Santander

ECONOMICS April 20, 2016

Brazil — Social Security Reform

Report on the Social Security Reform Proposal: A Risky Strategy

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- **We believe that the government has taken a significant risk in submitting a report on the social security reform proposal that eases most of the original proposal in the first stage of the Congressional approval process of the constitutional amendment (PEC).In our view, approval of the basic text does not win the battle, as negotiations must also include whether to approve additional changes that could be submitted by Congressional representatives. In our opinion, the risks inherent in such negotiations could become apparent during the voting session on the report, which is scheduled for May 2 in the Lower House Special Committee and then later during the 1st round voting session in the Lower House.**
- **Although our baseline scenario is that the basic text will be approved without changes, we attribute some probability to an alternative scenario, where some important changes could be approved in the Lower House's voting sessions.**
- **As opposed to the New Fiscal Regime PEC, the social security reform PEC lacks popular support. Furthermore, the earlier PEC garnered support from politicians of various parties, as they were incentivized to approve the proposal in order to reduce popular criticism in the wake of the corruption scandals involving federal and regional governments.**
- **In our opinion, two points are crucial in stabilizing the social security system's deficit: (i) raising the minimum age for retirement (in the private sector); and (ii) defining the transition rule (in other words, who will be exempt from the proposed changes). According to our estimate, these two items represent around 54% of total potential savings of the reform proposal, and both of the latest proposals represent less stringent parameters.**
- **In our opinion, although changing the minimum age of retirement for women has no significant impact on social security reform savings, changing the transition rules reduces the savings promoted by the reform. However, we still see the current version of the proposal stabilizing the social security deficit close to the current level of the deficit.**
- **According to our calculations, the proposed changes would represent a loss of ~40% in expected savings compared with the earlier proposal, suggesting, in our view, that: (i) from now on, there is not much leeway in the next steps of the Congressional approval process for PEC without risking ending up with no reform at all; and (ii) when looking at other countries' attempts to reform social security, this proposal will not be the final one and Brazil's social security system will require further adjustments in the near future.**

Summary

Four months after President Temer submitted to Congress his administration's proposal for reforming Brazil's social security system, the Special Committee on Social Security Reform's rapporteur, Arthur Maia, finally presented the Committee's report on the PEC reform. Unfortunately, in the report, each point of the original proposal was slightly modified. In our view, the report showed Congress's attempt to back away from the majority of the government proposals in favor of meeting social demands and increasing the body's approval rating. And although we acknowledge Congress's motivation in backing away from its original proposals, the new proposed reforms do not reverse the losses implicit in the overall changes.

Moreover, we see as risky the government's strategy of behind-the-scenes negotiations with Congressional representatives and including all the demand changes in the first stage of the approval process of this constitutional amendment (PEC). We have to bear in mind that the voting session in the Lower House Special Committee is the first of at least six voting sessions, which includes two rounds in the Lower House, a voting session in the Constitutional and Justice Commission (CCJ) in the Senate, and two rounds in the Senate — with the likelihood of additional changes being presented during voting sessions on the floor of both Houses.

Comparing the potential approval process of the social security reform with the New Fiscal Regime (PEC of spending cap) approved last year: in the case of the PEC of the spending cap, the majority of the changes to the original proposal were done in the report presented in the Lower House Special Committee. Nevertheless, (i) the popular support of PEC of the spending cap proposal was significantly higher than it is for social security reform; and (ii) there were incentives for Congressional representatives from different groups to approve the spending cap proposal without significant changes in order to reduce the population's criticism of federal and regional governments in the aftermath of recent corruption scandals.

Bear in mind that simply approving the basic text of the report in the Special Committee will not suffice, as the government coalition has to secure similarly strong support to defeat attempts to change the text. In other words, approving the basic text does not win the war, as we expect battles to be waged over whether to block additional changes potentially presented by representatives. In the Special Committee, party blocks are entitled to present a number of *destaques para votação em separado* (or DVS): that is, they can take some specific passages of the text and require that these excerpts be submitted to a separate vote, or take some specific amendments presented during the debate process and require that these amendments be submitted to a separate vote. This means that the government coalition has to secure the majority votes to approve the basic text, but also to reject each of these excerpts and amendments, in each of these separate votes, otherwise additional, and maybe, significant changes will be added to the approved text.

