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Brazil— Structural Reforms

Social Security Reform: First Thoughts

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- **The government's proposal for Social Security reform, sent today to Congress, was broadly in line with our expectations. The proposal addresses nearly all crucial problems of our social security system, ensures a relatively short convergence to the new rules and automatically adjusts the rules to the evolving demographics. As they are, the proposed rules seem sufficient to secure a relative stability for the Social Security deficit over the medium to long run.**
- **The key points in the reform are: (i) convergence of rules for retirement and benefits for public, private urban and rural sector workers; (ii) imposition of a minimum age for retirement; (iii) preserving the proportionality of the benefit to the period of contribution; (iv) stricter rules for survivor benefits; (v) transition rules valid only for men above 50 and women above 45, which suggests that in a matter of little more than a decade the vast majority of new retirees will abide by the new rules.**
- **We believe that Congress will approve the Social Security Reform over the course of 2017 (Lower House: by end of June, Senate: by year end). During the debates, it is possible that Congress introduces changes to the proposal, but its core should be preserved.**

Figure 1. Retirement rules: a summary

	Current rules	Transition rules	New rules
For whom will these rules be valid, once the reform is approved?	Civil employees (public and private sectors) that already meet the current requirements for retirement	Men above 50 and women above 45 at the date the reform is approved	New entrants in the job market, plus men below 50 and women above 45 at the date the reform is approved
Minimum age for retirement	Public sector: 60 years for men, 55 years for women Private sector: no minimum age	This group will not be constrained to the minimum age, but will be required to contribute for longer than before: to the minimum period of contribution	All workers: 65 years, with the threshold increasing by 1 year every time life expectancy increased by a full additional year
Minimum period of contribution	Public sector: 10 years working in the public sector Private sector: 35 years for men, 30 years for women	The additional period of contribution required to retire under current rules will be increased by 50% (the closer the worker is to meeting current retirement criteria, the lower the penalty)	All workers: 25 years
Benefit	Public sector: average of the higher wages (usually, the average of the last years wages). Private sector: conditional on life expectancy at the time of retirement and the period of contribution, according to either the fator previdenciário or the 85/95 rule[1]	According to current rules	51% of average value of contributions, plus an additional 1pp for each year of contribution (minimum: 76% for contributed for the minimum 25 years, maximum 100% for workers who contributed for 49 years or more)

[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 to 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

Social Security Reform: What's in Store

After six months of studies and behind-the-scenes negotiation, President Temer finally sent to Congress his proposal for reforming the Social Security system in Brazil. Under the current rules, it is believed that Social Security expenditures – currently running at a hefty 8% of GDP, notwithstanding the relatively young Brazilian population – could widen to a chilling 18% of GDP by 2060, mainly because the share of elder population will represent around 34% of total population in 2060. Much of this troublesome dynamic is due to the absence of a minimum age for retirement for private sector workers: although the current rules substantially reduce the benefits paid to those who are expected to long outlive their retirement, Brazilians still tend to retire at the very early age of 54, on average. Another problem is the variety of rules for retirement: private sector workers are subject to rules that are different than those for civil servants, which in turn are not as generous as those for military and politicians, not to mention a variety of exceptions to these rules. As a result, benefits and pensions oscillate within a very wide range, with many people receiving as little as minimum wage, and a smaller but significant group of people receiving extremely high benefits and accumulating them with survivor benefits from partners or parents.

The proposal sent to Congress encompasses a variety of changes that aim at addressing these problems. In our earlier reports, we anticipated most of the changes that were proposed today. For more details, please see our report *The Clash of Titans: Desirable versus Feasible*, published on May 12, 2016. However, **we were positively surprised with the inclusion of an automatic device to raise the minimum age for retirement in accordance to the evolution of life expectancy, something that we considered as possible but not likely.** Also, rules to be applied on benefits calculations and on the so-called transition group are rather strict, which leaves some room for negotiation once the proposal arrives on the Congressional floor.

