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ECONOMICS RESEARCH

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Brazil—Social Security Reform

Let's Try Again: The Positive and the Negative in the Latest Attempt to Pass Social Security Reform

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- **The executive branch and Congress have intensified their efforts to set social security reform back in motion: the softer version of the reform is expected to be submitted to a floor vote in the Lower House in the first week of December.**
- **In this piece, we look at the changes introduced in the text of the reform as part of the government's strategy to build support for social security reform. While some aspects of reform that we consider desirable have been left out (and will likely require addressing at some point in the future, in our view), the new version has preserved two core features of social security reform: the imposition of a minimum retirement age for all private sector workers and the imposition of a ceiling on civil servants' pensions, in both cases subject to transition rules for those already contributing to the system.**
- **Compared to the previous version, the new text preserves the bulk of fiscal and distributional effects, in our view. Our estimates indicate that, in its new version, the reform may have a fiscal impact of BRL 480bn, corresponding to roughly 57% of the savings associated with the initial version of the reform proposals. Thus, we believe there is no room for additional relaxation of the proposed changes without losing the main improvements of reform and missing another opportunity to make meaningful changes.**
- **From a distributional standpoint, in 20 years from 2018, the elimination of early retirement and above-ceiling pensions accounts for most of the expected improvement in income distribution, and as such their maintenance in the new text is positive, in our view.**
- **Passage of the reform during this legislative session remains a challenge, in our opinion, not only because of the wide support necessary for approval but also because of time constraints. Only three weeks of legislative activity remain for this year, and once Congress reconvenes next February for the current legislators' final year, there will be less than six months before the beginning of election campaigns. Such a tight timetable could prove challenging, in our view, particularly in light of the lack of consensus around social security reform.**

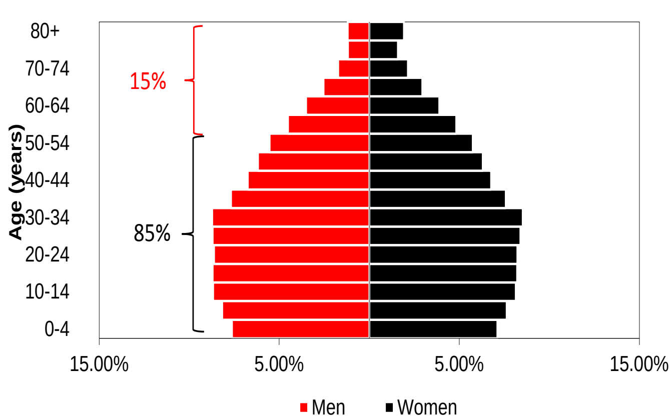
The long wait

Seven months after the approval of the proposed social security reform by the Special Commission of the Lower House, the government comes back with a full load to move forward with the social security reform. The government has drafted a softer version of the reform, which is expected to be submitted to a floor vote in the Lower House in the first week of December. In political terms, most commentators argue that full approval in the Lower House must be obtained before year-end, in order to allow time for Senate approval in the first half of 2018. This leaves only a narrow window of opportunity and a rather limited time for negotiations, considering that Congress will adjourn on December 22 and resume only next February.

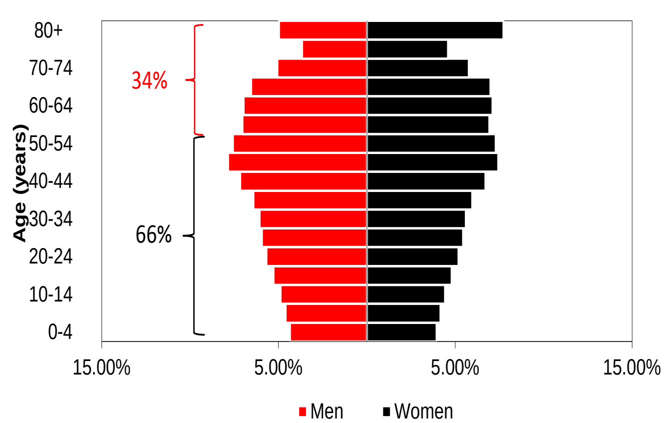
It is perhaps more correct to argue that the wait for such reform has been much longer than the seven months since the Special Commission approval – rather, society has been in wait-and-see mode for nearly 20 years. **In 1998, the government submitted to Congress a social security reform proposal, and, while it is fair to say that *some* reform was approved, it is also important to recall that the 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 the minimum age).** 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 – implying a transition of around 30 years.