For instance, several amendments regarding the minimum age retirement were presented, with different proposals, of which most of them were much lower than the 65-years proposed in the original proposal and maintained by the rapporteur in the Lower House Special Committee. Any significant change to the minimum age for retirement will mean a significant reduction in expected savings promoted by the social security reform. Thus, in our opinion, the risks are that the voting session of the report scheduled for May 2 in the Lower House Special Committee, and then the 1st round voting session in the Lower House, where the representatives could also add modifications to the proposal.

Our baseline scenario is that the government will succeed in defeating attempts to change the text. However, we attribute some probability to an alternative scenario, where some important changes could be approved in the Lower House's voting sessions. And, it seems that the market scenario is less skeptical than we are regarding the possible changes that could be imposed by Congress. Therefore, the session in the Special Committee, and in the 1st round in the Lower House should be monitored closely, because it is the most risky part to the success of this social security reform.

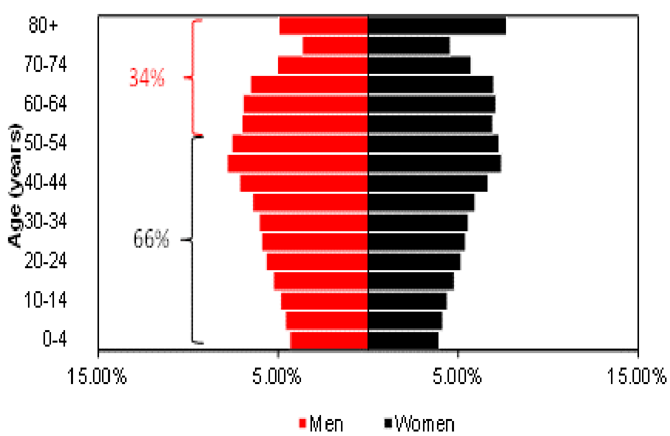
In this text, we estimate the impact of rapporteur changes to the expected savings of the original proposal and present our outlook for the social security balance.

According to our exercises, these changes represent a loss of around 40% of the expected savings of the original social security reform, slightly bigger than 30% of losses during the Congressional approval process expected by the consensus. This means (1) **from now on, there is not much leeway in the next stages in the Congressional approval process of PEC without risking ending up with no reform at all; and (ii) when looking at other countries' attempts to reform social security, this proposal will not be the final one and Brazil's social security system will require further adjustments in the near future, in our view.**

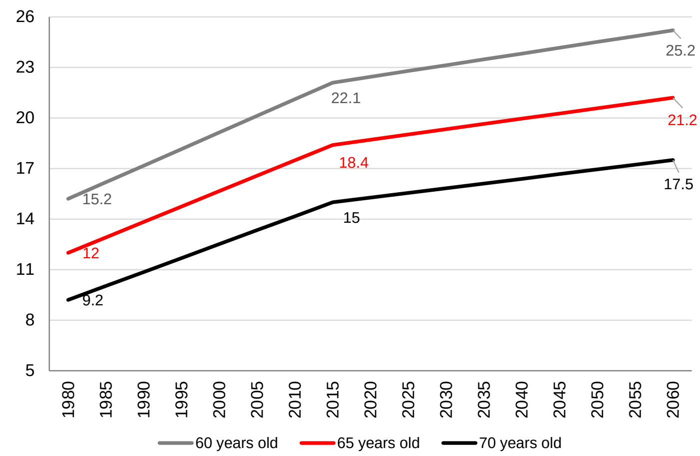
Current Situation

Under current rules, Social Security expenditures, which are running at a hefty 8% of GDP — notwithstanding the relatively young Brazilian population, could increase to a chilling 18% of GDP by 2060, given that the percentage of seniors in the population will represent ~34% of the total population by 2050 (vs. 15% at present).

Demographic 2050



Life Expectancy



Source: IBGE.

