual transition to the model of pensions as individual deferred income. Also the new rules for indexing the benefits contribute to increase the gap between pensions and wages over the retirement period. Moreover, the link between pensions and wages also weakens due to the divergence of the minimum pension levels from the minimum wage. The plan is still PAYG but has a changing nature: the wage reference is disappearing, while the system moves from a work-based logic to a savings-based logic.

Thus, although the rule changes are parametric, the overall effect of the reform is structural: the level of future benefits will decrease significantly, social objectives have changed from safeguarding the preretirement living standards to the guarantee of a modest income protection, and a new logic is ruling PAYG.

THE STRATEGY OF SOCIAL RIGHTS RETRENCHMENT IN PORTUGAL

The Portuguese social security pension system has been experiencing increasing political pressures. In recent years, we have identified a two-stage strategy for social rights retrenchment. Each stage presents a specific configuration.

In the first stage, marked by the 2007 reform conducted by a center-left government, the pressures were intended to contain spending. However, as observed ealier, this reform introduced significant changes in the structure of the social security pension system.

In the second stage, when a new right-wing government came into power in June 2011, the strategy for social rights retrenchment assumed a new configuration. The revenue side of social security budget has come under growing pressure. The new government has introduced several measures that reduce, directly or indirectly, the receipts from contributions. All the variables that influence the receipts from contributions came under pressure: the wage, the level of employment, and the contribution rate. In regard to the public sector, the government, in agreement with the *troika* (the European Commission, the European Central Bank, and the International Monetary Fund), has decided to reduce wages and employment. The private sector is recommended to follow the same route of wage reduction. In any case, wage reduction in the private sector is expected to occur as a consequence of massive unemployment. The third variable, the rate of contribution (*taxa social única*), has also been under downward pressure. The government has planned to reduce the employer contribution, arguing that it would reduce labor costs and thus improve the level of employment and external competitiveness of the economy. But, in regard to the reduction of the employer contribution, the government had to step back because of strong political opposition. These measures were planned when the social security budget was already extremely destabilized by the serious recession and massive unemployment that followed Portugal's bailout in May 2011. Massive unemployment has caused a significant decrease in receipts from contributions, an increase in spending on unemployment benefits, downward pressure on wages, and the growth of early retirement.

At the same time, a new political discourse has emerged. Invoking the excessive economic burden of social security, the government has introduced a new political speech on this subject intended to justify additional regressive reforms. The prime minister has announced that the reform of 2007 is not enough to guarantee the financial sustainability of the social security pension plan and that it is necessary to shift toward more funding and more private voluntary provision. Meanwhile, in April 2012, the government suspended the access to early retirement during the financial assistance period.[9] The financial assistance provided to Portugal after May 2011 by the European Central Bank, the European Commission, and the IMF was given on the basis of a policy program that required economic policy conditions. Following the demands of austerity established in the Memorandum of Understanding with the the *troika*, the new government has imposed deep cuts in expenditure, mainly in the wages of public servants and pensions, but also in a set of other social benefits, health care, and education. In 2013, after the periodical reviews of the *troika* for assessing the progression made with respect to the policy criteria specified in the memorandum, the government has accepted to impose additional cuts in expenditure. The focus will be on major budjet items, particularly the government wage bill and pension spending. A new reform of social security may be announced at any time.

The Influence of the EU on the Portuguese Reform Process

To understand the Portuguese reform process, we should not analyze it in isolation because it was significantly influenced by European prescriptions. The management of economic policy, imposing restrictive rules for the conduct of fiscal policy, and the social policy agenda set at the EU were important elements in that process.

The 2007 reform pensions, as well as the agenda of the current government, can only be understood by taking into consideration the social policy agenda set by the EU. The standpoint that has been adopted by both the previous and the current government is in line with the social policy paradigm dominant in the EU. This one is aligned with the paradigm that has guided economic policy, especially since the Maastricht Treaty in 1992. In order to clarify this subject and understand how the EU has influenced pension reforms in the member states, it is worth mentioning the pressures imposed by restrictive macroeconomic policy and the influence of the European strategy for pensions.