Nearly 20 years later, Brazil (as represented by Congress) faces the same dilemma, and there are reasons to question whether this time will be any different, as the topic continues to be 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 minimum age is now proposed at 62/65 (women/men), and 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. This follows from an undeniable circumstance that cannot be circumvented: population dynamics. **According to the demographic census of the IBGE, the ratio of formal workers (who contribute to the system) to retirees was 8 to 1 in 2000; it was 6 to 1 in 2014; and it will be only in 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.**

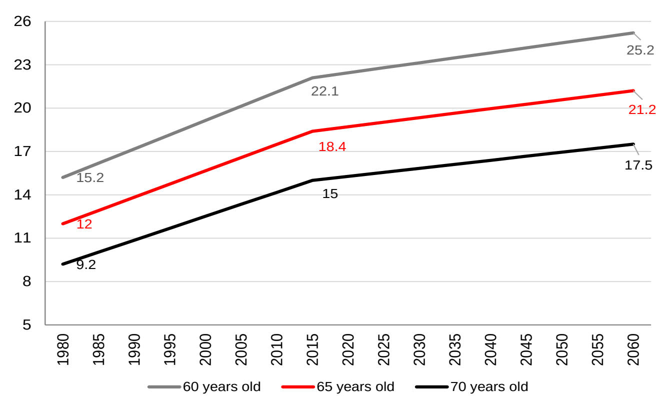
Age pyramid 2014



Age pyramid 2050



Expected survival: additional life expectancy at ages of 60, 65 and 70 years old



Source: IBGE.

The new, softer proposal

The new, softer version of reform has three main points:

- A minimum retirement wage (and a transition rule): 62 years old for women and 65 years old for men. Teachers and police officers retire earlier: at 60 and 55, respectively, regardless of sex. Exceptions have been granted for other hazardous occupations.
- A minimum contribution of 15 years for private sector workers and 25 years for public servants.
- A new formula to calculate the value of the benefit. For private sector workers, this starts at 60% of the full benefit for 15 years of contribution with a cap for 40 years of contribution. For public servants, this starts at 70% of the full benefit for 25 years of contribution with a cap for 40 years of contribution.

As shown in Figure 1, the new version preserves most of the main points approved by the Special Commission last April. One of the most noteworthy retreats from those proposals was on the minimum period of contribution for private sector workers, which the government originally wanted to raise to 25 years; the new version maintains the current requirement of 15 years. From a political and distributional point of view, the modification makes sense, as it protects the most vulnerable group of workers – low-income, low-skilled workers who might have difficulty in securing formal jobs (in which there is an automatic contribution to social security) for 25 years until they reach the minimum retirement age. The less stringent proposal makes no distinction for high-income, highly skilled workers – who tend to be the majority of early retirees, and whose benefits consume a disproportionate share of social security spending. However, the softer version has a narrower transition period of 10 years, reaching the minimum age of 60/65 in 2028.

Another significant concession concerns rural pensions, which the government is no longer trying to reform – a soft spot for politicians in smaller, poorer cities in the North and Northeast. By the same token, the government gave up raising the age at which low-income senior citizens are eligible to a 1-minimum wage social benefit (BPC). The fiscal cost associated with these concessions seems small, particularly if it is the price to pay to enhance the likelihood that reform will be approved in this legislature (which remains to be seen).

By preserving the minimum retirement age for the private sector and the changes in civil servants' retirement (with transition rules), the new version also preserves most of the fiscal and distributional effects of the reform, in our view. **According to our estimate, these two items represent around 54% of total potential savings from the proposed reform, and thus they are crucial in stabilizing the social security system's deficit ratio-to-GDP.** Initially, the government expected savings of BRL 849bn in social security spending (RGPS and RPPS) up to 2026 (the first ten years of the New Fiscal Regime's implementation). Following the changes approved by the Special Commission report, the government lowered the expected savings to around BRL 630bn, which represented 76% of the savings in the original proposal. The new, softer version further changes the government's expected savings, reducing their estimate to 60%. Our exercises suggest an even more significant impact, reducing the savings to around BRL 482bn (1.1% of GDP) between RGPS and RPPS, which means 57% of the original proposal's savings (see Figure 2). 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 to this legislature.

