EUROPEAN SOCIAL POLICY NETWORK (ESPN)

Financing social protection

Portugal

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Social Europe

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ESPN Thematic Report on Financing social protection

Portugal

2019

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Summary

Total social protection receipts in Portugal increased over the period examined in this report, from €42,940 million (24.9% of GDP) in 2005 to €47,504.5 million (26.9% of GDP) in 2016. Within this overall trend, the period was marked by fluctuations, influenced especially by the economic and financial crisis and by the evolution of employment and unemployment. The same factors also clearly influenced gross expenditure on social protection, which increased from 23.8% of GDP in 2005 to 25.2% in 2016.

Notwithstanding the fluctuations referred to, the main areas (‘functions’) of expenditure on social protection remained old-age pensions and healthcare/sickness benefits. During the period under scrutiny, there was a decrease in the share of the latter, linked to cuts in public funding for healthcare in response to the economic and financial crisis. The same rationale explains the decrease in the share of other benefits. Conversely, the share of expenditure on old-age pensions increased during the period, and is expected to continue increasing as a result of both an increase in the number of pensioners and an increase in the average statutory pension.

In order to try and counteract the pressure on the pensions system and the risks to its sustainability, different policy changes have taken place in recent years, especially since 2007 when a new social security framework law was approved. Overall, the reforms seem to have been endorsed by relevant international players, even if sustainability is not wholly assured in the short term.

Between 2005 and 2010 social contributions slightly exceeded general government contributions as a source of financing for social protection. This situation was then reversed, and in 2016 general government contributions represented 46% while social contributions represented 45.3%.

The structure of the Portuguese social security system is that non-contributory schemes are financed by taxes while contributory schemes are financed by the contributions of employers and employees. However, because of adverse economic developments during the early part of the period under scrutiny, there was a need to make extraordinary transfers from the state budget to the contributory regimes. Conversely, the economic upswing and the reinforcement of earmarked taxes contributed to higher transfers to the social security stabilisation fund[1] after a decade of decline. Nevertheless, as mentioned above, the risks of unsustainability are still real and remain a matter of concern.

Although the government has expressed concern over the challenges to the future of social security, and recognised the need to diversify its funding sources, the main solution adopted so far for overcoming funding imbalances has been transfers from the state budget to the social security budget. This approach may be sustainable during an economic upswing, with growing revenue from contributions and falling expenditure (especially on unemployment benefits). But it seems risky to rely on uninterrupted economic growth in the future. Moreover, Portugal ranks among the countries with the most aged population, and demographic factors seem far from encouraging.

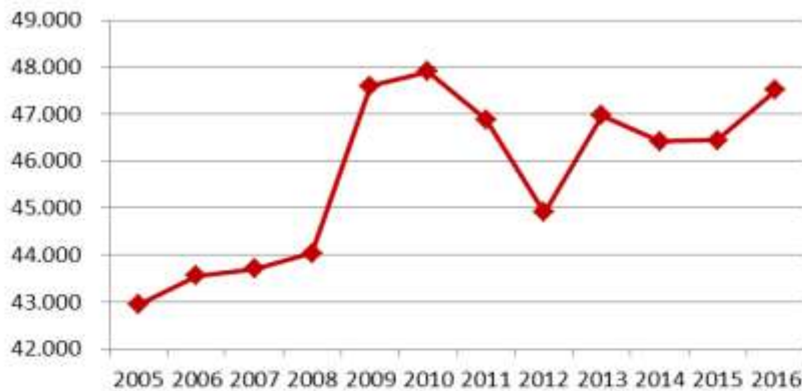
Thus, it would seem sensible to have a comprehensive and sustained discussion of the challenges to the future of social security and the diversification of its funding sources. It would also seem sensible to carefully consider options such as: extending the funding base of social security beyond salaries to the net added value of companies liable for corporation tax; considering the revision of withholding taxes applicable to capital income; and implementing, on a permanent basis, an extraordinary solidarity contribution for pensions, of a progressive character.

[1] Social Security Financial Stabilisation Fund (FEFSS).

1 Current levels and past changes in financing social protection

The **evolution of total social protection receipts** in Portugal over the period 2005-2016 was characterised by three distinct periods. The first was the period between 2005 and 2008, prior to the economic and financial crisis. Over this first period, total receipts (at constant 2010 prices) increased from €42,940 million in 2005 to €44,039 million in 2008 (Figure 1). According to Eurostat, employment grew slightly during this period, from 5.136 million people (73.2% employment rate) to 5.203 million (73.9%).

Figure 1 - Evolution of total of social protection receipts in Portugal (2005-2016) at constant 2010 prices (€m)

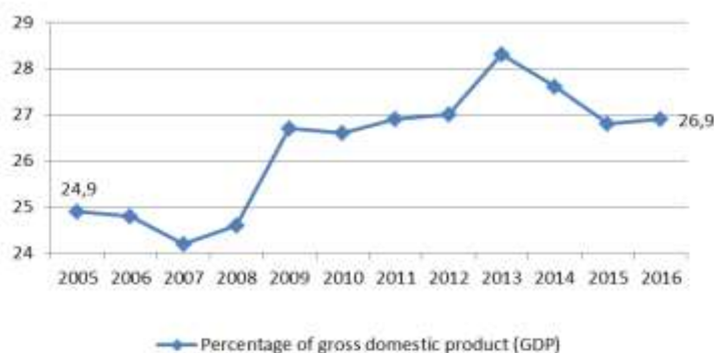


Source: Own elaboration on the basis of Eurostat, Table spr_rec_sumt, February 2019).

The second was the period 2009-2012, when the consequences of the crisis were most evident. However, this second period should be divided into two sub-periods, 2009-2010 and 2011-2012. In the former, there was a sharp increase in total receipts, which peaked at €47,897 million in 2010 boosted by the fact that new civil servants, formerly covered by a special social security scheme, became integrated into the general scheme. In 2011 and 2012 there was a steep fall in employment, causing a fall in total receipts.