The Economic Policy Paradigm Dominant in the EU

Especially since the Maastricht Treaty and the policy orientation adopted for the introduction of the single currency, the macroeconomic policy in the EU was defined in accordance to the prescriptions of the New Classical Economics (NCE). The same occurred with labor market and social protection policies.

The NCE defends monetary and fiscal policies based on rules rather than discretionary decisions of governments (Creel 2011). As the latter are considered to be moved by electoral purposes, rules are the only way to assign credibility to economic policies, a fundamental condition for guaranteeing its effectiveness. Therefore, economic policies should be ruled by restrictions imposed on the objectives or on the means.

Monetary policy should be conducted by an independent central bank and be committed to the objective of price stability. This commitment is fundamental in order to stabilize economic agents' anticipations and keep labor costs under control. In regard to fiscal policy, it should also be guided by strict rules. Two arguments justify it (Creel 2011). The first is the "Ricardian equivalence," stated by Barro (1974), according to which an expansionary fiscal policy has no effect on the level of economic activity. The argument may be summarized as follows: If a government tries to stimulate demand by increasing spending, the reduction of public savings will be offset by an increase of private savings. As people make perfect predictions of the effects of economic policy—assuming the rational expectations hypothesis—they will save more in the present in order to afford the future tax increases that will be necessary to pay off the increased debt. As a consequence, total spending will remain unchanged. Thus, demand-management intervention by governments is ineffective. The second argument states that the increase of the public debt may lead the central bank to increase money supply. According to the monetarist view, this will cause an increase in the price level. Both the inefficiency of fiscal policy and the importance of keeping price stability are arguments that justify the imposition of strict limits to budgetary policy.

Since Maastricht, EU countries have been submitted to a "culture of discipline" in the rules that guide macroeconomic policy (Fitoussi and Laurent 2009). According to the view that prevails in the EU, fiscal and monetary policy should have a limited role in stabilizing economies. The European Central Bank is responsible for guaranteeing the exclusive objective of monetary policy that is price stability. National fiscal policies have also been severely restricted by the Stability and Growth Pact and have been focused on the objective of balancing the budget. According to the dominant view, the role of the state in economic activity should be reduced to improve the performance of the economy. Therefore, it is essential to limit the growth of public expenditure. For this reason, a clause that prevents the governments from appealing to the European Central Bank to finance its deficits has been introduced. As a consequence, the governments have become dependent on deregulated and globalized financial markets.

Policies for the Labor Market and Social Protection

According to the paradigm that inspires European economic policy, growth and employment should not come through expansionary macroeconomic policies. These are replaced by the so-called structural reforms, such as the deregulation of the labor market or welfare retrenchment. Structural reforms in these two domains are recommended as a way to avoid distortions in the functioning of the labor market, promoting efficiency, and preventing high levels of public deficits and debts.

Policies for the labor market and social protection have been conceived in articulation with the supply-side orientation of economic policies. In regard to the functioning of the labor market, in this perspective unemployment is supposed to be caused by the malfunctioning of the labor market. It is considered largely voluntary, occurring when wages are above the level needed to clear the labor market. The source of massive unemployment is considered to be excessive regulation and high labor costs. Thus, the recommended solution is to make labor markets more flexible. Less regulation and the reduction of labor costs (wages and social contributions) are advocated in order to promote employment and the external competitiveness of economies.

Social spending, in turn, is considered unfavorable to economic growth. Social protection mechanisms are regarded as something that disturbs the market process. Welfare state programs, and social security pension plans in particular, are accused of contributing to the increase in the size of the government, causing inefficiency and originating huge public deficits and debts. It is assumed that the provision of welfare should not rely exclusively on public intervention. Instead, it should allow an increased role for the market, that is, private plans and voluntary provision. Additionally, pension plans should contribute to improve labor market efficiency by promoting employment and competitiveness. Thus, they should focus on containing labor costs and providing benefits that do not create disincentives.

Pressures Imposed by EU Macroeconomic Policy

The pressures for reforming social security pensions imposed by economic policies in the EU have been underestimated in most of the literature on the subject. In particular, the significant influence on pensions of the rules that guide fiscal and monetary policies in the EU should be underlined.

