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Brazil – Fiscal Policy

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It's Show Time: The Battle for Social Security Reform

- **The new government's proposal for Social Security reform, sent today to Congress, came in broadly in line with our expectations. In our view, the proposal addresses all fundamental problems of the Brazilian system, assures a relatively fast convergence to the new rules and takes into account evolving demographics.**
- **One of the greatest strengths of the proposal is its approach to eliminating discrepancies and reducing inequalities, which will likely be used as a communication tool aimed at fostering popular support and reducing resistance in Congress.**
- **The government estimates that pension reform would provide total savings of nearly BRL 1.2 trillion in 10 years. The big question for markets is what type of reform is feasible. We should expect that some of the government's proposals will be watered down in the process of negotiations with Congress.**
- **We see potential for the approval of a pension reform with savings of around BRL 800 billion in 10 years. In our view, the most likely and important subject of negotiations will be the minimum age for retirement.**

Pension Reform Proposal Under the New Government – General Assessment

In our view, the pension reform bill disclosed by the government was in line with expectations, particularly as the overall expected savings figure was confirmed above BRL 1 trillion (USD 320 billion, or 16% of GDP). Moreover, most of fiscal benefit expected to be generated by the new framework results from the already expected definition of tougher conditions for retirement, based on increased minimum age requirements. The intention to unify the rules for private sector employees and civil servants was also confirmed and welcomed, as is the inclusion of the military in the reform.

In short, the proposal addresses all fundamental problems of Brazilian pension system, assures a relatively fast convergence to the new rules and takes into account evolving demographics.

Positives

Apart from fiscal savings, the greatest strength of the proposal is its approach to eliminating discrepancies and reducing inequalities, which will likely be used as a communication tool aimed fostering popular support and reducing resistance in Congress. In this respect, we highlight the introduction of a progressive system of brackets for contributions to be charged on both private sector employees and civil servants. This would certainly concentrate most of the burden of the reform on the richest, slightly reducing contributions from the great majority of individuals who earn up to 2 minimum wages.

Moreover, the bill also attempts to reduce important differences among categories that still prevail in Brazil, such as the military, teachers, police officers and civil servants. This also sends a powerful message in terms of the government's intention to pursue a fairer system.

Finally, **another important positive feature is related to the fact that the proposal intends to unify the rules applied to federal government civil servants with those of states and municipalities.** This will be important in attracting support from governors and mayors who have been facing challenges in balancing their budgets, due to the heavy burden associated with pension payments.

Risks

The most obvious risk for the reform will be the ability to get it approved by Congress before the end of 2019, particularly considering that the government is still short of an organized coalition and strategy. Nevertheless, we believe that both the government as well as society are convinced about the importance of changing the current framework for pensions in order to reduce fiscal uncertainties, which have been an important obstacle for investment and growth.

The big question for markets is what type of reform is feasible. We should expect that some of the government's proposals will be watered down in the process of negotiations with Congress. It is going to be crucial to keep expected savings not far from BRL 1 trillion, considering that the expected increase of spending associated with benefit payments is projected at around BRL 1.5 trillion over the next 10 years. **We see potential for the approval of a pension reform with savings of around BRL 800 billion in 10 years. In our view, a final outcome with savings much below this amount would be disappointing.** In this sense, we highlight that the most likely and important subject of negotiation will be the minimum age.

According to our estimates, **ex-president Michel Temer's original proposal for pension reform would save around BRL 845 billion in 10 years.** Nevertheless, following the changes approved by Congressional commissions, **a modified (watered-down) proposal would lead to savings totaling nearly BRL 550 billion in 10 years,** which means a reduction of 35%.

Important points still to be defined

There are still very important features of the pension reform (and related issues) that were not yet defined. Those could represent opportunities as well as risks: 1) a more detailed definition of the capitalization framework; 2) a detailed framework for the military, which will be important in order to signal the government's degree of commitment in not favoring specific segments of society; and 3) a new rule for minimum wage readjustments, which is very important for fiscal accounts in the short term.

The table below presents the government's official estimates for savings arising from the reform of Brazil's social security system. The next sections of this report (including the Appendix) provide further details on the proposal's key points.