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 in a horizon of 20 years, 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. **Hence, we view positively the potential for reform to move ahead in the current Congress; the negative is that there appears to be no further room for negotiation. If society is unable to support the new proposals in their current form, we believe the choice will be not a milder but a tougher version of reform in the near future.**

Figure 1. Highlights of Social Security Reform

Topic	Text approved by the Special Commission	Text to be submitted to the Lower House floor
	Private Sector (RGPS)	**Private Sector (RGPS)**
Minimum age for retirement	62 (women)/65 (men), with a minimum 25 years of contribution	62 (women)/65 (men), with a minimum **15 years of contribution (as in the current 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	**No change**
Transition rule (current contributors who have not yet met eligibility criteria under the prevailing rules)	Addition 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)	**No change**
Rural workers	Minimum age at 57 years old for women and 60 years old for men and 15 years of contribution, contributions based on a minimum wage	**Changed. 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)	Minimum age gradually rising from the current 65 to 68 (men/women)	**Changed. Maintains the current rules** minimum age at **65 years old** (men/women)
	Public Sector (RPPS)	**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	**No change**
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	**No change**
Transition rule (current contributors who have not yet met eligibility criteria under the prevailing rules)	To those who 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.	**No change**
	Pensions	**Pensions**
Value of benefit	50% for the widow+ 10% per child	**No change**
Value of benefit	non accumulation of benefits up to 2 minimum wages	**No change**

Sources: Lower House and Santander.

Figure 2. Estimated impact of social security reform

	2017-2026 impact (%of GDP) - original proposal	2017-2026 impact (%of GDP) - Special Commission's report	2018-2027 impact (%of GDP) - Softer version
Total savings of the social security reform	**2.2%**	**1.4%**	**1.3%**
Total impact of the reform on RGPS (private sector)	**1.4%**	**1.0%**	**0.9%**
Total impact of the reform on RPPS (civil servants)	**0.4%**	**0.2%**	**0.2%**
Social Assistance and Pensions	**0.5%**	**0.2%**	**0.2%**
Retirement eligibility: Minimum age + Transition rules+ end of special rules for retirement	1.2%	0.9%	0.9%
Rural Social security Contribution (charged on benefits)	0.05%	n/a	0.0%
Rural exporters tax	0.10%	0.10%	0.0%
Survival pension: 50% family for the widow + 10% per child	0.10%	0.10%	0.10%
Survival pension: non accumulation of benefits	0.10%	0.05%	0.05%
BPC- Benefits payment to seniors	0.05%	0.01%	0.0%
BPC - delinking of benefits and social assistance from minimum wage	0.20%	n/a	0.0%
Civil servants retirement rules: Minimum age + Transition rules+ end of special rules for retirement	0.10%	0.02%	0.02%
Civil servants (after 2003) retirement rules - % of benefit (average of received salaries since 1994) + non accumulation of benefits	0.20%	0.20%	0.20%

Sources: Ministry of Finance and Santander estimates.

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Fiscal Budget Surplus after October

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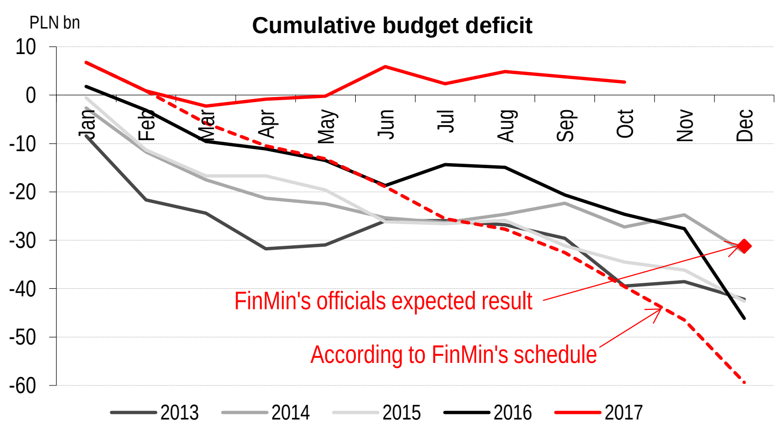
The Polish central budget was still in surplus after October. According to the MinFin schedule of revenues and expenditures, the YtD deficit was supposed to reach cPLN40bn after October, but the actual figure is a PLN2.7bn surplus. A representative of MinFin, Deputy Finance Minister Teresa Czerwińska, claims this means we could see a PLN30bn deficit as the full-year result. Her estimate includes the approved amendment that shuffled some spending limits within the budget, while keeping the nominal overall revenues and expenditures (and thus the PLN59.3bn fiscal balance) intact. The corrections to the budget should allow extra spending of cPLN11bn, though. It nevertheless seems that the Deputy Minister's claim may leave room for another budget amendment to allow larger expenditures in some areas thanks to the very comfortable budget position so far. The positive labor market situation with acceleration of wages leads to much lower subsidies from the central budget to the social security system (-19% y/y in YtD terms). Debt servicing costs are also down c10% y/y. The budget balance is so high also due to slow take-up of EU funds.

Poland, central budget performance, YtD



Source: Ministry of Finance, BZ WBK.

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