Since the Stability and Growth Pact, governments have been directly pressured to tighten fiscal policies (Fitoussi 2002, 2004). The imperative of balancing the budget has led the governments to cut public spending in general, and spending on pensions and other social transfer programs in particular. This fact has led to an attentive supervision of spending on pensions by the EU institutions charged with economic and financial affairs.

The imposition of the Maastricht "culture of discipline" in macroeconomic management materialized into restrictive fiscal and monetary policies (Fitoussi 2002, 2004). These policies have imposed indirect pressures on social security budgets. As restrictive macroeconomic policies have depressed growth and employment, they have undermined social security budgetary equilibrium. Under these circumstances, the pressure to impose reforms in social security pension systems increases.

The European Strategy for Social Security Pensions

At the same time, EU institutions have built a common political view about social security pensions, which is aligned with the mainstream in the international debate on pensions, inspired by the recommendations of the World Bank (1994) and the OECD (1996).

In the EU, social security pension system reform has been included in the political agenda after 1999. The effects of aging on pensions' spending have been under attentive supervision by the EU institutions charged with economic and financial affairs as a consequence of the budgetary discipline imposed by the Stability and Growth Pact. The member states were asked to adopt measures in order to guarantee the financial "sustainability" of PAYG plans by containing future spending and by encouraging the development of funded plans and voluntary provision. During the 1990s, and following these recommendations, many European countries have introduced reforms in social security pension plans with the implicit or explicit aim of containing spending.

Since 2001, the strategy designed for the field of pensions was pursued through the open method of coordination (OMC), which aimed to promote an increasing coordination of national reforms by building a consensual perspective regarding pension policy. It has contributed to define common principles and objectives, establish a common set of indicators to assess national pension arrangements, and offer periodic monitoring of progress made toward the common objectives. Although it has not imposed the same orientation to all member states, the OMC has been influential for decisions on national pension policy: it has contributed to build a shared view that has been translated into orientations for pension reforms. Palier (2006) has described the OMC as "a new form of intervention which is less aimed at institutional harmonisation or legislation than at harmonising ideas, knowledge and norms of action, in order to have common policy goals converging towards 'a common political vision' . . . The aim here is to achieve a Europeanization of social policy paradigm" (p. 8).

As mentioned earlier, the EU pension policy agenda is focused on reducing spending and organizing the plans in order to strengthen the "competitiveness" of national economies. First, it is assumed that the provision of welfare should not rely exclusively on public intervention; an increased role for the market should be allowed. Second, pension policy orientations are configured to meet the requirements of economic policies supply-side oriented. This view emphasizes that both contributions and benefits affect the functioning of labor markets. Pensions and other social benefits are analyzed in terms of their effects on labor costs and the incentives they embed. First, as the contributions required for financing pensions are a component of the labor costs, the contribution rate should be contained in order to avoid reducing labor demand. Therefore, cuts in social contributions are advocated to improve the performance of the labor market by favoring employment and the external competitiveness of economies. Second, generous pensions disincentivize the labor supply of older workers. Thus, in order to improve the functioning of the labor market to promote employment and competitiveness, pension policy should focus on containing the contribution rate to avoid the increase in labor costs, on providing benefits that do not create disincentives, and on "activating" older workers (European Commission 2006, p. 18).

This shared view inspired the reform programs developed in many member states, after 2003, like the one introduced in Portugal in 2007. The analysis of the progress in reforming pension systems in these countries, after the second round of the OMC (European Commission 2006), has identified common lines of reform. The conclusion was that, since 2003, when the first comprehensive analysis of national strategies in the area of pensions was reported (European Commission 2003), a general move has been observed in many member states regarding some features that may be summarized as follows. First, many countries have introduced rule changes such as incentives to extend working lives or disincentives to early retirement, the strengthening of the link between contributions and benefits, and the inclusion of life expectancy in pension formulas. Second, in many cases, the level of guaranteed minimum pensions has been increased to prevent the risk of poverty. Third, private provision has been promoted. It was recognized that, in general, the reforms caused the decrease in social security pensions, but it was admitted that it could be "compensated by longer working lives as well as by higher personal savings" (European Commission 2006, p. 3). Obviously, in Portugal these common lines of reform have been replicated in 2007.