The third period covered 2013-2016, during which the employment rate recovered to 73.7%. At the beginning of this period there was a big increase in the share of receipts coming from general government contributions, needed to cover rising expenditure (especially on unemployment benefits). In 2013, total social protection receipts amounted to 28.3% of total gross domestic product (GDP), the peak in the period under scrutiny (Figure 2).

Figure 2 - Evolution of total social protection receipts in Portugal (2005-2016) as percentage of GDP



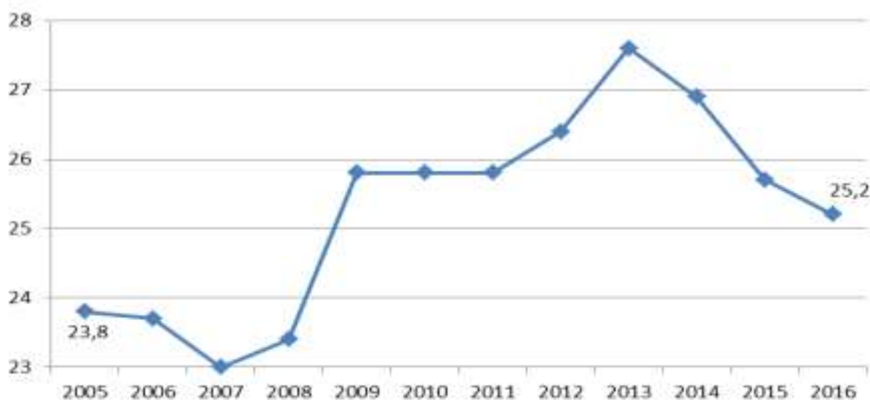
Source: Own elaboration on the basis of Eurostat, Table spr_rec_sumt, February 2019).

Overall, total social protection receipts in Portugal increased from €42,940 million (24.9% of GDP) in 2005 to €47,504.5 million (26.9%) in 2016. (The slightly different patterns in Figures 1 and 2 reflect fluctuations in GDP caused by the economic crisis.)

Gross expenditure on social protection as a share of GDP remained fairly stable between 2005 and 2008, registering a slight decrease from 23.8% to 23.4%. However, the advent of the crisis, and especially the sharp rise in unemployment rates – from 8.8% in 2008 to 10.7% in 2009 and to a peak of 16.4% in 2013, led to an increase in social protection expenditure to 25.8% of GDP between 2009 and 2011, and to a peak of 27.6% in 2013 (Figure 3).

Thus, the Portuguese social security system was confronted with the challenge of dealing simultaneously with higher demand for social protection spending and the financial restrictions imposed by budgetary consolidation. As a result, 'from 2011 to 2014 the system was managed with the objective of reducing expenses and of finding additional sources of revenue in the short run' (Silva, 2018: 15).

Figure 3 - Evolution of gross expenditure on social protection in Portugal (2005-2016) as percentage of GDP



Source: Own elaboration on the basis of Spasova and Ward (2019), Annex ESSPROS tables.

After 2013 expenditure began to fall relative to GDP, reaching 25.2% in 2016 (although this was still above the figures registered before the crisis). This corresponded to a fall in the unemployment rate, to 11.2% in 2016.

Gross expenditure on social protection at constant 2005 prices increased slightly between 2005 and 2008 (annual average 0.6%) and sharply in the two following years (annual average 5.2%). In 2010 it reached a peak, 12.7% higher than the 2005 base. It then fluctuated between 2010 and 2016, falling overall by 0.6% each year, leaving the index at 108.4 in 2016. Overall, between 2005 and 2016 the index rose by an annual average of 0.7% (Spasova and Ward, 2019: Annex ESSPROS[2] tables).

The effective tax and social contribution rate on social protection expenditure in Portugal remained stable at 3% between 2007 and 2010, but had more than doubled by 2015 to stand at 6.5% – bringing Portugal closer to the EU28 average (7.8% in 2015). The tax rate rose from around 2% to 4.7%, and the social contribution rate from around 1% to 1.8%. The difference between net and gross social protection expenditure in Portugal stood at -0.7% in 2007, -0.8% in 2010 and -1.7% in 2015.

In terms of the **different areas (functions) of spending**, there was an increase in the share of gross social protection expenditure on old-age pensions, along with a decrease in the share of healthcare/sickness benefits. The former climbed continuously from 41.2% in 2005 to 44.2% in 2008 and 44.4% in 2010, peaking at 50.2% in 2016.

[2] European System of integrated Social PROtection Statistics.

Conversely, the latter fell continuously, from 30.2% in 2005 to around 28% in 2008, 2010 and 25.2% in 2016 (Spasova and Ward (2019), Annex ESSPROS tables.).

1.1 Expenditure on healthcare/sickness benefits

From 2005, when it stood at €11,594 million[3] (6.7% of GDP), expenditure fell continuously, to reach €10,739 million (6.1% of GDP) in 2016 (Eurostat, Table spr_exp_sum, February 2019).

The **fall in expenditure on healthcare/sickness benefits** was closely related to the measures implemented as a response to the economic and financial crisis as over two thirds of expenditure adjustment regarded salaries especially in the health and education sectors (IMF, 2017: 18). Data released by Statistics Portugal (INE) show that, between 2009 and 2017, there was only one year (2016) when current health expenditure increased at a faster pace than GDP. Additionally, the increase of 3% registered in 2017 was lower than in 2015 and 2016. The proportion of expenditure accounted for by the national health system fell to 66.6% in 2017, compared with 73% in 2002 (INE, 2018).

This was acknowledged by the OECD, which noted that 'while nearly all EU countries have seen positive growth between 2013 and 2017, per capita health spending in countries such as Greece and Portugal continued to be at a lower level in 2017 than in 2009' (OECD/EU, 2018: 132).

The European Commission (EC) country report on Portugal for 2018 emphasised that 'significant measures are continuously taken to improve cost-effectiveness in the National Health Service' (EC, 2018a: 23). However, this did not prevent international organisations from recommending further action to cut expenditure. The first EC Country Specific Recommendation for both 2017 and 2018, for instance, was that Portugal should strengthen expenditure control, cost-effectiveness and adequate budgeting, in particular in the health sector.

