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Brazil: Pension Reform

The Moment of Truth: From Intentions to Bargaining

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- **Congress's first steps in the pension reform process have not sustained the market optimism seen just after the bill was unveiled by the new administration.**
- **The estimated net fiscal savings from pension reform for the military (tougher social protection rules offset by higher spending for a career restructuring program), as announced last week, disappointed market expectations.**
- **In addition, recent political turmoil has raised doubts about the government's ability to gain congressional support and obtain the required votes to pass a constitutional amendment.**
- **While acknowledging the challenging task of predicting the evolution of the pension reform proposal given rising uncertainties, this report presents our estimates for a watered-down version of the bill (after negotiations with Congress), as well as the timing for its approval.**
- **We estimate that a watered-down version of the government's draft could save BRL615 billion in 10 years, implying keeping around 55% of the original proposal (considering the pension regimes for the private sector, civil public servants, and military forces). Regarding the timeline, we expect the first round of voting in the Lower House to take place after the parliamentary recess, that is, only in 2H19. In our view, the final vote in the Senate should occur in 4Q19.**
- **The approval of such a reform, in our view, would be positively perceived by market participants, as it would provide a signal of the government's commitment to fiscal discipline and its capacity to mobilize the Congress to approve further austerity measures, much-needed, in our view.**
- **Nevertheless, we acknowledge that the balance of risks for approval of the pension bill has worsened recently: the likelihood of a more modest modified version seems higher than that of a more robust reform, and delays in the timeline are, in our view, more likely than positive surprises.**

Savings from Pension Reform – Original Proposal vs. Expectations for the Modified Version

Social Security Reform - Main Measures	Savings in 10 years (BRL billion) *Government estimates*	% of total estimates	Savings in 10 years (BRL billion) *Watered-down version - Santander estimates*	% of total estimates	*% of watering down*
Private Sector (RGPS)	715.0	66.0	337.8	55.1	52.8
- Urban Workers	565.0	52.2	337.8	55.1	40.2
- Rural Workers	150.0	13.8	0.0	0.0	100.0
Public Sector (RPPS)	173.5	16.0	120.7	19.7	30.4
Social Security Contribution Rates (RGPS)	-27.6	-2.5	-27.6	-4.5	0.0
Social Security Contribution Rates (RPPS)	29.3	2.7	21.9	3.6	25.3
Wage Benefit	150.2	13.9	150.2	24.5	0.0
Continuous Cash Benefit Program (BPC)	32.0	3.0	0.0	0.0	100.0
Military Forces*	10.5	1.0	10.5	1.7	0.0
Total Impact	**1,082.9**	**100.0**	**613.5**	**100.0**	**43.3**

Source: Ministry of Economy and Santander estimates

* Net savings: changes in Social Protection for military forces subtracted from career restructuring spending

A Tumultuous Journey

Following the announcement of the new government's pension reform proposal about a month ago (February 20), markets showed renewed optimism concerning fiscal consolidation in Brazil and a consistent recovery of the Brazilian economy in the coming years. Despite the general assessment that some of the original proposals would be watered down in the process of negotiations with Congress, the higher-than-expected government estimates of fiscal savings (about BRL1.2 trillion in 10 years) and measures focused on reducing inequalities and distortions (e.g., a progressive system for pension contribution rates) boosted confidence that the new attempt to address the worrying trajectory of public debt in Brazil would have a strong start (for more information, see *It's Show Time: The Battle for Social Security Reform*, February 20, 2019).

However, recent events directly or indirectly related to pension reform have not been auspicious, in our view. First, the bill proposing new rules for military social protection (popularly known as pension reform for the military) arrived in Congress last week and triggered much criticism from analysts and politicians. The fiscal impact of tougher rules for the military forces (e.g., increase of the minimum length of service from 30 to 35 years; higher rate of pension contributions, to 10.5% from 7.5%) will reach BRL97.3 billion in 10 years, according to the government's estimates, but a significant proportion of these savings could be offset by spending on a career restructuring proposal for the military also submitted to Congress (totaling BRL86.8 billion in 10 years). **Hence, the net savings of only BRL10.5 billion frustrated expectations, which were assuming somewhat closer to BRL100 billion in savings.** In addition, we think the terms of the military's pension reform will likely be seen as more favorable in relation to other sectors, which increases the risks of more pronounced changes in other key elements of the overall proposal.