Of the many detailed changes introduced by the proposed reform, we highlight the following points: (i) average age of retirement will rise substantially over the coming years; (ii) benefits may be higher on average, but will be paid for a shorter period (hence, the savings); (iii) the discrepancy between benefits and pensions will be greatly reduced, increasing fairness and reducing costs of the system; (iv) implied social assistance will be somewhat diminished, which is more meaningful in terms of incentives than it is in terms of savings.

i) Average age of retirement will rise substantially over the coming years

The new rules propose that any worker (private sector or civil servant) will only be eligible for retirement when they reach the age of 65. Under the current rule, only civil servants face an age condition for retirement (60 for men, 55 for women), whereas private sector workers can retire at any time they meet a minimum period of contribution under either of the two coexisting rules. The cut in benefits imposed by current rules on those who retire too early has not been sufficient as an incentive for them to postpone their retirement: in fact, according to MinFin data, the average age of retirement of those who are not subject to a minimum age is lower than 55 years, whereas average life expectancy at that age is for an additional 26 years. The reform sets 65 as the minimum age of retirement for all workers (with few exceptions), of both genders, and in both the public and private sectors, reducing total Social Security expenditures by adjusting for the life expectancy of the newly retired. The life expectancy of a 65-year-old person is under 20 years, according to IBGE. This minimum age is in accordance with the average and median threshold for retirement in OECD countries; plus, the government is proposing that it should rise in tandem with the progress of life expectancy, reducing the need for future rounds of social security reform (a pressing problem in most economies).

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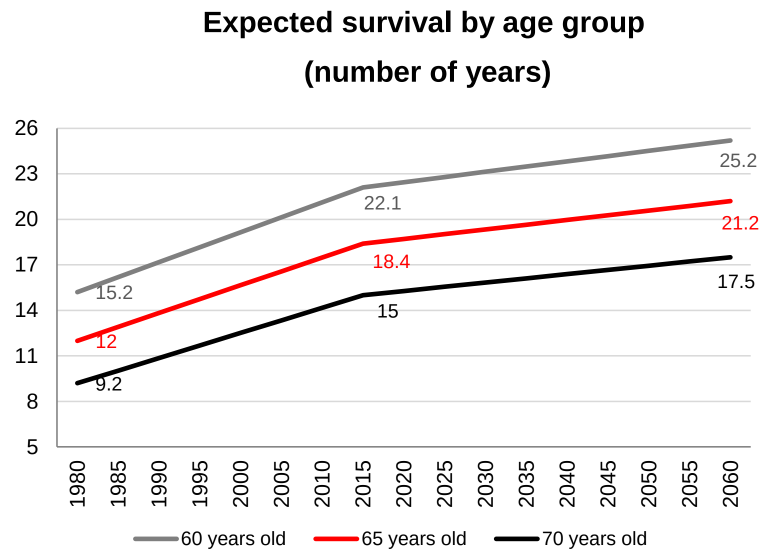
retire, but their benefit is diminished by a factor (fator previdenciário), which takes into account life expectancy at the age of retirement and years of contribution.



Source: IBGE.

In order not to create severe discontinuity in rules, the government is proposing that those who already meet eligibility criteria under current rules will have their rights preserved (i.e., they can retire at any moment); furthermore, relaxed rules were proposed for a "transition group" comprised of men older than 50 and women older than 45 at the time the reform is approved (see Figure 1 for details). How encompassing are these rules once transition criteria are taken into account? Our estimates suggest that, at the time the reform will be approved (end of 2017), only less than 25% of people currently contributing to social security will be eligible to retire under current and transition rules. This should enable the government to reap most of the benefits from this reform within the next two decades, whereas if the new rules were only valid for new entrants in the job market, it would take over 30 years for their effect to materialize in public accounts.

ii) Benefits may rise on average, but will be paid for a shorter period – hence the savings

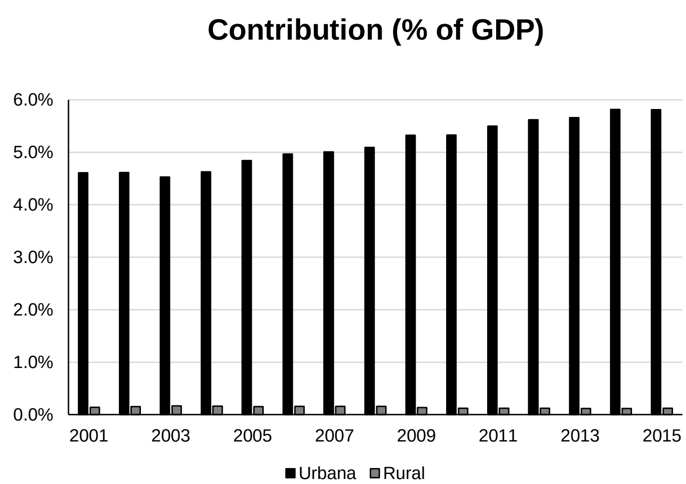
According to official data, by opting to retire at a relatively early age, Brazilians currently suffer the penalty implied by the *fator previdenciário*, which is factor that reduces the benefit of those who have contributed for few years and/or are expected to live many years after retirement. On average, women retire at the age of 57 with benefits corresponding to 64% of their average contributions and receive this benefit for an average survival period of 26 years (as per current mortality tables). Meanwhile, men retire at 59 earning around 81% of their average contributions for an additional 22 years. With the new rules, benefits will range from a minimum 76% to a maximum 100% of average contributions (see Figure 1). This, in practice, means that average benefits may rise (as a proportion of contributions, and excluding the many existing exceptions under the current rules). However, there are savings in store, as those benefits will be paid for less time (the period of contribution will increase by 6 to 8 years, with the survival period reduced by 4 to 8 years, almost the same amount). Also, although average benefits may rise, they would still likely be lower than the one that retirees could receive under current rules if they retired at the age of 65 (a difference that should be around 10% on average).