ECONOMIC POLICY AND PENSION POLICY: PENSION POLICIES IN A CONTEXT OF INCREASING LONGEVITY

The increased pressures on public finances caused by an aging population has prompted many authors and policymakers who criticize state intervention in this sphere to recommend that the governments promote ambitious reforms of pension systems by means of rolling back spending. The “unsustainability/roll back argument” (Barr 2000b, p. 740) has been spread and consolidated as common sense.

Despite the recurrent use of this simple argument, it may be misleading because it neglects the decisive influence that economic performance has on the social security budget. The present difficulties in pension system financing are, to a great extent, the consequence of the economic dysfunctioning. Therefore, the analysis of pension policy should not be dissociated from the debate on macroeconomic policies.

Economic Growth, a Fundamental Issue

The economics of pensions has shown the relevance of promoting economic growth in order to face population aging.[10] Thompson (1998) has shown that, from an aggregate and real perspective, the economic cost of retirement equals the consumption of goods and services of the retired in relation to the total production of goods and services. The economic cost of retirement may be represented by the following expression:

$$\frac{C_R}{Y},$$

where C_R represents the consumption of retirees and Y represents total income. The analysis of this simple expression allows us to take two fundamental conclusions. First, retirement costs do not depend only on the consumption of retirees, but also on the level of total income. Thus, output is a central variable, as Barr (2001, 2004) and Barr and Diamond (2008) have emphasized. Second, pensions represent a claim on the output (Barr 2004).

Thus, the problem with pensions is essentially a distributive issue: it is the question of defining the rule that specifies pensioners’ share in total income. Pensioners’ income share depends on the distribution of income between capital and labor and on the division of the labor income between workers and pensioners. Thus, the social bargaining that leads to income distribution and so defines capital and labor shares and the political decision regarding the way the latter is divided between workers and pensioners are critical issues.

To sum up, in society's perspective, pensions represent a claim on the output. If life expectancy increases, other things equal, pensioners' share in spending will grow. At a given level of output, the adjustment may be realized by increasing contributions (of the employer or the employee), by reducing the benefits, or by increasing the legal age of retirement in line with rising life expectancy to avert the growth of the dependency ratio. However, in order to face rising life expectancy there is also a fourth solution: to increase the supply of goods and services. So, policies that promote economic growth are central. If the output grows, the distributive problem will become easier. There are two basic strategies for rising output: to increase labor productivity or to increase the number of workers (by reducing unemployment, by increasing women's participation in the labor market, by rising the legal age of retirement, or by immigration).

The public debate on the future of pensions has focused on two of the possible options: reducing pensions or increasing the age of retirement. In both cases, the burden of the adjustment is placed on the elderly. The relevance of policies that promote economic growth and full employment as a means to deal with future problems posed by demographic aging has been underestimated. However, a serious debate on pension policy cannot be dissociated from the debate on the model of macroeconomic regulation, income distribution in society, and the way labor income is divided between workers and pensioners.

The problem posed by the change in the age structure of the population—an increasing share in spending—has to be faced independently of the method of financing pensions. A shift toward funding would not avoid it. As Barr (2004) has shown, PAYG and funded plans represent two sorts of claims on future production, that is, two different ways of claiming the share of pensioners in national output. In the first case, the question is decided in the political process. In the second case, the question is decided in the market sphere. If the role of private plans and of voluntary provision increases, the pressures on public finances will reduce—because the retirement costs will not burden the public budget—but the economic cost of retirement will rest unchanged, unless it could be proved that a shift toward funding would lead to a higher increase in output. It is often argued that funding increases savings and hence will lead to higher productive investment and economic growth. Although there is a vast economic literature on this subject, there is a great controversy regarding both the causal link between funding and saving and the effect of saving on productive investment.[11]

Economic Policy and Pension Reforms in Portugal

The EU has declared concern for the future of pensions. However, European macroeconomic policies followed in the last two decades, inspired by the prescriptions of the New Classical Economics, have not been conceived in order to promote growth and full employment. Instead, the restrictive rules that have guided macroeconomic policies, focused on restrictive fiscal policy, price stability, and a strong euro, have depressed growth and employment, especially in peripheral countries like Portugal. Economic policies have contributed to deepen the social security budgetary problems and thus helped to present the reforms as unavoidable. Moreover, in Portugal, as in many developed countries, labor income share has decreased significantly in the last decades.

