A PENSIONS SYSTEM FOR THE FUTURE

Pedro Pita Barros

Institute of Public Policy & NOVA-SBE
A pensions system for the future

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Back-to-basics: the debate on pensions in Portugal

- Starting point
  - Concerns about standard of living after retirement
  - Concerns about redistribution and social cohesion
  - Concerns about financial sustainability of pension systems
  - Concerns about myopic decision making over pension decisions in lifetime view

- Constraints
  - Problem of financial architecture or of real resources available for consumption?
  - Sensitive issue in the political arena and willingness to engage in productive debate?
The current public pensions system in Portugal

The tensions that the political debate has shown may stem from conceptual problems and differing interpretations and misunderstandings.
The current public pensions system in Portugal

How does the pensions system work in Portugal?

Social Security System in Portugal

Social Security

- Sistema previdencial (earnings-based)
- Regime de proteção social convergente (earnings-based)
- Certificados de Reforma, etc. (public capitalization scheme)

Caixa Geral de Aposentações (public employees)

- PayG Capitalization Special subsystems
- Sistema proteção social de cidadania (non earnings-based)
- Special payments (non earnings based)

Secondary system

- Individual schemes
- Collective schemes (private capitalization schemes)
The current public pensions system in Portugal

Assessment of the international institutions

- Differing costs and benefits across different generations (both in the design and outcomes delivered by the system thus far, and in the impacts of reform measures). More favourable situation for those currently in or close to retirement (AWG).

- Fiscal savings only from 2020 onward; entitlements of current pensioners are protected.

- Current workers have larger fiscal burden and seem to internalize expectation of lower pension levels (replacement rates).
Criteria for the assessment of pensions systems

3 essential criteria for the assessment of pensions systems and reform measures (which should frame diagnoses and reform measure impact assessments and discussion)

- Sustainability
- Adequacy
- Equity
Criteria for the assessment of pensions systems

**Sustainability:** can be used to name several very different dimensions (financial, demographic, economic, political, environmental).

- Related to the link between the present and the future: rational use of available resources.

- Ability of the system to produce, distribute and use accumulated resources in a responsible and equitable (between generations) manner as time goes by.

- In the Portuguese fiscal framework law: “Sustainability is the ability to fund all commitments made or to be made, while respecting the structural balance rule and the public debt ceiling”. (unsurprising focus on the financial element of public sector)
Criteria for the assessment of pensions systems

**Adequacy:** the *net* replacement rate is one key figure to build a solid indicator of the generosity levels of pension systems: the ratio between the income replacement payment (pension) and the reference base salary, net of taxes and social contributions.

- A proper assessment of adequacy should take into account, however, additional features of pensioners (home ownership, non-labour income, etc.).

**Equity:** criteria to order social preferences.
- "Vertical" equity: distributional fairness.
- "Horizontal" equity: differences between different (institutional) schemes e.g. public employees v. other workers.
- Intergenerational equity: between different cohorts along complete life cycles.
The public and political discourse on pensions in Portugal

- Strong doubts and tensions persist in Portugal regarding the diagnosis of financial (im)balances of the public pensions system in the short, medium and long term.

- Public debate has been inconsequential and contributes to i) scarce understanding of how the system works (by the public and by political actors) and the challenges it faces and ii) for less transparent policymaking, which seems to have privileged **grandfathering** approaches.

- The discussion can mostly be framed into two sides of the wall between the “**left**” and “**right**” of the political spectrum...
The public and political discourse on pensions in Portugal

Fallacies on the left...

• Any reform of the current system violates “intergenerational solidarity”.
• The system’s shortcomings are only due to unemployment and recessions.
• Cuts to pension amounts are unfair and worsen inequalities.
• Capitalization schemes are individualistic, there is no solidarity nor risk sharing.

... and on the right

• Large deficits during the crisis prove the system is completely unsustainable.
• The current system is badly damaging of economic competitiveness.
• “Virtual capitalization” is very similar to “real capitalization”.
• In PAYG the money “disappears”.
• Implicit debt is excessive and demonstrates the urgency of reform.
The public and political discourse on pensions in Portugal

- **On the “left”:** conservative view, rigidly protective of established entitlements.
- **On the “right”:** a fragile diagnosis of financial sustainability is used to propose an “inevitable” structural reform purportedly inspired (mainly) by the Swedish model.
- Recent quantitative studies that meet the following two criteria are sorely missing:
  - i) recognized by both sides as independent and credible;
  - ii) clearly diagnose the situation, the current perspectives of the system, and impact assessment of recent reforms and reform proposals on the table, featuring distributional details.
- *Ageing Report* very useful but not enough => a sample of individual (micro)data on pensions and contributions would be essential.
A quick example on the use of micro data

- Two cases (using the current simulator provided by the Government)
  - Short contributive career
  - Long contributive career
- Assumptions: contributions present value computed using interest rate (AMECO), future values discounted at 3% (using 2% is similar), pension nominal updates keep their real value (looking at purchasing power of financial flows)
The aggregate view
Simulated life-time relation with pension system

- Real wages: 1990-2017
- Simulated wages (SS): 2018-2033
- Retirement at 66Y 4M death at 85 years
- Net present value of stock each period
- Replacement rate 77%
- Gross pension wealth 8.62

The micro data view
Relation with pension system

Full career
Short career
From these two examples

- Not a significant imbalance on net present values (net position depends on discount rate)
- How does the aggregate view look like? (no information to answer it now, but it can be computed – examples used information from individual page in social security website)
- Importance of moving from aggregate computations to micro level data to know who is affected and in what ways by current policy and future policies
- Also, identification of what types of redistribution are present to make clear what are the sources of problems, so that future policies can address the problems that really exist (and not the problems that we assume that exist)
Thank you