Even more importantly, **the new government continues to lack an organized coalition and political strategy. The relationship between the executive and legislative branches has not been free of tensions, raising doubts about the government's ability to gain support in Congress** and reach the required votes to pass a constitutional amendment (308 votes in the Lower House and 49 votes in the Senate – 3/5 of total seats in both houses). According to our estimates, around 140-150 representatives from opposition parties are likely to vote against the reform, which implies that the government needs to be effective in converting votes from the remaining 363-373 deputies (the silver lining is that the opposition seems to be short of the 206 votes required to block the reform outright). So far, coordination and coalition-building seem to be the main constraints on approval of the reform – legislative procedures can easily be expedited if the government has control over the committees and the majority, as Speaker of the House Rodrigo Maia has declared repeatedly to the press. **The fact that so far, almost three full months into Jair Bolsonaro's presidential term, no party in Congress has declared support for the government corroborates our view that we are still many months away from an agreement that could lead to a floor vote** (we assume that the government will send the reform to a floor vote only when its calculations point toward 3/5 support plus some margin of safety of at least 10 representatives). We expect the reform to be put to a floor vote only in 2H19, although our base scenario still implies the reform will at least be approved in the Lower House by the end of this year. We believe that, once approved in the Lower House, the reform is unlikely to be substantially changed by the Senate.

On the political economy of the reform, it is also worth noting that:

- **The Lower House in Brazil is notably malapportioned** – the Constitution dictates that the Lower House must have 513 representatives and that no state can have fewer than eight or more than 70 seats. This leads to overrepresentation of small, relatively rural and poor states in the North and Northeast of the country and a significant underrepresentation of São Paulo, the most populous, wealthy, and predominantly urban state. As a consequence for the reform, **changes in retirement rules for rural workers and social protection for the destitute are particularly challenging to pass,** whereas the unorganized majority of urban workers is likely to bear most of the costs of the reform.

- **The agribusiness caucus is the largest interparty group in the Lower House,** which adds to the difficulty of approving any changes that imply larger contributions from rural producers to the pension system.

- **Parties from *Centrão*, an informal group of 12 centrist parties that together include around 280 representatives, has already released a note opposing some points of the government's draft,** including changes in retirement rules for rural workers and in the Continuous Cash Benefit program (BPC; for details, see page 5 of this report).

- **Federal civil servants, who constitute a large share of the federal capital's workforce, have unique mobilization capabilities,** especially compared to unions of private workers, who lost a substantial part of their funding after the changes imposed by the labor reform approved by the previous administration.

- Among the elements usually linked in the economic literature[1] to a high probability of success in achieving structural reforms, Brazil lacks a "strong" government (i.e., one where the ruling party holds a majority in Congress, with few constraints on executive decisions); in addition, the absence of an ongoing economic crisis in Brazil (characterized as falling real incomes) does not help create a sense of urgency among the executive and lawmakers. On the other hand, the threat of a double-dip recession during a weak recovery if the fiscal consolidation fails may provide an incentive to coordination, **as we believe neither the executive nor the legislature would benefit from a deteriorating economy as we approach the 2020 municipal elections**.

Thus, while acknowledging the challenging task of predicting the evolution of the pension reform proposal under rising uncertainties, **we present in this report our estimates for a watered-down version of the bill (after negotiations with Congress) and the timing for its approval.**

What Will Be Lost Along the Way?

As we noted in our report *It's Show Time: The Battle for Social Security Reform* (February 20, 2019), our first impression of the new government's pension reform proposal was positive. At that point, we saw potential for the approval of a bill with savings of around BRL800 billion in 10 years, a better outcome than the modified version that came out of Michel Temer's administration (following the changes approved by congressional commissions), which were pointing to total savings close to BRL500 billion in 10 years.

From the beginning, we expected significant changes in two controversial key points of President Bolsonaro's pension reform proposal: (i) new rules for retiring rural workers and (ii) social security payments for the elderly and disabled (Continuous Cash Benefit Program – BPC, the acronym in Portuguese). In our view, nearly 40% of reduced savings after negotiations with Congress (the watering-down process) would come from these two areas.

In light of the recent deterioration in pension reform developments, as aforementioned, **we now expect that the government is likely to make more concessions as the bill makes its way through Congress.** Our main assumptions and estimates for the watered-down version are presented below.