It also seems worth mentioning, however, that the Portuguese Observatory of Health Systems (OPSS) has said that 'the Portuguese system is relatively efficient. Most of the figures in health indicators are better than EU15 average and expenditure per capita is lower. However, public funding is significantly lower and private expenditure, particularly direct payment plays a more central role.' It emphasised that 'to remain healthy, the Portuguese spend much more from their own pocket than most Europeans' (OPSS, 2017: 164-165).

According to Eurostat data, in 2016 out-of-pocket (OOP) payments represented 27.75% of total current health expenditure, which was almost double the EU average (15%). This made Portugal the EU country with the seventh-highest level of payments. Different international entities have acknowledged the high share of OOP payments in the country. OECD's 'Health at a Glance 2017' report noted that Portugal remained one of the countries with a relatively high share of OOP expenditure as a percentage of final household consumption (3.8% compared with the 3.0% OECD average), which may create barriers to accessing care (OECD, 2017a).

The EC country report on Portugal for 2017 (EC, 2017) also acknowledged this, following the assessment made in the previous year. It noted the increase in OOP payments as a share of total health expenditure between 2007 and 2013, to a level well above the EU average – 26.6% compared with 16.1% in the EU in 2013 (EC, 2016a).

The country report for 2018 emphasised that 'the short-term sustainability of the health system is not ensured. (…) The burden of healthcare spending on the budget is projected to be among the largest in the EU in the long term. In the long run, pressures from the costs of ageing point to increased public spending on health from 5.9 % of GDP in 2016

[3] At constant 2010 prices.

(below the EU average of 6.8%) to 8.3 % in 2070, which represents a 2.4 pp increase compared with the projected EU average increase of 0.9 pp.' (EC, 2018a: 23).

On the other hand, a national study on the sustainability of the national health system concluded that the sustainability index (established in 2014) registered a significant increase between 2015 and 2016, from 100.2 to 102.2 (IS^2, 2017).

The latest OPSS report underlines that 'the current situation in the hospital sector is marked by the consequences of the Programme of Economic and Financial Assistance between 2011 and 2015 as result of Troika's external intervention and (…) it is now necessary to correct the impacts of the measures introduced into the health system during the austerity period' (OPSS, 2018: 17).

In addition, the report 'Financing – formula for the future' released in October 2018 stressed that 'the strong restriction on public spending, in an attempt to improve efficiency in healthcare, resulted in under-budgeting and cash-flow bottlenecks (…) resulting in chronic indebtedness and in an inglorious effort for the preservation of adequate levels of service provision' (APAH, 2018: 13).

1.2 Expenditure on old-age pensions

The **increase in the share of social protection expenditure on old-age pensions** in Portugal reflects both the above-mentioned decrease in spending on healthcare and increased spending on pensions. Spending increased continuously between 2005 (€18,972 million, 12% GDP) and 2016 (€27,226 million, 14.7% GDP). The number of pensioners increased from 2.887 million in 2006 to 3.007 million in 2016 (Eurostat, Table spr_exp_pens, February 2019).

This trend is expected to continue in the future. A national actuarial valuation of the social security system concluded that 'the main contribution for the increase of the costs with social benefits is due to pensions and complements which will represent, in 2060, 90.3% of total expenditure. Expenditure on pensions will grow significantly between 2013 and 2060, both by volume-effect – increase in the number of pensions, and by price-effect – increase of the average statutory pension of the stock of pensioners' (GEP-MSESS, 2015: 6).

Like many other countries, Portugal faces considerable challenges regarding the sustainability of the pensions system and of social security overall. However, in the case of Portugal these are exacerbated by three concomitant factors which result in an increased vulnerability of the country's economy: i) the strong pace of demographic ageing – Portugal has the sixth most aged population in the world (Rodrigues, 2018); ii) the outmigration of many people of working age; and iii) the very high public debt, which reduces the system's capacity to face critical funding needs.

In the period under scrutiny, the **pensions system underwent changes aimed at promoting its sustainability**. In 2007 the system was significantly reformed following approval of the new Social Security Framework Law (Law 4/2007 of 16 January). The main measures included: i) the public employees' special unfunded scheme (*Caixa Geral de Aposentações*, CGA) was closed, with civil servants transferred to the general statutory system for the whole population; ii) a new formula for the calculation of pensions was brought forward from the planned date of 2017 (under the previous Social Security Framework Law of 2002) to 2007; iii) a 'sustainability factor' was incorporated in the formula for calculating the pension benefit, linking the pension value to the evolution of life expectancy at the age of 65; iv) new, less favourable, indexation rules were introduced; v) the financial penalty for early retirement was increased, and bonuses granted for postponing retirement; and vi) the means-testing criteria for non-contributory benefits were revised, and a new non-contributory allowance for the elderly was introduced (Baptista et al., 2015).

The sustainability factor was redesigned in 2013 and the reference year was changed from 2006 to 2000, entailing an increasing cut in the statutory benefit for successive new

early retirees. The effect of linking pension benefit to changes in life expectancy has been that the normal age of entitlement to the old-age pension has been increasing over time. In 2016 it reached 66 years and 2 months and in 2019 it reached 66 years and 5 months.

Throughout the period several changes have been made to the early retirement scheme, usually involving stricter access rules. As from 2015, early retirement can only be claimed if the insured person has both a minimum age of 60 and a contributory career of 40 years. Early retirement is penalised by 0.5% per month of anticipation, reduced by 12 months for every period of three years for those with an insurance record of more than 30 years.

Overall, the reforms in the pension system implemented in the 2011-2015 period seem to have been approved by relevant organisations such as the EC and the International Monetary Fund (IMF), but both institutions agree that sustainability in the short term has not been adequately addressed (e.g. EC, 2018: 22). The EC, for example, expressed concern (EC, 2016b, 2017, 2018a) over a recent reform, effective from October 2018, under which workers aged 60 or more with a contribution record of at least 46 years, and who started their working life at the age of 16 or younger, were granted access to early retirement without penalties. Even before this change was implemented, the EC said that it would jeopardise the long–term sustainability of the pension system and the objective of eliminating, by 2019, extraordinary transfers from the state budget to the social security system (EC, 2016b). Similarly, the EC country report for 2017 warned that 'the sustainability of the pension system in the short to medium term risks deteriorating if the budgetary impact of the new early retirement rules is not fully compensated' (EC, 2017: 5). And in 2018 the EC said that 'some recent measures are however expected to contribute to higher pension spending in the short term' (EC, 2018a: 22).

