SUBNATIONAL CIVIL SERVANT PENSION SCHEMES IN BRAZIL:

CONTEXT, HISTORY, AND LESSONS OF REFORM

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Table of Contents

1 Executive Summary

1. Executive Summary

Brazil's pension system takes up an oversized proportion of its social protection spending. It comprises of *Regime Geral de Previdência Social* (RGPS), covering private sector workers, and over two thousand *Regimes Próprios de Previdência Social* (RPPS), insuring public civil servants at federal and subnational levels. While the total membership of RPPS only stands at about 10 percent of RGPS coverage, its spending amounts to almost half of RGPS pension outlays.

This paper attempts to present an integrated view of RPPS pension schemes, their influence on subnational budgets, and their interaction with human resource policies. After a brief introduction, Chapter 3 starts by documenting the history of civil service and its associated pension schemes, looking for explanations on how subnational RPPS became so big, dispersed, and difficult to reform. The fiscal consequences of subnational civil service pension scheme expansion and maturation, including RPPS role in the fiscal challenges and policies of the last few years, are discussed in Chapter 4. Chapter 5 attempts to expose important interlinkages between pension and human resource policies and argues for the need of integrated policy approach. Chapter 6 describes the history of previous RPPS reform attempts, while Chapter 7 focuses on the effects of federal pension reform of 2019 on subnational civil servant pension schemes. The paper ends with lessons and policy recommendations for the future.

History of civil service and RPPS. Prior to the adoption of Brazil's constitution in 1988, the size of the civil service was limited. The Constitution has established universal access to public services, which has led to increased demand and a rise in the number of public officials, especially at the municipal level. Major changes to the way civil servants were contracted were also introduced, granting workers substantial legal protections and backloaded remuneration structure, culminating in high pension after the lifetime of steep wage increases.

Since then, the overwhelming majority of civil servants exhibit life-time attachment to their employer (the government) and tellingly, even as pensioners, are referred to as "inactive civil servants". The life-time affiliation concept helped create an implicit expectation that retirement should not imply any notable change in the civil servant's income stream. This meant continuation of salary and benefits associated with the last position into retirement and subsequent wage increases. <u>The civil servant hiring wave that followed the establishment of the</u>

Constitution in 1988 as well as legal protections and generous benefit packages granted to civil servants at that time are major events that influence fiscal and political landscape of subnational governments today.

Role of RPPS spending in subnational finances. For the first few decades, the creation of new generous pension regimes had an extremely limited effect on subnational government finances, as the numbers of pensioners were still low. However, the beginning of the XXI century marked the start of a rapid maturation of RPPS, when big previous hiring wave has led to a new wave of retirements. This has strained subnational finances, compromising service provision and investment. The trend is expected to continue, with the full maturation of most subnational systems not expected before 2040. However, the variability of pension scheme maturation levels across regions and states is considerable: northern states tend to lag behind in this process due to later hiring waves, while older states of the south and southeast have already been struggling with resultant pressure on public finances for a while. In aggregate, half of state revenues are spent on wages, pensions, and other personnel costs. Furthermore, personnel spending, including pensions, has increased faster than the stock of government debt, especially after 2009. This means that some of the state borrowing in the last decade was used to meet growing personnel spending obligations.

Federal policies have tried to limit the growth of subnational spending on personnel by shaping the overall fiscal trajectory of local governments. The institution of CAPAG imposed limits to subnational government indebtedness and allowed federal oversight of subnational spending. The Fiscal Responsibility Law, enacted in 2000 in the aftermath of subnational government bailout, also helped to better manage subnational public finances. It set a cap on personnel spending - wages and pensions - at 60 percent of state revenue (*Receita Corrente Líquida*, or *RCL*).

As a consequence of the vigorous economic growth between 2008 and 2014, procyclicality of CAPAG and Fiscal Responsibility Law allowed some flexibilization in borrowing limits, some of which found its way into the further expansion of civil service wage bill. Brazil, as a whole, has approached the 60 percent personnel spending limit in 2015-2017 period, led by the Southern and Southeastern states, where pension bill alone already hovers around 20 percent of state revenues. Midwestern and Northern states, with still immature pension schemes and free of constraints of Fiscal Responsibility Law, have seen significant wage bill expansions in the 2000s, now spending 40 percent of state revenues on wages alone, substantially higher than older states. This spells trouble ahead, once pension schemes of these states inevitably mature and expose the flaws of Fiscal Responsibility Law. Reliable municipality data is harder to collect, but in some ways their situation is even more alarming for the long term.

The suboptimal fiscal adjustment mechanism, observed in 2015-2016, partially stems from the current fiscal framework, which is mostly conceptualized in relation of current spending to current revenues and does not encourage states to think ahead. It is also clear that blunt macro-level policies aimed at controlling the growth of the wage and pension bill have been shown ineffective, which requires more detailed examination of micro-level issues contributing to the rigidity and elevated growth rate of these expenditures.