Figure 1. Savings from Pension Reform – Original Proposal vs. Expectations for the Modified Version

Social Security Reform - Main Measures	Savings in 10 years (BRL billion) *Government estimates*	% of total estimates	Savings in 10 years (BRL billion) *Watered-down version - Santander estimates*	% of total estimates	*% of watering down*
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Source: Ministry of Economy and Santander estimates

* Net savings: changes in Social Protection for military forces subtracted from career restructuring spending

1) Private Sector Regime (RGPS)

(a) Urban Workers

The category of **urban workers in the private sector** is covered by the General Regime of Social Security (RGPS), accounting for around 52% of the estimated total savings with Bolsonaro's pension reform proposal. Thus, **maintaining the core changes proposed for this segment is crucial for the success of the pension bill.** In our opinion, three main parameters could be modified during negotiations with Congress: **(i) transition rule** – as an assumption for our simulation, we considered it will be

[1] See, for example, Lora (2000), *What Makes Reforms Likely? Timing and Sequencing of Structural Reforms in Latin America* (IDB Working Paper #424) and Alesina et al. (2006), *Who Adjusts and When? On the Political Economy of Reforms* (IMF Staff Papers Vol. 53).

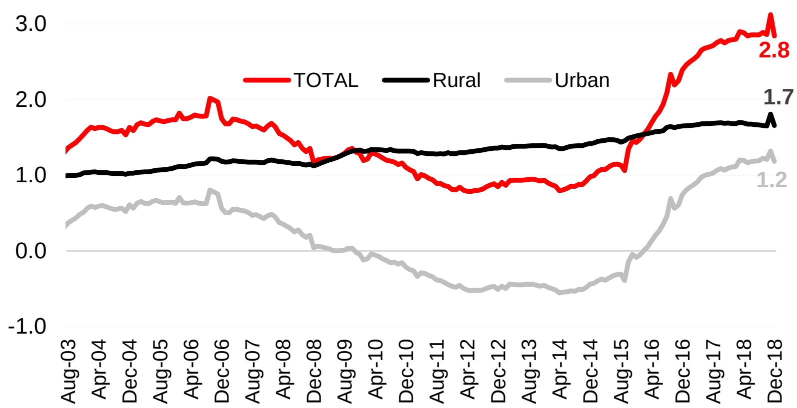
lengthened from 12 to 15 years; **(ii) minimum age for retirement** – as already mentioned as a possibility by President Jair Bolsonaro, we think the minimum age for women to retire could be reduced from 62 to 60 years; and **(iii) rule for pension benefit**[2] – for our simulations, we considered a slightly higher starting point (70% after 20 years of contribution, instead of 60%), but we maintained 40 years as the required period for accessing the full pension. Regarding the **minimum period of contribution,** we assume that the proposed parameter of 20 years will not be changed.

As shown in Figure 1, we estimate that, after negotiations with Congress, **the savings from the changes proposed to the urban workers covered by the RGPS (private sector) would be reduced by around 40%**. Despite this watering-down process, **urban workers would be responsible for more than 55% of total savings from the pension bill.** It is important to bear in mind that these numbers derive from our own perception and estimates (as well as simulation methods) about possible changes in the main parameters proposed in the original text. In other words, the estimates do not reflect government announcements, especially because the pension reform proposal is in the early stages of the legislative process.

(b) Rural Workers

As aforementioned, the agribusiness sector is strongly represented in Congress, and some recent statements by politicians (not only from opposition parties) have reinforced our assessment that the **Brazilian Congress has significant resistance to changes in the current rules of the pension scheme for rural workers.** Hence, despite the relatively large social security deficit[3] (there is a significant mismatch between rural workers' contribution and benefits), **we do not expect any savings from this segment.**

Figure 2. Social Security Deficit – Private Sector (% of GDP)



Source: National Treasury

2) Public Sector Regime (RPPS)

Apart from the fiscal impact, we believe **the greatest strength of the pension bill consists of eliminating discrepancies and reducing inequalities,** which could build popular support for the reform. In this sense, the pursuit of a fairer system by unifying the rules for private sector employees and public civil servants is a crucial element, in our view. Following the mantra "who earns more, pays more," **Bolsonaro's pension reform encompasses a system of progressive contribution rates, weighing mainly on the public sector** (for details, see *It's Show Time: The Battle for Social Security Reform*, February 20, 2019). Moreover, we highlight the proposal of 25 years as the minimum period of contribution for RPPS beneficiaries (above the parameter of 20 years for the private sector) and also the minimum age for retirement of 62 years for women and 65 years for men (the same as the RGPS).