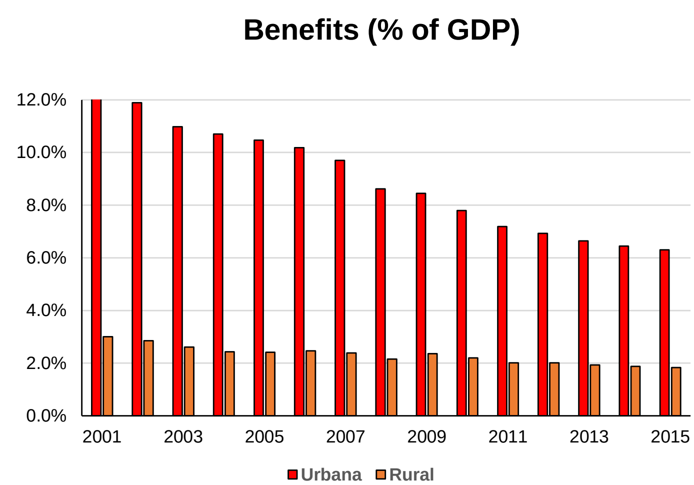
iii) Discrepancy in benefits and pensions will be greatly reduced, increasing fairness and reducing costs of the system

The current fragmentation of the Social Security regime (Brazil has different Social Security regimes for at least five different groups, which are: women, teachers, military force, policemen, and rural workers), the criteria for survivals benefits, and the possibility of accumulating benefits, especially for civil servants, are considered crucial points in the reform. According our analysis, by only setting the same age of retirement for men and women, the equalization between men's and women' requirement age at 65 years old with no system fragmentation would save approximately 2.0% of GDP by 2040.

iv) Implied social assistance will be somewhat diminished, which is more meaningful in terms of incentives than it is in terms of savings

The proposal solves the "old problem" regarding social security benefits for rural workers, which has no funding, given that rural workers' contribution is close to 0% of GDP, while the benefits achieved 2% of GDP in the last years. Another misalignment of the social assistance system was the linking of benefits to the minimum wage, which the proposal also solves by disentangling these benefits from the minimum wage. The social assistance benefit could be lower than the minimum wage in the upcoming years, which means no real growth for these expenditures, breaking the upward trend of social assistance spending-to-GDP ratio in the last decade. Finally, the minimum age for the elderly without the minimum years of contributions to receive a minimum wage benefit is raised to 70 years old from 65.





Source: Ministério da Fazenda / Tesouro Nacional.

Proposed versus feasible: what to expect

Unlike the New Fiscal Regime ("spending growth cap"), Social Security deals with a theme that is easily translated into the day-to-day life of the population, and because of that, it will likely warrant a longer, deeper and more difficult debate around its reform. It is very likely that some of the proposed rules are watered down over the course of negotiations, as it is natural to the legislative process. Despite the strong opposition that will be posed by leftist parties and union members, however, we expect that the bulk of the reform should be preserved over the course of negotiations. Recall that the government holds a very comfortable majority in Congress, with parties comprising President Temer's cabinet controlling nearly 70% of seats in the Lower House and 76% of the seats in the Senate, well above the minimum 60% support required for approving a constitutional reform such as this one. For more details, please see our report *Closed for Renovation: The Challenging Reform Agenda*, published on October 3rd 2016. While approval seems the most likely scenario, it is worth noting that its will likely come at a slower pace than the approval of the New Fiscal Regime. We expect the Lower House to hold the two rounds of voting during the first semester, and the Senate to give a final approved before the end of 2017.

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