In Portugal, population aging has provided the argument to the former center-left government to restructure the system by reducing spending on pensions. In the years preceding the 2007 reform, social security has been characterized by a significant financial destabilization. The budgetary difficulties identified were, to a great extent, the outcome of economic policies—restrictive fiscal policy, monetary policy focused on price stability, and a strong euro in a context of external trade liberalization—that have depressed growth and employment. Since the introduction of the single currency, Portugal has experienced a decade of low growth and increasing unemployment, as Table 5.3 shows.

A low rate of economic growth and unemployment are big threats to the financial balance of social security. The official diagnosis mentions it: "As a consequence of a set of negative factors, like the slowdown of economic growth, a parallel increase in unemployment, the maturation of the system and the consolidation of schemes of anticipation/flexible age of reform, we have assisted, in the last five years, to an increased deterioration of the financial balance of the social security system . . . " (MTSS 2006a, p. 14).

Unemployment leads to the decrease in contributions and to a downward pressure on wages, which translates into lower contributions. Moreover, it causes an increase in spending on unemployment benefits and favors early retirement. In this context, retirement may

Table 5.3 Real Growth Rate of GDP and Unemployment Rate

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP real growth rate (%)	3.40	1.70	0.80	−0.80	1.30	0.50	1.40	2.40	0.00	−2.90	1.40	−1.60
Unemployment rate (%)	3.90	4.00	5.00	6.30	6.70	7.60	7.70	8.00	7.60	9.50	10.80	12.70

SOURCE: Banco de Portugal.

be the appropriate alternative for older workers facing the risk of unemployment. Early retirement becomes more frequent and creates additional financial pressures on pension systems. The budgetary problems identified were also conditioned by the increased maturity of the system, mentioned in the same report. Furthermore, these difficulties were aggravated by several measures of reduction or exoneration of contributions, expanded after 1999 with the purpose of stimulating employment, based on the idea that high labor costs are the main cause of unemployment. Population aging has also imposed financial pressures, but at a slow and gradual rate.

Thus, economic policies have contributed to deepen the budgetary problem and, as a result, to present the reform as unavoidable. At the same time, the social security plan came under growing political pressure. In particular, the recommendations from the EU level, regarding benefit retrenchment and the design of the plans, have been influential for decisions on national pension policy.

THE PRESENT CRISIS

The present crisis has revealed the adverse effects of economic policies oriented by the New Classical Economics in stabilizing economies with regard to growth, employment, and the external equilibrium of several member states, particularly the peripheral nations. After the global recession in 2008, some EU countries had to face problems of public debt financing. However, in order to manage the crisis, the leaders of the EU have imposed budget austerity to these countries, thereby contributing to deepen the recession and worsen the public finance crisis. The governments were asked to cut their deficits even when they had to face serious recession.

According to the understanding of European leaders, the present crisis is the consequence of the lack of rigor and effectiveness in the governance of the euro zone. Thus, discretionary decisions of national governments and parliaments with regard to fiscal policy should be subject to additional constraints in order to enforce budget consolidation. The commitment to this view has been embodied in the fiscal pact signed in March 2012 by European leaders. Expansionary fiscal policy is considered ineffective with regard to growth and responsible for increasing deficits and debts. The proposed solution to promote growth is to deepen structural reforms, which should improve competitiveness at the national level. Inspired by this view, European leaders have called for additional regressive reforms of the labor market and welfare systems. Thus, a "race to the bottom" for wages and social benefits is emerging.

As a consequence, welfare systems have been under growing pressure. Restrictive rules on monetary and fiscal policies result in a growth path that puts social protection systems under increasing stress in times of recession, since the receipts from contributions decrease while social expenditures are increasing. However, structural reforms promoting labor market flexibility and welfare state downsizing have not reduced massive unemployment in European countries, as predicted by the New Classical Economics. Instead of acting in favor of growth and employment, the decline in wages and social benefits has caused a decrease in effective aggregate demand and thus contributed to deepen the recession.