Social Security Reform - Main Measures	Savings in 4 years (BRL billion)	Savings in 10 years (BRL billion)
Private Sector (RGPS)	82.5	715.0
Change in the Social Security Contribution Rates (RGPS)	-10.3	-27.6
Public Sector (RPPS) - Federal Government	33.6	173.5
Change in the Social Security Contribution Rates (RPPS)	13.8	29.3
Social Assistance and Pension Benefits	41.4	182.2
Total Impact - New Social Security System	**161.0**	**1,072.4**
Military forces (additional bill to be sent later)	28.0	92.3
TOTAL IMPACT	**189.0**	**1,164.7**

Source: Ministry of Economy

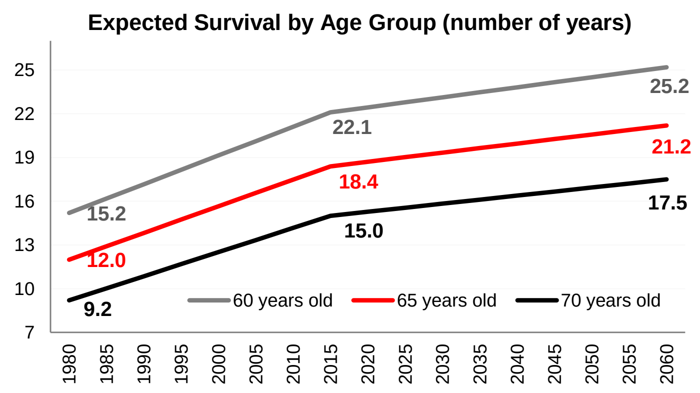
What's New?

1) Establishing a Minimum Age for Retirement

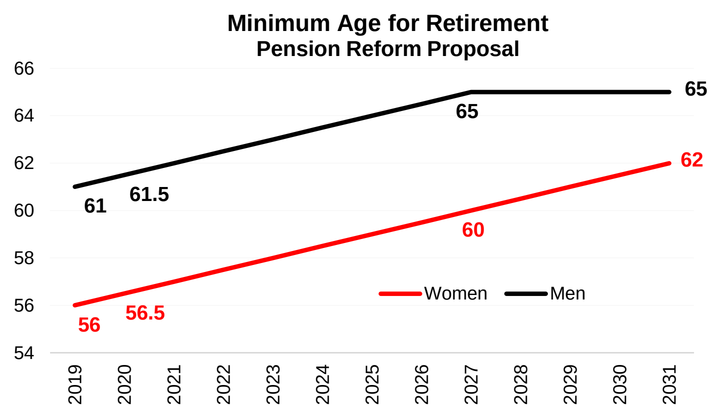
The new rules propose that any female/male worker (private sector or civil public servant) will only be eligible for retirement when they reach the age of 62/65. Under the current rule, only civil public servants have an age condition for retirement (55/60 for women/men). Private sector workers can currently retire when they meet a minimum period of contribution (30 years for women and 35 years for men, regardless of their age), and the reduction in pension benefits determined by current rules on workers who retire early has not been sufficient to incentivize them to postpone their retirement. According to Ministry of Economy data, **the average age of retirement of private sector workers (not subject**

to a minimum age condition) is around 55, while the average life expectancy at that age is 26 years[1], which does not vary significantly across the different regions of the country** (it is important to note the difference between life expectancy at birth and life expectancy at retirement age). The minimum age set by the proposal is in line with the average threshold for retirement in OECD countries. Furthermore, it was proposed that the minimum age would rise in tandem with the increase in life expectancy, an automatic mechanism that could prevent the need for further rounds of pension reform. Finally, the **government has announced that there will be a transition period of up to 12 years as the new system is phased in,** a shorter period than that set out in the pension reform proposal by former president Michel Temer (20 years).