Hence, the government believes that in order to tackle this problem, reform must focus on these issues:

i) increasing the minimum age for retirement for private sector workers, as currently this segment of Brazilians retire at the very early age of 54 on average (though we note that current rules[1] substantially reduce the benefits paid to those who are expected to long outlive their retirement);

ii) the variety of special rules for retirement: private sector workers are subject to rules that differ from those valid for civil servants, which in their turn are not as generous as those for military and politicians — not to mention a variety of exceptions to these rules, for instance for women, teachers, and rural workers; and

iii) the social assistance programs that are included in the social security system, such as the single minimum wage paid to those who are older than 65 years old, but who never contributed to the social security system.

Consequently, benefits and pensions oscillate within a very wide range, with many people receiving as little as the minimum wage and a smaller but significant group of people receiving extremely high benefits as well as survivor benefits from partners or parents.

Changes impact on reform savings

The government was expecting savings of BRL849bn in social security spending (RGPS and RPPS) up to 2026 (the first ten years of New Fiscal regime implementation), which would reach savings of 1.8% of GDP (BRL221bn) in 2026. The savings in the private sector social security regime (RGPS) would be around 1.4% of GDP (BRL185bn) in 2016.

After the changes in the Special Committee report, the government expects savings around BRL630bn, which represents 74% of the original proposal savings. According to our estimate, the impact of the changes will be more significant, reducing the savings to around BRL530bn (1.2% of GDP) between RGPS and RPPS, which means 60% of the original proposal savings.

[1] Workers whose sum of age at the time of retirement and years of contribution exceed 85 years for women and 95 years for men are eligible for retirement with no discount in their benefits. Workers who have contributed for the minimum period but who do not meet the 85/95 rule can still retire, but their benefit is diminished by a factor (fator previdenciário), which takes into account life expectancy at the age of retirement and years of contribution.

Simulation

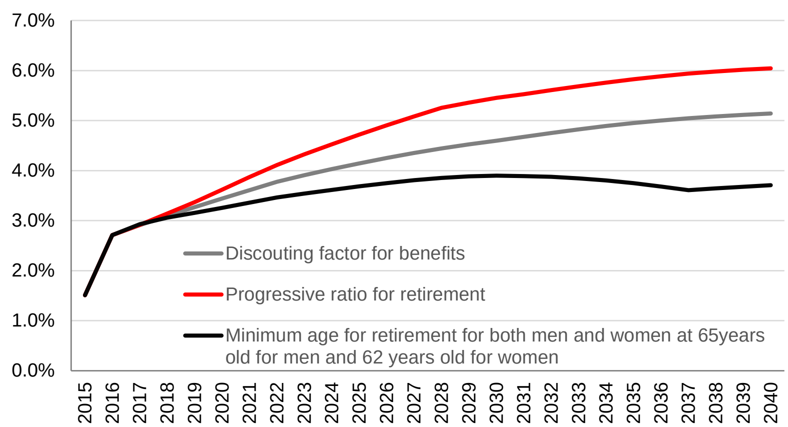
	Up 2026 impact (%of GDP) - original proposal	Up 2026 impact (%of GDP) - Special Committe's report
Total savings of the social security reform	**2.2%**	**1.4%**
Total impact of the reform on RGPS (private sector)	**1.4%**	**1.0%**
Total impact of the reform on RPPS (civil servants)	**0.4%**	**0.2%**
Social Assistence and Pensions	**0.5%**	**0.2%**
Retirement eligibility: Minimum age + Transition rules+ end of special rules for retirement	1.2%	0.9%
Rural Social security Contribution (charged on benefits)	0.05%	n/a
Rural exporters tax	0.10%	0.10%
Survival pension: 50% family cote + 10% per kids	0.10%	0.10%
Survival pension: non accumulation of benefits	0.10%	0.05%
BPC- Benefits payment to seniors	0.05%	0.01%
BPC - delinking of benefits and soacial assistance from minimum wage	0.20%	n/a
Civil servants retirment rules: Minimum age + Transition rules+ end of special rules for retirement	0.10%	0.02%
Civil servants retirment rules - same private sector ceiling for benefits + non accumulation of benefits	0.20%	0.20%

Sources: MinFin and Santander estimate.