CONCLUSION

The 2007 reform of the social security pension system in Portugal was presented to the public as fundamental to contain pressures on the social security budget and guarantee its financial sustainability. The reform has been described as merely parametric, aimed at reducing the level of benefits for improving financial sustainability while preserving the overall logic of the system. However, it did not have a limited impact in the structure of the social security pension system. It might be better described as structural.

This chapter has argued that the Portuguese process of pension reform was deeply influenced by European guidelines and policies. The economic policy paradigm dominant in the EU helped to create an economic environment since the early 1990s that has favored the introduction of pension reforms. Since Maastricht, the imposition of restrictive rules in macroeconomic management has contributed to impose pressures for reforming pensions. As the governments were recommended to cut spending on pensions and other social transfer programs, there were direct pressures to lower public deficits and debts. There were also indirect pressures, since restrictive rules on fiscal policy have caused the slowdown of growth and the increase of unemployment, destabilizing social security budgetary equilibrium. However, a European strategy for the field of pensions, compatible with economic policies supply-side oriented, was designed in parallel. An open method of coordination was followed, which has been an important factor in the process of reforming pensions in many member states. It has contributed to build a common view on this subject and to define guidelines for policy that have been translated into common trends in reforms. The Portuguese reform in 2007 and the new political discourse that calls for an additional reform have been aligned with the EU orientation for pensions.

The chapter has also emphasized that the present difficulties in pension system financing are, to a great extent, the consequence of economic dysfunctioning. This fact, however, has been underestimated in the public debate, which has been dominated by the argument that spending on pensions will be unsustainably high because of population aging. The use of this simple argument may be misleading as it underestimates the decisive influence that economic performance has on pension systems budgetary equilibrium.

Economic growth is crucial, as the problem posed by the change in the age structure of the population is one of an increasing share in spending. If output grows, the distributive problem becomes easier. However, economic policies inspired by the New Classical Economics have had extremely adverse effects in stabilizing economies with regard to growth, employment, and the external equilibrium of several Member States, particularly the peripheral nations. A paradigmatic change in economic policy is fundamental to allow the appropriate policies for growth.

Furthermore, the discussion on the future of social security pensions should not be dissociated from the debate on income distribution in society. In a system financed on a PAYG basis, pensioners' income share depends on the distribution of income between capital and labor and on the division of the labor share between workers and pensioners. Ultimately, pension policy is about political choices.

Notes

1. Law n.º 4/2007, January 16, and Decree-Law n.º 187/2007, May 9.
2. Significant measures intended to harmonize the public scheme with the scheme that covers civil servants were introduced. See Law n.º 60/2005, December 29. Notice that Decree-Law n.º 187/2007 also applies to the calculation of pensions for civil servants whose working career started after September 1, 1993, in accordance with Decree-Law n.º 286/93.
3. Decree-Law n.º 329/93, September 25.
4. Decree-Law n.º 35/2002, February 19. See also DecreeLaw n.º 17/2000, August 8, art.º 57º3.
5. Law n.º 53-B/2006, December 29.
6. Ordinance n.º 1316/2005, December 22.
7. Ordinance n.º 1357/2006, November 30.
8. Decree-Law n.º 232/2005, December 29.
9. The official speech of the present government includes two policy orientations: increasing the labor market participation of older workers and promoting complementary private retirement savings. These orientations seem to have been inspired by the proposals of the EU social policy agenda defined in the Green Paper (European Commission 2010) and the White Paper (European Commission 2012).
10. See, for example, Barr (2001, 2004); Barr and Diamond (2008); and Thompson (1998).
11. First, funding might not increase savings, since an increase in mandatory savings can be offset by a reduction in voluntary savings. Second, increasing savings might not increase productive investment. Savings do not convert automatically into productive investment. However, if there is a low rate of economic growth, increasing savings may have a depressive effect on the level of economic activity, and thus reduce productive investment. Third, an increase in productive investment might not have a significant effect on growth. This is the reason why Barr (2004, p. 207) argues that funding, as a mechanism intended to promote economic growth, is both indirect and debatable. On the effects of pensions on saving and investment, see Barr (2004), Barr and Diamond (2008), and Thompson (1998). The "myths" on the advantages of funding have been examined by Barr (2000a, 2001, 2004); Barr and Diamond (2008); Orszag and Stiglitz (2001); and Thompson (1998).

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