In our opinion, **the establishment of a minimum age for retirement is crucial for the correction of significant distortions in Brazil's pension system with regard to income distribution.** As mentioned, the current rules allow the access to pensions (for private sector workers) conditional on period of contribution, regardless of the age of the retiree. However, only the wealthiest and most educated workers tend to retire according to this regime, while the majority of the low-income population retires by meeting a minimum age (60 for women / 65 for men), provided that the worker has contributed to the pension system for at least 15 years. According to IPEA, less than 5% of early retirees (classified as retired men up to 59 years old and retired women up to 54) belong to the poorest 20% of Brazilian population. On the other hand, around 45% of early retirees belong to the richest 20%, and almost 85% belong to the wealthiest half of the population. In addition, since workers who retire by meeting the minimum period of contribution are better educated and employed more often in formal jobs, they account for around 15% of the General Pension System (RGPS, acronym in Portuguese) beneficiaries, but receive almost 30% of total benefits paid. That is, lower-income workers are subject to a higher degree of informality and usually retire by meeting the minimum age, which is linked to the minimum wage pension-payment floor.



Source: IBGE



Source: Ministry of Economy

2) Transition Period: Three Alternative Options

Three options are offered by the pension reform proposal regarding the transition period: (i) an increasing minimum age; (ii) a scoring system (age + period of contribution)**; (iii) retirement according to the period of contribution** (valid only for workers who would retire within two years under the current rules).

(i) Increasing Minimum Age

Based on this model for the transition period, the approval of pension reform would immediately require a minimum age of 61 years for men and 56 years for women. Thereafter, **the minimum age for retirement would be increased by six months every year until reaching the maximum of 65 for men in eight years and 62 for women in 12 years.**

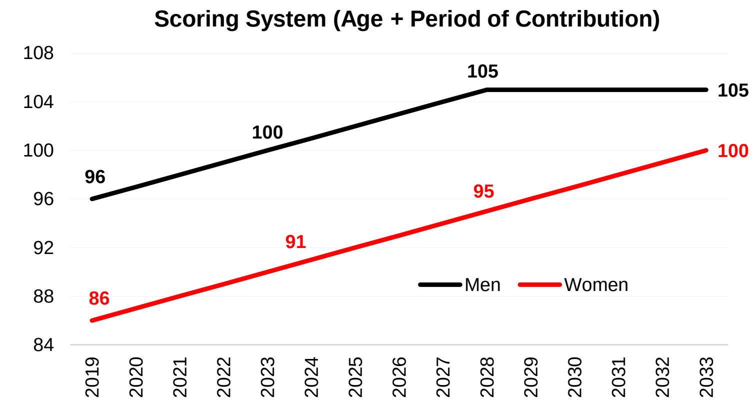
(ii) Scoring System

In this case, **the sum of the worker's age and his/her period of contribution to the social security system would have to meet a minimum score that begins at 96 points for men and 86 points for women**, increasing by 1 point per year from 2020 onward (considering the approval of the reform in 2019), until the limit of 105 points for men in 2028 and 100 points for women in 2033.

(iii) Retirement by Period of Contribution

This option only applies to workers who would retire within two years under the current rules. Workers would have to pay a penalty of 50% on the remaining time to retire, along with the discounting factor, which would reduce benefits in case of early retirement.

[1] Life expectancy in Brazil was 63 in 1980, but rose to 76 in 2018 and is projected to rise to 80 by 2040.