At the same time, however, the EC country report for 2018 emphasised that 'the long-term sustainability of the pension system has been strengthened in the last few years' (EC, 2018a: 22). And a later report in the same year noted that 'the sustainability of the pension system appears ensured in the short term' (EC, 2018b: 5).

Another issue of concern has been the heavy reliance, over time, on budgetary transfers (EC, 2017: 22). However, in 2018, for the first time since 2012, there were no extraordinary budgetary transfers to the social security system. This was the result of factors anticipated in the country report for 2018, i.e. 'the projected strong increase in social contributions (…) linked to the positive economic environment and the improvements in the labour market' (EC, 2018a: 22).

1.3 Expenditure on other benefits

The **share of 'other' benefits** (i.e. disability, survivors, family, unemployment, housing, and social exclusion not elsewhere classified) remained fairly stable between 2005 and 2010 at around 28% of total social protection spending, but fell to 24.6% in 2016. The explanation for this fall can be found in budget cuts and increased restrictions on access to social protection, decided within the framework of the state's commitment to the stability and growth pact. They also reflected a narrower focus of public policies in this area, aimed exclusively at the 'most disadvantaged' and on emergency provision only.

Stricter rules for access to social benefits and social security allowances between 2010 and 2015, at a time when the impacts of the crisis were getting worse, withdrew an important source of income available for many families (e.g. Baptista et al., 2016, 2018). For instance, changes to the minimum-income scheme (RSI) led to a decrease both in adequacy and in coverage. As put by Rodrigues, the reforms implemented in 2010 were 'an alteration that was needed, implemented at the worst possible moment due to the economic and financial crisis, and led mainly by the need to cut costs. The potential efficacy and efficiency gains that could be achieved were clearly eliminated by the intention to keep unchanged the benchmarked values, leading instead to a reduction in

the efficacy of most benefits with minimum gains in terms of their efficiency' (Rodrigues, 2011: 2).

In a more recent study, the same author emphasised that 'the changes in the RSI rules between 2010 and 2013 resulted in a decrease of about 34% in the threshold and on a decrease of the amount of the RSI from 64% to 42% of the poverty threshold. A direct consequence is the exclusion of a very significant number of former beneficiaries and the decrease in the amounts received by those remaining in the programme' (Rodrigues et al., 2016: 135). The number of beneficiaries fell by over one third between 2009 and 2014. At the same time, expenditure fell by about 41% in nominal terms and the share of the measure in total social security expenditure decreased by almost 1 percentage point.

These developments were reflected in the share of expenditure on means-tested benefits, which fell from 10.9% in 2005 to 10% in 2010 and to 8.1% in 2016 (Spasova and Ward, 2019: Annex ESSPROS Tables).

2 Current mix and past changes in the sources of financing social protection

Between 2005 and 2010 social contributions represented, even if by a small margin, the main **source of financing for social protection** in Portugal. However, between 2010 and 2016, and contrary to the situation experienced in most EU countries, the main source of financing for social protection in Portugal was (again, by a small margin) general government contributions. In 2016, these represented 46% and social contributions 45.3%. This contrasted with the situation in the first part of the period under scrutiny when social contributions (45.6% in 2005 and 46.1% in 2008) exceeded general government contributions (44.1% in 2005 and 44.9% in 2008). The share of other receipts oscillated over the period, but fell from 10.3% in 2005 to 8.7% in 2016 (Spasova and Ward, 2019: Annex ESSPROS Tables).

As regards the different sources of general government contributions, earmarked taxes accounted only for 1.5% of total financing in 2005 and 1.6% in 2016. The overwhelming majority derived from general revenue, both in 2005 and 2016 (42.6% and 44.4% of total financing, respectively).

The breakdown of social contributions by type of contributor remained fairly stable, despite fluctuations, between 2005 and 2016. The share provided by employers fell slightly from 30.6% to 29.8%, while the share provided by employees was the same in both years at 12.3%; the share provided by self-employed people increased slightly from 1.6% to 1.7%. The sharpest increase was in the share provided by benefit recipients, from 1.2% to 1.6%.

This latter increase may be linked to measures implemented as a response to the economic and financial crisis. One in particular was the 'extraordinary solidarity contribution' levied on pensions from 2011 to 2016. Different rules applied throughout the period. In 2013, for instance, it applied to pensions over €1,350/month at different rates (between 3.5% and 10% depending on income); there were also additional rates of 15% (applied to the pensions between 11 and 17 times the amount of the social support index (IAS)[4]) and 40% (applied to pensions 18 times the IAS or more). From 2015 there was a phasing-out process and the contribution was levied only on pension amounts higher than 11 times the IAS. In 2016 the rates applied were half those applied in previous years (i.e. 7.5% and 20% for each of the higher thresholds mentioned above).

It should also be mentioned that the reduction in the number of income tax brackets during this period resulted, in many cases, in increased amounts of personal income tax paid by taxpayers, including pensioners.

According to a study on the impacts of austerity on pensions, the gross amount of smaller pensions (below €1,000/month) did not experience a significant reduction. However, their value was affected by changes to personal income tax. In 2015, a gross pension of €500/month was worth almost 3% less in net terms, compared with 2011. Higher pensions registered higher accumulated losses during the same period (e.g. a gross monthly pension of €1,250/month in 2011 was worth around 8% less in net terms in 2015) (Centro de Estudos Sociais, 2014).

The increase in the share of social protection financing provided by benefit recipients was also linked to the increase in OOP in healthcare, from 23.3% of total health expenditure in 2005 to 27.8% in 2016 (Eurostat, Table hlth_sha11_hf, February 2019).