In our opinion, two points that are crucial in stabilizing the social security system's deficit: (i) raising the minimum age for retirement (in the private sector); and (ii) defining the transition rule (in other words, who will be exempt from the proposed changes). According to our estimate, these two items represent around 54% of total savings of the reform proposal, and both of them were loosened.

That said, it is important to highlight that the change in the minimum age of retirement for women **does not have a significant impact on social security reform savings, however the change in the transition rules reduces the savings promoted by the reform.** We still see the current version of the proposal as stabilizing the social security deficit below 4% of GDP, which is close to the current level of the deficit. We point to two things, however: there is no room for additional relaxation, without losing the importance of the reform; and the reform is not still sufficient to stabilize the current social security deficit, but not to reduce it.

Social Security Balance (private sector - RGPS)



Sources: MinFin and Santander estimate.

The rapporteur's report that will be voted on

As mentioned above, each point of the original proposal was slightly changed. Some of these changes were already expected by the market consensus, such as the small reduction in the minimum age for retirement for women to 62 years old from 65 years old (original proposal), or the reduction of the numbers of years of contribution to the social security system required to obtain 100% of the benefit (average of received salaries since 1994). Other changes were bad news, in our view, despite already having been expected, such as keeping special rules for retirement (for teachers, policemen, politicians, rural workers) with small changes in these special rules in order to reduce the differences compared to the average of private sector workers, though still maintaining some differences.

Table 1. Highlights of Social Security Reform

Original social security reform proposal	Special Committee's report proposal	
Private Sector (RGPS)	**Private Sector (RGPS)**	**Signal of the change**
Retirement eligibility for urban workers: minimum age of 65 years old for men and women	Retirement eligibility for urban workers: minimum age at 65 years old for men and 62 years old for women	Insignificant
Requirement to receive 100% of the benefit (average of received salaries since 1994) with a benefit cap of R$ 5,579: 49 years of contribution	Requirement to receive 100% of the benefit (average of received salaries since 1994) with a benefit cap of R$ 5,579: 49 years of contribution	+/- Significant
Transition rule: men 50+ years old and women 45+ years old could retire by the current rules (adding ½ to the number of years remaining for retirement under the current rule (30 years of contribution for women and 35 years for men)	Transition rule: no age requirement. 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 55 years old for men and 53 years old for women	+/- Significant
Social security contribution to be charged on rural worker benefits	To be defined	Significant
Retirement eligibility for rural workers (RGPS): minimum age at 65 years old for men and women and 25 years of contribution	Retirement eligibility for rural workers (RGPS): minimum age at 60 years old for men and 57 years old for women and 15 years of contribution	Significant
None special social security rules for teachers, police force	Special social security rules for teachers (retirement eligibility of 55 years old for men/ 30 years of contribution, and 50 years old for women/ 25 years of contribution. Special social security rules for police force (retirement eligibility of 55 years old for men and women/ 25 years or 20 years of contribution depending on the type of work (frontline or not)	Significant
Delinking of social assistance and minimum wage	Link of social assistance and minimum wage	+/- Significant
Minimum age eligibility for seniors at 70 years old (benefit of 1 minimum wage to those do not have enough years of contribution - BCP)	Minimum age eligibility for seniors at 68 years old (benefit of 1 minimum wage to those do not have enough years of contribution - BCP)	Insignificant
Public Sector (RPPS)	**Public Sector (RPPS)**	**Signal of the change**
Retirement eligibility to those that became civil servants after 2003: minimum age of 65 years old for men and women	Retirement eligibility to those that became civil servants after 2003: minimum age at 65 years old for men and 62 years old for women	Insignificant
Requirement to receive 100% of the benefit (average of received salaries since 1994): 49 years of contribution	Requirement to receive 100% of the benefit (average of received salaries since 1994): 49 years of contribution	+/- Significant
Benefits cap at R$ 5,579 to those who became civil servant after 2015	Benefits cap at R$5,579 to those who became civil servants after 2015	Significant
Survival Pensions	**Pensions**	**Signal of the change**
50% family cote + 10% per kids	50% family cote + 10% per kids	Significant
non accumulation of benefits	non accumulation of benefits up to 2 minimum wages	Insignificant

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