Source: Ministry of Economy

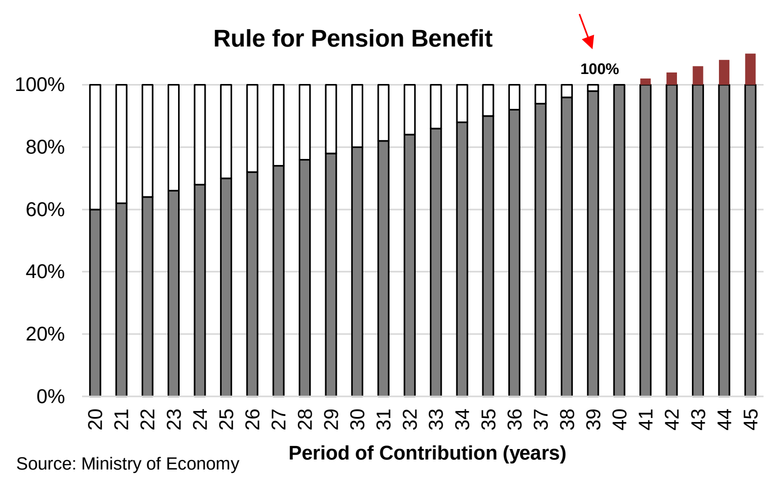
3) Increased Period of Contribution

Due to current early retirement rules, Brazilian workers suffer the penalty implied by the discount factor called *fator previdenciário*, which reduces benefits for those who have contributed only for a few years and/or are expected to live many years after retirement. Based on Ministry of Finance data, Brazilian men retire, on average, at the age of 59 (considering all the pension systems), receiving around 80% of their average contributions for an additional 22 years of life expectancy. At the same time, Brazilian women retire, on average, at the age of 57, earning around 65% of their average contributions for an additional 26 years. **Taking into account the new rules of the pension reform proposal, average benefits would likely increase as a proportion of contributions, but would be paid for a shorter period** (the period of contribution would rise, whereas the survival period at retirement would decrease).

- **With respect to private sector workers (RGPS), the new rules propose 20 years as a minimum period of contribution,** more than the 15 years required under current rules.

- **For civil public servants (RPPS), nevertheless, the proposal for the minimum period of contribution is 25 years** (in general, public jobs have greater stability / lower probability of dismissal).

The **full pension benefit**[2] (currently at BRL 5,839.45 for RGPS) **could be reached only after 40 years of contribution** to the social security system. The benefit value could not be less than one minimum wage (BRL 988.00 in current values).



Source: Ministry of Economy

4) Convergence of Rules for Public and Private Sectors

In our view, one of the most important features of the pension reform proposal is the convergence of contribution rates for the private and public sectors, resulting in an outcome of **"who earns more, pays more"**. As presented in the tables below,

[2] With respect to the rule for calculating pension benefits for private sector workers, the new proposal defines: 60% (20 years of contribution) + 2pp per year exceeding 20 years multiplied by Average Contribution Wages.

the most significant changes would take place for public servants: the contribution rates for salaries above BRL 5,839 would be higher than under current rules.

In short, we consider the progressive contribution rates to be particularly ingenious from the point of view of equity, easing the burden on the poorest and weighing more on the richest.

Private Sector (Current Rules)	
Salary Range (BRL)	**Effective Contribution Rate**
Up to 1,752	8.0%
1,752 - 2,920	9.0%
2,920 - 5,839	11.0%

Source: Ministry of Economy

Private Sector (Proposed Rules)	
Salary Range (BRL)	**Effective Contribution Rate**
Up to 1 Minimum Wage	7.5%
998* - 2,000	7.5% - 8.25%
2,000.01 - 3,000	8.25% - 9.5%
3,000.01 - 5,839.45**	9.5% - 11.68%

* Minimum Wage (current values)

** Full Benefit (current values)

Public Sector - RPPS (Current Rules)	
Salary Range (BRL)	**Effective Contribution Rate**
Admission until 2013	11% on full salary
Admission from 2013	11% up to RGPS ceiling

Source: Ministry of Economy

Public Sector - RPPS (Proposed Rules)	
Salary Range (BRL)	**Effective Contribution Rate**
Up to 1 Minimum Wage*	7.5%
998.01 - 2,000	7.5% - 8.25%
2,000.01 - 3,000	8.25% - 9.5%
3,000.01 - 5,839.45**	9.5% - 11.68%
5,839.46 - 10,000	11.68% - 12.86%
10,000.01 - 20,000	12.86% - 14.68%
20,000.01 - 39,000.00	14.68% - 16.79%
Above 39,000	> 16.79%

* Minimum Wage = BRL 998 (current values)

** Full Benefit for RGPS (current values)

5) Tougher Rules for All Segments

The pension reform submitted by Jair Bolsonaro's government also includes changes in the granting of benefits related to rural workers; low-income seniors and disabled citizens not eligible to regular retirement (BPC); surviving spouses; and others.

Regarding the former, it is worth noting that **rural workers' contribution** to social security system is around 0.15% of GDP, while the benefits are slightly less than 2% of GDP. Although some differentiation was maintained in relation to urban workers (minimum age of 60 for men and women), there has also been some tightening of rules (e.g., minimum period of contribution raised to 20 years from 15).

