Brazil—Social Security Reform

Same proposal. Different probability?

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- **The Executive Branch and Congress have intensified their efforts to set social security reform back in motion: the new version of the reform is expected to be debated in the Lower House beginning February 19 and submitted to the floor for a vote by February 28.**
- **In this new round of negotiations, the most relevant change was in the pension rules for police officers' widows; in our opinion, this change does not significantly reduce the reform's potential impact on the social security system.**
- **From a distributional standpoint, the elimination of early retirement and above-ceiling pensions accounts for most of the expected income distribution improvement; as such, their being maintained in the new proposal is positive, in our view. Our estimates indicate that, in its new version, the reform may have a fiscal impact of BRL480 billion on a 10-year horizon, corresponding to roughly 57% of the savings associated with the initial version of the proposed reform.**
- **In our opinion, the market is not pricing the pension reform's approval, mainly because of the proximity of electoral campaigns. This tight schedule is even more challenging than last December, in our view, especially given the lack of consensus around pension reform.**

The long wait

Ten months after the Special Commission of the Lower House approved the proposed social security reform, the government is back with full plate as it try to move forward with social security reform. The new proposal is a softer version of the proposal approved by the Special Commission of the Lower House in April 2017. However, it does not differ significantly from the November 2017 proposal, suggesting that the government intends to move forward with the same proposal presented in November, while hoping this time around that it will be approved. The good news the proposal maintains crucial points (i.e., those that promote adjustments to imbalances in the pension system over time). Nonetheless, we still believe the possibility of its approval remains challenging.

In 1998, Congress submitted to the government a social security reform proposal; while it is fair to say that *some* reforms were approved, it is also important to recall that a key aspect of the current proposal — a minimum retirement age — was excluded from the final text because the government fell one vote short of the necessary number (there were 307 votes in favor and 148 against). At that time, the proposal was even milder than the current one, with a minimum age for retirement for all private sector workers (55 for women and 60 for men), valid only for new entrants to the system and thus implying a transition of ~30 years.

Nearly 20 years later, Brazil (as represented by Congress) finds itself in a similar quandary, and we see reasons to question whether this time will be any different, as this issue remains controversial and once again is being debated on the eve of Congressional elections. The price of postponing the reform for two decades is that the reform under consideration now is tougher: the proposed minimum retirement age is now 62 and 65 years, respectively for women and men. Moreover, the new rules will apply to all contributors who have not yet met eligibility criteria, implying a transition period of around 20 years. If Congress once again is unable to change the pension rules, we believe it will be necessary to revisit the theme in the coming years, and the longer it takes, the stricter the changes will have to be, in our view. Why? The undeniable circumstance that cannot be circumvented: population dynamics. **According to the IBGE's demographic census, the ratio of formal**

workers (who contribute to the system) to retirees was 8-to-1 in 2000, 6-to-1 in 2014, and will be only 2-to-1 in 2050. In a pay-as-you-go system (as exists in Brazil), in the absence of reform we believe these dynamics will imply either a heavy burden on working-age citizens, an erosion in benefits (and consequent impoverishment) of future retirees, or a combination of both.

New proposal, same proposal

Minimal changes from previous proposal:

- Pension due to death of a police officer (civil, road, Federal, civil and legislative) as a result of death in the exercise of (or because of it) his or her function will correspond to the integral salary for those who entered the career before 2003. For those who entered up to 2013, the pension could be above the benefit ceiling paid to the private sector.
- As of December 31, 2019, the minimum age limits shall be increased by 1 year every 2 years, up to the limit of 62 years old for women and 65 years old for men.

The minimum contribution period for workers in the private sector and the public sector were maintained at 15 years (the same period currently required) and 25 years, respectively. Also in the proposal is the granting of rural pensions, which the government left out of the reform, maintaining the current rules — a relaxation aimed at the smaller and poorer cities in the North and Northeast. In addition, the proposal maintains the current rules for low-income elderly and disabled persons to be eligible to a 1-minimum wage social benefit (BPC).

The crucial points of the reform: the minimum age for retirement of private sector workers and changes in the retirement of civil servants (with transition rules) are maintained in the new version, thus, most of the fiscal and distributive effects of the reform, in our view. Our exercises suggest **the reform may have a fiscal impact of BRL480 billion on a 10-year horizon, corresponding to roughly 57% of the savings associated with the initial version of the reform proposals.** Still, eventual approval of this softer proposal would likely highly benefit asset prices, in our view. We note, however, that market consensus at this time attributes a low probability of approval in this legislative session.

As the legislation moves ahead in Congress, it is important to keep a close watch on details that may be changed either beforehand, in negotiations, or in last-minute floor votes (as occurred in the vote that excluded the minimum age requirement in the 1998 reform). In our view, **there is no room for additional relaxation of the proposed rules without losing the core of the reform.** For instance, according to our exercises, the social security deficit of the General Social Security System (RGPS) could worsen by 1% of GDP on a 20-year horizon, if a minimum age for retirement in the private sector is introduced but at a lower threshold (58 years old for women and 60 years old for men, as some members of Congress have said they intend to propose). Similarly, we believe tampering with the speed of the transition could be harmful not only to public debt dynamics, but also to the capacity of the government to comply with the constitutional spending cap. For details see our report, *Let's Try Again: The Positive and the Negative in the Latest Attempt to Pass Social Security Reform*, published on November 28, 2017**.**

Figure 1. Highlights of Social Security Reform

Topic	New proposal (Feb 2018)
	Private Sector (RGPS)
Minimum age for retirement	62 (women)/65 (men), with a minimum **15 years of contribution (as in the currently prevailing rule)**
Value of benefit	Requirement to receive 100% of the benefit (average of received salaries since 1994) with a benefit cap of R$5,531: 40 years of contribution
Transition rule (current contributors who have not yet met eligibility criteria under the prevailing rules)	Additional of 1/3 to the number of years remaining for retirement under the current rule (30 years of contribution for women and 35 years for men), given the minimum age for retirement is 53 years old for women and 55 years old for men in 2018, reaching 62/65 years old as minimum age in 2038 (20 years)
Rural workers	**Maintains the current rules** (**55 years old for women and 60 years old for men / minimum of 15 years of contribution**)
Social assistance (BPC, 1-minimum wage benefit to low-income seniors and disabled citizens not eligible to regular retirement)	**Maintains the current rules** minimum age at **65 years old** (men/women)
	Public Sector (RPPS)
Minimum age for retirement	Retirement eligibility : minimum age at 62 years old for women and 65 years old for men, with a minimum of 25 years of contribution
Value of benefit	Benefits to those that became civil servants before 2003 and reached 62/65= last salary + civil servants workers annual readjustment. Benefits to those that became civil servants after 2003= 70% of the benefit (average of received salaries since 1994) if 25 years of contribution and requirement to receive 100% of the benefit : 40 years of contribution
Transition rule (current contributors who have not yet met eligibility criteria under the prevailing rules)	To those became civil servants after 2003 under the current rule (30 years of contribution for women and 35 years for men), given the minimum age for retirement is 55 years old for women and 60 years old for men in 2018, reaching 60/65 years old as minimum age in 2028 (10 years), and 62/65 in 2032. Cap at R$5,530 to those that became civil servants after 2015
	Pensions
Value of benefit	50% for the widow+ 10% per child
Value of benefit	non accumulation of benefits up to 2 minimum wages

Sources: Ministry of Finance and Santander estimates.

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