In our view, **the convergence of rules for the private and public sectors is viewed favorably by a large proportion of Brazil's population,** owing to a perception that there are historical discrepancies between these two groups, chiefly related to

[2] According to the original proposal, the rule would be defined as: 60% (with 20 years of contribution) + 2pp per year exceeding 20 years multiplied by average contribution wages, that is, the full benefit could be reached after 40 years of contribution to the social security system.

[3] The social security deficit of rural workers (RGPS) totaled BRL 113.8 billion in 2018 (-1.7% of GDP), while the urban workers segment registered a deficit of BRL 81.4 billion (-1.2% of GDP). Rural workers' contributions to the social security system correspond to 0.1% of GDP, while the benefits represent 1.8% of GDP.

salaries and job stability. **However, as already discussed, federal civil servants have distinctive mobilization capabilities,** which, added to the low net fiscal savings from the military pension bill, will put substantial pressure on Congress, in our view. Summing it all up, we take as premises that: **(i)** the progressive system of contribution will be maintained, albeit with some loosening of the rates on the highest public wages, which may help to prevent the litigation of this subject; **(ii)** the minimum age for women to retire in the public sector will decline from 62 to 60 years, in line with our assumption for the private sector; and **(iii)** for teachers, the minimum age for retirement will be 55 years for both women and men (below the proposed parameter of 60 years). We do not expect the threshold of 25 years as the minimum period of contribution to be altered.

Accordingly, our calculations indicate that **savings from the changes proposed to the public sector regime (RPPS) –** except for the contribution rates – **would be reduced by about 30%** during negotiations with Congress, **resulting in around BRL120 billion in 10 years, or 20% of the total savings arising from the pension bill.** With regard to the modifications in the contribution rates, we estimate them to be watered down by 25%[4].

3) Wage Benefit

The new government's pension reform proposal limits the payment of salary bonuses[5] to workers who earn up to 1 minimum wage, instead of 2 minimum wages under current rules. According to our estimates, this change would provide BRL150 billion in fiscal savings over 10 years, since around 90% of beneficiaries earn between 1 and 2 minimum wages (see Figure 3). In our view, **evaluating the maintenance or exclusion of this item plays a key role in assessing the pension bill's fiscal impact.** Our baseline contemplates no watering-down of the proposed changes in the granting of wage benefits; nevertheless, we recognize a high degree of uncertainty around this topic.

On the one hand, **the still high unemployment rate (about 12% or 13 million people) and only modest signs of recovery in the Brazilian labor market justify the proposal to reduce the payment of complementary income to employed people**, in our view**.** Thus, in our opinion, the expenditure of political capital associated with cuts in wage bonuses may not be an insurmountable problem, especially because the most vulnerable group of workers (who earn up to 1 minimum wage) would not be affected by the proposed changes. On the other hand, we acknowledge that all measures with some income redistributive impact have historically faced significant resistance in Congress. Therefore, **our base case scenario takes into account fiscal savings of BRL150 billion from the wage benefit item, but alternative scenarios seem to have a relatively high probability of being enacted instead.** For instance, if there are no changes in the current rules for granting wage bonuses, our estimated savings from the social security bill would be close to BRL460 billion, slightly below the savings if the modified version of Michel Temer's proposal were approved (about BRL480 billion in 10 years).

Figure 3. Employed Population in the Brazilian Labor Market (in thousands of workers)

Income Group	2012	2013	2014	2015	2016	2017
Up to 1 MW*	**2,675**	**2,714**	**2,700**	**2,600**	**2,594**	**2,650**
1 MW - 2 MW	**21,405**	**21,734**	**21,519**	**20,950**	**20,802**	**21,296**
Above 2 MW	23,379	24,500	25,352	24,511	22,664	22,335
TOTAL	47,459	48,948	49,571	48,061	46,060	46,281

Source: Annual Social Information Report (RAIS, acronym in Portuguese)

* MW = Minimum w age (currently at BRL 998.00)

4) Continuous Cash Benefit Program (BPC)

Perhaps the most controversial aspect of Bolsonaro's pension reform proposal is associated with the changes in the Continuous Cash Benefit Program (BPC, acronym in Portuguese), in line with many recent comments from politicians and analysts. In short, BPC is a welfare right guaranteed by the 1998 Federal Constitution to elderly people aged 65 years and over and to people with disabilities whose family income is up to ¼ of the minimum wage[6]. **Because changes in the BPC affect much lower-income segments of society, and legislators' initial reaction has been heavily opposed, we assume that such changes will not be approved (that is, no fiscal savings).**

[4] We do not see changes in the proposed progressive system for the private sector's social security (RGPS), since the net savings are negative as a consequence of lower contribution rates for low-income groups.