Looking at **social assistance benefits**, the pension reform proposal raises the minimum age (from 65 to 70) for low-income seniors to receive a minimum wage benefit. As a compensatory measure, it provides for an early benefit of BRL 400 for elderly people in extreme poverty above the age of 60. Moreover, the proposal **limits the payment of salary bonuses[3] to those who earn up to 1 minimum wage** (instead of 2 minimum wages, as currently).

The new proposal also tightens the rules for **surviving spouse benefits** by imposing proportionality to the benefit according to the number of dependents (limited to 100% of the benefit), as well as preventing the accumulation of social security benefits.

6) Additional Proposals to Be Submitted

Jair Bolsonaro's proposal also presented **guidelines for the creation of an individual capitalization regime as an alternative to the current system.** The scheme is comprised of a defined contribution, with free choice of the entity or modality of management, and guaranteed portability between public and private pension entities, provided that they are authorized by a regulatory institution. **The details about the capitalization scheme will be addressed in a complentary proposal (no pre-determined date for release).**

[3] Salary bonus consists of the payment of one year's minimum wage, for supplementation of income according to legally-established criteria.

New rules will also be established for the military. In this case, there would be no need for approval of a constitutional amendment. According to the government, a complementary proposal will be sent to Congress within 30 days, addressing tougher rules for accessing pension benefits.

Moreover, the government will send a separate proposal **to combat large social security debtors and strengthen the active debt collection system**. The bill will propose: prohibition of installment payments over more than 60 months; alternative measures for receiving credits considered as irrecoverable; and measures to facilitate the legal alienation of property.

Finally, **all the new benefit rules for the federal government employees (RPPS) – if approved – would also apply to states and municipalities.** According to the Ministry of Economy's team, in case of financial and actuarial deficit, states and municipalities would be required to increase their contribution rates to at least 14% within 180 days. However, it is important to keep in mind that changes in contribution rates require the approval of the respective state assemblies and city councils.

APPENDIX

Social Security System: Current rules versus Jair Bolsonaro's proposal

Main Measures	Current Rules	Jair Bolsonaro's Administration - Original Proposal
Minimum Age for Retirement	**Private Sector:** no minimum age; sum of age and period of contribution = 96 for men, 86 for women **Public Sector:** 60 years for men, 55 years for women	**Private Sector:** 65 years for men, 62 years for women **Public Sector:** 65 years for men, 62 years for women
Minimum Period of Contribution	**Private Sector:** 15 years	**Private Sector:** 20 years **Public Sector:** 25 years of contribution
Retirement by Period of Contribution	**Private Sector:** 35 years for men, 30 years for women **Public Sector:** 35 years for men, 30 years for women and minimum age of 60 years for men, 55 years for women	Extinct option
Value of Benefit	**Private Sector:** conditional on life expectancy at the time of retirement and contribution period, according to 86/96 rule **Public Sector:** average of the higher wages (usually, the average of last years wages)	**Private Sector:** 60% + 2% for each year that exceeds the 20 years of contribution multiplied by the average contribution wage (none benefit can be lower than the minimum wage or above the ceiling of RGPS - private sector regime) **Public Sector:** 60% + 2% for each year that exceeds the 20 years of contribution multiplied by the average contribution wage (none benefit can be lower than the minimum wage or above the ceiling of RGPS - private sector regime of INSS)*
Rural Workers	Minimum age: 60 years for men, 55 for women Minimum period of contribution: 15 years	Minimum age: 60 years for men, 60 for women Minimum period of contribution: 20 years
Teachers	No minimum age Minimum period of contribution: 30 years for men, 25 years for women	Minimum age: 60 years for men, 60 for women Minimum period of contribution: 30 years
Survivor Benefits	**Private Sector:** 100% of the benefit **Public Sector:** 100% of the private ceiling benefit + 70% of the share that surpasses that ceiling	60% of the benefit + 10% per child (limited to 100% of the benefit)
Social Assistance (BPC, benefit to low-income seniors and disabled citizens not eligible to regular retirement)	1 minimum wage from the age of 65	BRL 400 from the age of 60 and 1 minimum wage from the age of 70

* Creation of a supplementary pension system

Source: Ministry of Economy

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