The current Basic Law of Social Security (Law 4/2007) provides for a structure under which non-contributory schemes are financed by taxes while contributory schemes are financed by the contributions of employers and employees – that is, the **allocation of financial resources accords with the nature and objectives of the different branches of social protection**.

[4] From 2009 to 2016 the IAS amount was €419.22/month.

Thus invalidity, old-age and survivor schemes are financed through contributions. Minimum pensions are partly financed by the state. Pensions under the non-contributory regime are also financed by the state. Unemployment schemes and cash benefits under sickness and maternity schemes are financed partly by contributions and partly from taxes. (Despite the significant fluctuation in the unemployment rate during the period under scrutiny, there were no major changes in the design of the unemployment benefit.) Long-term care, family allowances and sickness/maternity benefits in kind are tax-financed. Employers finance insurance for accidents at work through insurance premiums, and for occupational diseases through contributions (MISSOC, 2019).

The overall contribution rate for the general social security system (with the exception of work-related accidents) (TSU) is 34.75%, of which 11% is paid by employees and 23.75% by employers. There is no ceiling. Contributions are reduced for certain activities and employers (in particular non-profit-organisations), and for certain groups (such as young people looking for their first job, and disabled employees). Unemployment, invalidity, old-age and survivor schemes, as well as cash benefits under sickness and maternity schemes, are all included in the overall contribution (MISSOC, 2019).

Although the overall rate suffered no changes during the period under scrutiny, its disaggregation by type of benefit changed with the publication of the current code on contributory social security regimes, in force since 2011 (Table 1).

Insurance premiums for accidents at work (paid by employers) vary according to levels of risk, taking into account the nature of activities and the preventative measures adopted at the workplace. There are no specific regulations regarding ceilings. Employers pay a social contribution of 0.5% regarding occupational diseases: there is no ceiling (MISSOC, 2019).

Regarding long-term benefits, both accidents at work and occupational diseases operate on a pay-as-you-go basis, although the former is also funded. Regarding invalidity, old-age and survivor schemes, there is current income financing and capital cover through funds.

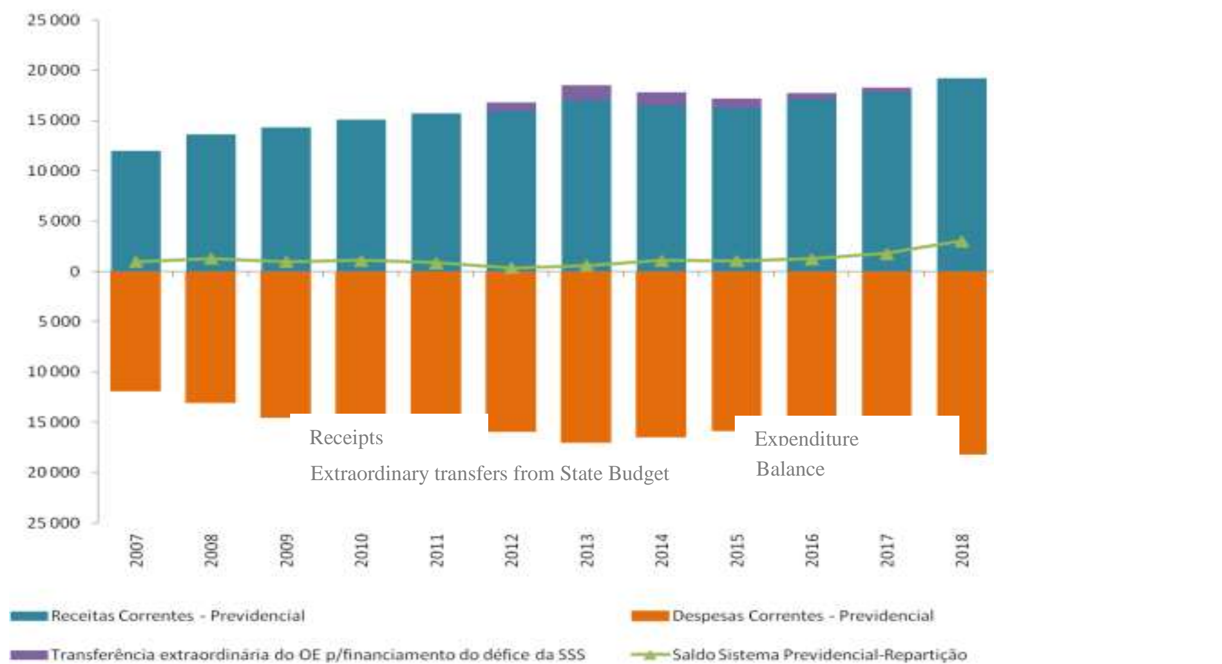
Table 1 – Disaggregation of the overall contribution rate for the general social security system by type of benefit, 1999-2010 and 2011 to present

	1999-2010 %	2011-present %
Sickness benefits	3.05	1.41
Occupational illnesses	0.50	0.50
Child benefits	0.73	0.76
Unemployment benefits	5.22	5.14
Invalidity benefits	3.42	4.29
Old-age benefits	16.01	20.21
Death benefits	3.67	2.44
Family expenses	2.15	---
Total	34.75	34.75

Source: Own elaboration on the basis of Portugal, 1999 and DGSS, 2019.

Despite these provisions, budget retrenchment measures and measures such as the extraordinary solidarity contribution, there was a need to make extraordinary transfers from the state budget to the contributory regimes during most of the period under scrutiny. Between 2011 and 2016 the weight of these transfers in the total revenue of contributory regimes increased from 2.4% to 8.4%, after having peaked at a little over 13% in 2013 and 2014, when they stood at €1,430 million or 0.84% of GDP (Silva, 2018).

Figure 4 – Evolution of expenditure and receipts of the social insurance contributory system, Portugal 2007-2018 (€million)



Source: MTSS, 2019: 11.