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

[6] The pension bill raises the minimum age (from 65 to 70) for low-income senior (and disabled people) to receive a minimum wage benefit. As a compensatory measure, it provides for an early benefit of BRL 400 for people in extreme poverty above the age of 60.

5) Military Forces

As already discussed in this report, the government calculates net savings of BRL10.5 billion from the pension reform for military forces, considerably below the initial estimate of about BRL90 billion. **Although we believe that measures related to the military's career restructuring could be softened during negotiations with the Congress (increasing the net savings), our simulations did not change the potential fiscal impact of BRL10.5 billion.**

Balance of Risks, Timeline, and Final Considerations

Based on the assumptions and simulations presented throughout this report, **we believe that the approval of the new government's pension bill could result in around BRL615 billion in savings in 10 years, which means keeping around 55% of the original proposal** (considering the pension regimes for the private sector, civil public servants, and military forces). Compared with the estimated savings from the pension bill released in mid-February (thus, before the proposal for military forces that arrived in Congress a month later), the concessions expected after negotiations with the legislative branch would reach around 45% of that amount.

Hence, our baseline scenario points to a fiscal impact below the desirable savings of around BRL1 trillion in 10 years, as repeatedly put forward by the government's economic team, albeit still higher than the estimated gains from approval of Michel Temer's modified pension bill. Looking at the balance of risks, we think it has worsened significantly in recent days, implying a downward asymmetry. In other words, the likelihood of an even more modest modified version seems higher than that of a more robust reform, in our assessment.

In this sense, the **main downside risk** to our base case scenario would be a failure to approve changes to the rules for granting **wage bonuses,** which would reduce our estimated savings by nearly 25%. In contrast, the **main upside risks,** in our opinion, consist of **greater net savings from military pensions** (due to non-approval of higher spending for the career restructuring) and the approval of **12 years as the transition rule** for the new social security parameters.

Last but not least, we have already observed delays in the timeline for the approval of the new pension scheme in Congress. For instance, we do not anticipate that the pension bill will be voted on in the Lower House's Constitutional and Justice Committee before mid-April (see Figure 4), whereas the initial expectation was for a vote in March. Thus, **we expect the first round of voting of the Lower House to take place after the parliamentary recess, that is, only in 2H19. The final vote in the Senate should occur in 4Q19, in our view.**

The pension reform, in our view, is not a panacea for Brazil's deep fiscal troubles, which will require more measures to cut the primary budget deficit, stabilize the debt/GDP ratio, and prevent government spending from breaching the constitutional spending cap. We will present our updated estimates of the impact of the reform on the main fiscal variables in a forthcoming report.

Figure 4. Expected Timeline for the Pension Reform Proposal

Stage	Expected Date
(a) - Government presents its Pension System Reform (PSR) proposal to Congress	20 Feb
(b) - Set up of CCJ[/1]	11-15 Mar
(c) - CCJ starts appraising PSR proposal	01 Apr
(d) - CCJ concludes its appraisal and sends it to Lower House board	17 Apr
(e) - Set up of CE[/2] and definition of the rapporteur of PSR	22-26 Apr
(f) - CE starts shaping the version to be voted on in the Lower House	29 Apr
***Optimistic* scenario**	
(g.1) - Completion of 40 sessions of discussion within CE, assuming Mon-Fri meetings	12 Jun
(h.1) - 1st round vote in the Lower House	19 Jun
***Baseline* scenario**	
(g.2) - Completion of 40 sessions of discussion within CE, assuming Tue-Thu meetings	14 Aug
(h.2) - 1st round vote in the Lower House floor	21 Aug

Sources: Lower House, Santander.
/1 – the venue where compliance with constitutional rights will be assessed.
/2 – the venue where items of the PSR proposal will be removed/changed/kept.

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