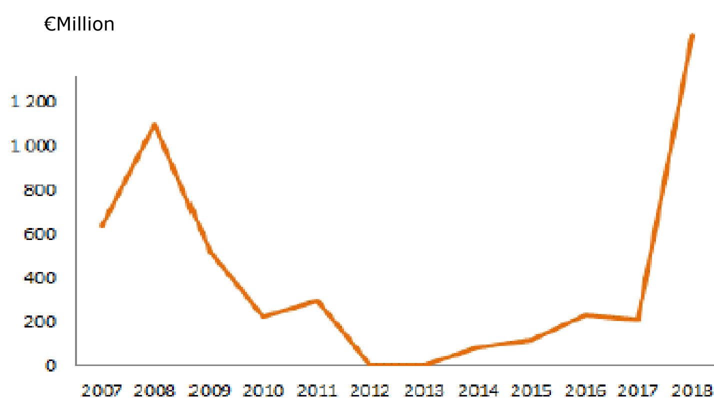
Over the period under scrutiny some **earmarked taxes** were created. The revenue resulting from the value-added tax (VAT) increase in 1995 was earmarked for social security. Additionally, the VAT increase in 2005 was also earmarked to social security until 2009.

The 'additional tax to the municipal property tax' (AIMI) was created in 2017 and its receipts were earmarked for the reinforcement of the Social Security Financial Stabilisation Fund (FEFSS). The AIMI was levied on the tax values over €600,000 of residential property owned by individuals and companies. For individuals, the tax was set at 0.7% for values between €600,000 and €1 million, and 1% above €1 million. Married/cohabiting contributors could opt for joint taxation, in which case the AIMI was 0.7% on values between €1.2 million and €2 million, and 1% over €2 million. For companies, the tax was the same as for single individuals if the property was intended for the personal use of capital shareholders or corporate board members, as well as of their spouses or children. In the remaining cases, the AIMI was set at 0.4% on values over €600,000. As from 2019 there is a new bracket for individual contributors, with a tax rate of 1.5% on values over €2 million.

As from 2018, part of corporate income tax revenue was earmarked to the FEFSS. The proportion will increase by 0.5 percentage points per year, increasing from 0.5% in 2018 to 2% in 2021.

Earmarking, as well as the favourable economic situation, were crucial elements in the significant increase in **transfers to the FEFSS** between 2013 and 2018 after a decade of decline. The FEFSS was created in 1989 to manage the surpluses of the contributory system. It follows an investment strategy similar to that of private funds. It is financed through the transfer of a percentage of the contributions from salaried workers. However, these depend on the economic situation during the year in question, which may justify its temporary suspension, as was the case in 2012-2013 (Figure 5). The FEFSS is designed to provide a buffer at times when the social security system faces diminished revenue.

Figure 5 – Evolution of the transfers to the Social Security Financial Stabilisation Fund (FEFSS), Portugal 2007-2018



Source: MTSS, 2019: 10.

The state budget for 2019 estimates that the FEFSS will be depleted by the end of the 2040s, 19 years later than the projection made in 2015. Similarly, it notes that annual deficits are now projected for the second half of the 2020s rather than continuing throughout the 2010s. However, the FEFSS is still likely to be depleted at some point. As mentioned by Silva, 'besides the European Commission's projections, all national prospective studies indicate, even if with diverse time profiles and degrees of severity, the risk of an increase in the deficit of the contributory pension system within a few decades and the exhaustion of the Stabilisation Fund. Some studies point to an implicit

debt, i.e. the difference between future responsibilities and revenues, of 175% of GDP.' (Silva, 2018: 18).

Over the first part of the period under scrutiny there was a debate on the introduction of a **cap on contributions** – a possibility provided for by the Basic Law of Social Security in 2007. However, the Law also established a set of conditions for its implementation, including the production of a report demonstrating that the cap would contribute to promoting the sustainability of the social security system. Reduced financing of the system, most of all in the crisis period, as well as the real risks of unsustainability have meant that a cap is no longer being discussed.

There is a **yearly minimum level of subsistence**, set at 1.5 times the IAS x 14 (€9,006.90 in 2018) under which no income tax is due. This has been in place since 2018. Previously, from 2015 to 2017, the threshold was fixed at €8,500. From 2005 till 2014 the threshold for the exemption from contributions was set at the level of the minimum wage plus 20%.[5]

Throughout the period under scrutiny there were several **changes to the number of personal income tax bands and respective tax rates,** which influenced the degree of progressivity that contribution rates should have according to article 104 of the Portuguese Constitution.

In 2005 there were six tax bands with tax rates varying between 10.5% and 40%. Between 2006 are 2010 there were seven bands and the highest rate was 42%. In 2011 a new top tax band was added with a tax rate of 46.5% (raised to 49% in 2012). At the same time there were increases to other tax bands, with the minimum rate standing at 11.5%.

In 2011 a proportional contribution rate was introduced: the personal income surcharge of 3.5% applicable to all taxable income bands. In the same year the additional solidarity tax was also created, applicable to the highest incomes: 2.5% on the slice of annual incomes between €80,640 and €250,000; 5% on the slice above €250,000.

From 2013 to 2017 there were only five tax bands. The minimum tax rate increased to 14.5% and the maximum rate was 48%. These tax rates are still in force. However, as from 2018 there were again seven tax bands. As from 2016 the personal income surcharge was progressively eliminated, starting with the lowest tax band. The surcharge for the highest tax band was eliminated in 2018.

The OECD highlighted in 2016 that 'the countries that experienced the most significant revenue increases between 2010 and 2014 included Portugal' (OECD, 2016: 24), adding that 'tax burden increases on low-income workers were particularly high in Portugal where the system of tax credits was made less progressive' (OECD, 2016: 33).

Until 2012 self-employed workers did not have access to unemployment benefits. Law 20/2012 of 14 May **extended unemployment benefits to cover self-employed workers** in a situation of economic dependence – that is, where at least 80% of their yearly activity was conducted on behalf of a contracting entity (provision of services contract). In 2013 (Decree-Law 12/2013 of 25 January), unemployment benefits were again extended to cover self-employed workers who earned their income through a registered business of their own or possessed an individual commercial establishment, as well as their spouses if performing a professional activity together with them on a regular and permanent basis. (Those who did not perform 80% of their activity in the same entity did not have access to unemployment benefit.) This widening of social security coverage occurred without the imposition of additional social security contributions on self-employed workers.

As from 2019, the global contributory rate for self-employed people has been reduced from 29.6% of gross revenue to 21.4%. For those engaged exclusively in commercial or

[5] €485/month X 14 + 20% = €8,148/year in 2014.

industrial activities, and proprietors of individual limited liability establishments, it was reduced from 34.75% to 25.2%.

Another change regards the establishment of a minimum monthly level of contributions of €20 for self-employed workers. The declared aim is to ensure more effective social protection. It was often detected that workers whose invoicing was highly irregular tended to close their activity and reopen it when relevant in order to avoid high contributions that did not correspond to the income they were actually earning. This often resulted in gaps in the contributory career and could lead to non-compliance with the warranty period necessary for the attribution of social benefits.

As regards the **mix of public/occupational and private schemes**, until the economic and financial crisis some priority was granted to reinforcing funded **pension regimes**, whether based on mandatory or voluntary enrolment. The private pension fund assets as a percentage of GDP reached a maximum in 2007, at 12.7% (Silva, 2018).

As from 2008 there was a downward trend, driven by the economic and financial crisis and by the extinction of pension funds in the banking sector and in some public companies (which were integrated into the public system). As mentioned in a report of the former ASISP network (Network for the Analytical Support on the Socio-Economic Impact of Social Protection Reforms), 'on the whole, second and third pillar private pensions lost ground and became less relevant to compensate for the drop of social security replacement rates' (Mendes, 2014: 11).

According to the OECD, private pension fund assets in Portugal represented 10.8% of GDP in 2016 (OECD, 2017b). 97% corresponded to occupational pensions and 3% to individual pensions. Occupational and personal schemes covered 3.7% and 4.5%, respectively, of the working-age population (aged 15 to 64).

It should be mentioned that, within the goal of promoting the sustainability, equity and redistributive effectiveness of social security, the current government's programme (2015-2019) includes the aim of 'reinforcing the support instruments to complementarity with individual savings instruments' (Portugal, 2015: 227).

Private and voluntary health insurance schemes are estimated to cover approximately a quarter of the population (OECD, 2017a). The major voluntary scheme is that for civil servants ('ADSE'), currently covering around 1.2 million people. The system was co-funded through state budget transfers till 2011. Over the years and with the goal of promoting the (self-) sustainability of ADSE, user contributions to the system increased gradually, and currently stand at 3.5% of beneficiaries' monthly salary or pension. According to a study by the Portuguese health regulatory body, public funding for the system fell from approximately 80% in 2009 to approximately 10% in 2015 (ERS, 2016: 17).

3 Strengths and weaknesses of the existing mix of financing options and potential future sources of financing - national debate on the topic

The government's major planning options for 2019 stress that 'the demanding context of economic and financial adjustment faced recently by Portugal caused a set of effects over the social security system. These resulted both from a decline in employment and the devaluing of work (with subsequent decrease in contributions) and from a sharp increase in unemployment (with effects in the form of increased spending), generating the need to transfer funds from the State Budget to Social Security's Budget between 2012 and 2017' (Assembleia da República, 2018: 6030).

Indeed, this has been so far the **main solution adopted** for overcoming funding imbalances. It is the simplest and most immediate solution and probably the one with fewest political costs. However, it is undoubtedly a false solution in the sense that, rather than addressing the issue structurally, it places an emphasis on decisions taken while preparing the annual state budgets.

The current government's programme (2015-2019) is clear in stating that 'the reinforcement of the financing and of the sustainability of Social Security through the diversification of its funding sources should be assessed in social dialogue' (Portugal, 2015: 227).

The government has regularly expressed its concern at the challenges to the future of social security, and the need to diversify its funding sources. However, at other times, government officials have also said that the most crucial factor in the sustainability of social security is the performance of the economy.

This perspective also seems to be reflected in the major planning options for 2019. Despite acknowledging the importance of the measures taken to strengthen social protection financing, it says that recent improvements are also connected to 'a more favourable macroeconomic environment – acceleration of economic growth, sustained improvement of the labour market and increase of families' real income. This context led, on the one hand, to the sustained growth of the revenue resulting from contributions and, on the other, to the decrease in spending on unemployment benefits, contributing to an improvement of the financial balance of the social security system' (Assembleia da República, 2018: 6031).

From a social policy perspective, **relying (only) on the behaviour of the economy seems rather risky**, especially given the lessons of the recent past, when falling employment was largely responsible for undermining the system's sustainability. Moreover, this 'solution' also seems to be jeopardised by current and future demographic trends (see Section 1, above).

In its latest opinions regarding the major planning options and the state budget proposals, the Portuguese Economic and Social Council (CES) has addressed this issue. Although acknowledging that economic growth and the evolution of the labour market are key variables for the sustainability of social security, the CES alerts that avoiding negative balances 'will crucially depend (…) on the measures taken by governments regarding the reinforcement of funding namely through the diversification of financing sources' (CES, 2018b: 30). The CES criticises unfounded optimism in the state budget for 2019 regarding the long-term financial prospects for the social security system, especially in view of the demographic background. It recognises the positive effects of renewed growth in contributory revenue, but points out that the impact and effectiveness of measures for combating fraud and tax evasion are not known (CES, 2018a).

The CES has also reaffirmed the need to deepen the debate on the funding of the social security system (CES, 2017) and to **promote the diversification of funding sources** (CES, 2018b). It said that reinforcing the FEFSS through the AIMI and a (small) part of corporate income tax revenue 'only modestly contributes to such purposes as the respective revenue represents only 1.4% of the reserves expected for the FEFSS in 2019'

(CES, 2018b: 29) and 'should not replace the commitment regarding the diversification of funding sources; thus it is recommended that the government conduct an urgent analysis and discussion, with social partners, of the subject' (CES, 2017: 20).

Such a discussion is all the more important to the CES as it 'advocates that this Fund, which aims at ensuring the coverage of expected pensions spending for a minimum period of two years, should have established annual revenues. Very irregular allocations have been made since the Fund's creation in 2017 based on short-term economic conditions.' (CES, 2018b: 29-30).

A recent report studied the **impacts of a new funding model** based on the extension of the funding base of social security beyond salaries to the net added value of companies liable for corporation tax. The study highlights different tax combinations ensuring a neutral tax effect. One combination would involve a reduction of 10 percentage points in the single social tax (TSU), fully compensated for by a tax of 5.4% on net added value. The amount of taxes paid over salaries would be deducted from the overall amount (Silva, 2018).

The author identifies three main advantages. The first is a positive effect on employment and therefore contributions: reduced labour costs of as much as 8% would lead to net job creation of 200,000. The second advantage is that the fiscal system would be more neutral as between different combinations of production factors (the current system is deemed to favour companies with a great deal of capital and little manpower). The third advantage would be a more dynamic tax base that would evolve more closely in line with GDP rather than wages. The study stresses that, if the expected trend regarding the evolution of wages proves right, the revenue from the TSU will fall from 7.8% of GDP to 6.6% in 2060. This would result in lower volatility as a result of the economic cycle.

On the other hand, there is a risk of creating a disincentive to invest in companies adversely affected by the proposal, if they could not transfer increased costs to consumers. There is also an increased risk for tax evasion as net added value may prove harder to determine than wages. A third risk is the fact that the expected negative effects of the proposal would probably be concentrated in a small number of large companies, which may take concerted action to block change.

These risks could be mitigated through more consistent co-ordination between the tax and social security services, and by introducing a degree of progressivity in the transition to the new model. It should also be mentioned that, according to the ex-ante simulations conducted by the author, the impact on companies' average return on equity would be fairly modest, not exceeding 2.7%.

Other proposals have been made in the past aimed at widening the contribution basis to other production factors or to consumption. These include:

- increasing VAT and/or eliminating the lower VAT rate for basic products;
- creating a new direct tax levied on all sources of income, including on social benefits and capital;
- creating a new indirect tax levied on companies' gross receipts; and
- increasing tax on the profits of large companies.

These proposals entail risks such as price and salary inflation, regressive distributive effects, higher production costs and an increased tax burden on individual taxpayers.

Other proposals focus on alternative financing models that simultaneously promote sustainability and job creation, by reducing the contributory burden on salaries close to the statutory minimum wage – simulation models have been provided for cuts of 13.75, 10 and 5 percentage points. Significantly reducing the TSU on a permanent basis for workers earning the minimum wage or slightly above could allow the minimum wage to be set at a higher level while stimulating employment. The reduction of the TSU would be degressive for workers earning salaries between the minimum wage and a determined

point – usually 1.2, 1.3 or 1.4 times the minimum wage. The reduction in labour costs would be greater, the more ambitious the change.

Silva (2018) provides the example of a decrease in the TSU of 10 percentage points, degressive for salaries up to 1.3 times the minimum wage in 2015. According to the simulation, this would produce an average reduction in labour costs of 2.7%, possibly leading to the creation of between 43,000 and 78,000 additional jobs in the short term. Within this model, fiscal losses could be offset by additional revenues resulting from the jobs created and savings in unemployment and other social benefits. The author adds that the net fiscal loss per new job in the case of a reduction of 10 percentage points would be around €2,500, which was lower than the cost of the measures promoting employment through direct subsidisation (e.g. Dias & Varejão, 2012)

For the supporters of this option, the permanent and transversal character of a reduction in the TSU is an advantage compared with measures that are temporary and encourage the precariousness at work. By promoting employment it would also reduce the need to subsidise job creation.

Conversely, critics point out the risk of promoting low-qualified and low-paid jobs, especially if focused on the minimum wage and slightly above it. The degressive character of the measure could help mitigate such a risk but would not eliminate it.

Another debate relates to **ways of ensuring more sustainable financing, especially in relation to the unemployment protection system**, while simultaneously reducing the incentive for companies to resort to excessive staff turnover. Currently, companies have an incentive to use short-term temporary contracts, because of the costs of either extending them or turning them into permanent contracts. The prevalence of such contracts has been increasing, and placing additional pressure on the unemployment protection system. According to Eurostat, the share of temporary contracts in total employment in Portugal (employees aged 15 to 64) increased from 19.4% in 2005 to 22.3% in 2016 (from 18.6% to 22.5% among males and from 20.4% to 22.1% among females). Thus Portugal has the third-highest share of temporary employment among EU countries. Probably as a result, one of the country specific recommendations for both 2017 and 2018 was for Portugal to promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners.

In June 2018, the government and most social partners in the Standing Committee for Social Dialogue agreed on a set of measures aimed at fighting precariousness and reducing labour market segmentation (non-permanent contracts, seasonal work and temporary work) as well as at promoting collective bargaining (CPCS, 2018). Following this agreement, the Resolution of the Council of Ministers 72/2018 approved the Action Programme for Fighting Against Precariousness and Promoting Collective Bargaining (Portugal, 2018a).

The programme opens room for changes to the labour code aimed at limiting the legal possibilities for the excessive usage of temporary contracts, and includes measures aimed at strengthening the protection of temporary workers. It also opens room for changes to the code on contributory schemes, include the establishment of an additional social security contribution for employers whose annual use of temporary contracts is higher than the average for the relevant economic sector. As for labour market policies the programme envisages extra transitional support to companies for converting temporary contracts into permanent ones.

According to the simulations undertaken by Silva regarding the services sector, raising TSU by 3 percentage points for companies hiring on temporary contracts, and reducing it by 1 percentage point for companies hiring on an open-ended basis, would lead to an average increase of 1.6% in contributions (Silva, 2018). However, this measure would not distinguish between companies that turned temporary contracts into permanent ones from those replacing a temporary contract with another one. A possible alternative would

be modulating the TSU according to the extent to which a company renewed temporary contracts.

Summing up, in order to ensure a financing base for social protection in future years, the following **policy recommendations** could be considered:

- extending the funding base of social security beyond salaries to the net added value of companies liable for corporation tax;
- revising withholding taxes applicable to capital income that result in taxation lower than what would result from its aggregation in global income; and
- implementing, on a permanent basis, an extraordinary solidarity contribution on pensions, of a progressive character.

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