<u>To summarize, continued maturation of pension schemes has been and will continue further straining subnational finances at least until 2040 with varied severity across different regions. While Fiscal Responsibility Law, implemented with the help of CAPAG index and other tools, have had some positive effect, their procyclicality and focus on current expenditures limit their effectiveness as tool to achieve long-term fiscal prudence. To help subnational governments face future fiscal challenges, the Ministry of Economy recently launched several programs to support subnational governments in debt and/or fiscal distress, in exchange for the commitment to fiscal reforms. Strong commitment to control personnel expenditures is a major part of all these programs. While Covid-19 has appropriately taken government attention away from these issues in 2020-2021, it also was extremely detrimental to long term subnational finances and formation of human capital, which in turn reduce long term growth potential. Therefore, continuation of the pension reform agenda has become even more important and urgent in the aftermath of the pandemic.</u>

Effect of human resources policies on RPPS. Rapid personnel expenditure growth in recent years has been primarily driven by pension scheme maturation, but it has also been strongly influenced by micro-level human resource policies. Average hiring ages, retention of workers with the right to retire, use of temporary workers, and the number of hours for which civil servant contracts are issued all contribute to the elevated ratio of retirees to workers. The overall employment contract is also heavily backloaded with steep wage increases and generous pensions. In addition, automatic promotions within numerous careers allow employees to reach the top salary in a relatively short period.

In addition to flawed career design, other characteristics of the public employment system also make it difficult to control personnel spending. Each of the 5,570 municipalities and the 27 state governments have prerogatives to regulate their civil service. This gives rise to a multitude of different rules and schemes, hard to oversee and regulate, which might encourage abuse. . A plethora of bonuses and variable remuneration payments further swell the wage bill. Some of such payments are deemed "pensionable" and get entrenched in the form of pension increases to be paid for many years into the future. The federal government and some states have tried to curb these expenses, but oversight is even laxer at municipal level. <u>It is hard to see how more sensible, efficient, and fairer human resource policies can be achieved without greater unification and simplification of civil servant employment rules, as well as increased transparency and accountability for their implementation. It is also imperative that human resource policies at all branches of government are informed by their effect on pension spending, both short- and long-term.</u>

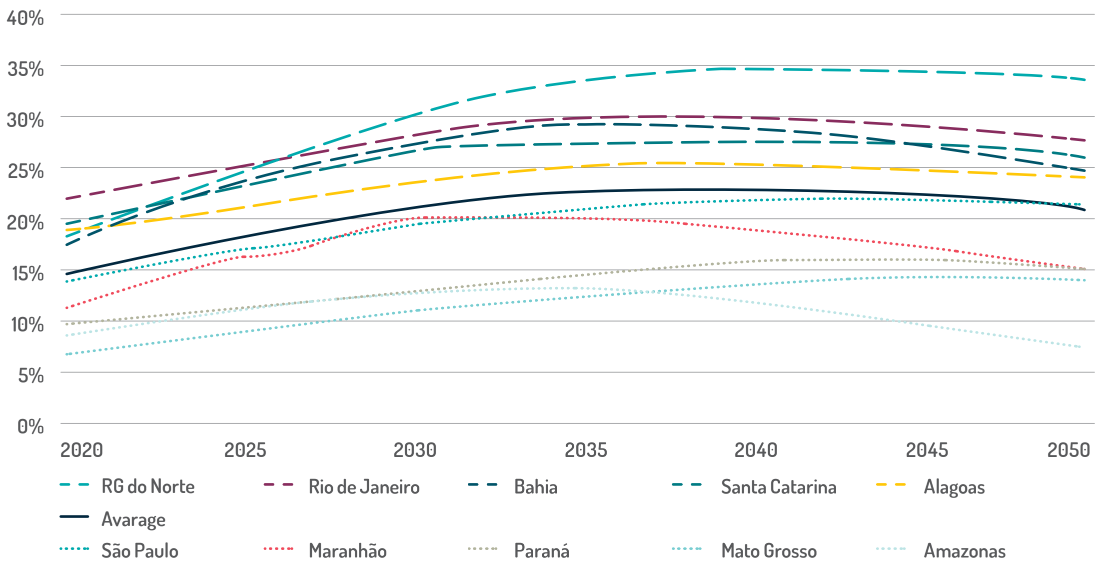
Previous attempts at civil servant pension reform. Pension policy has long been a focus of discussions geared towards limiting overall personnel expenditure growth. In sharp contrast to human resource policies, which have been lightly regulated at the federal level, pension scheme rules that apply to all RPPS schemes have been enshrined in the federal Constitution. Two of the original principles, integrality and parity, made those schemes especially expensive and continue to apply to pensions in payment today. Integrality principle ensures that retirement earnings and survivor benefits correspond to the totality of the servant's last salary as an active worker. Parity means that retirees, and their survivors, have a right to all salary increases, associated with the position from which the former civil servant retired.

There were multiple reform attempts to reduce the generosity of pension provisions. The first pension reform that somewhat tightened pension eligibility requirements of RPPS took place in 1998 through the Constitutional Amendment 20. Subsequently, the 2003 reform abolished both integrality and parity principles, but only for civil servants entering service after 2003. Crucially, the reform also completely excluded uniformed personnel. Although on the surface the reform measures might appear mild, they had considerably decreased life-time pension benefit generosity for post-2003 hires. As a consequence, the reform arrested the growth of pension expenses for teachers and other civil servants hired post-2003. However, the saving-generating effects of the reform have been delayed for a few decades at the time of reform implementation, and the effects of pre-2003 pension rules were only expected to wain around 2040. The long-term cost of exempting uniformed personnel from 2003 reform was still expected to pressure the sub-national governments in the long term

The projected path of pension deficits for ten selected states follows a similar trajectory. On average, state pension outlays are projected to rise around 50 percent, from current 15% of the state revenues to 22% in the next 15 years. However, there is a wide dispersion across the states. For example, pension deficit is expected to reach 35 percent of state revenues in Rio Grande do Norte, while the state of Amazonas, which has put a lot of effort in fostering fiscal sustainability of its pension scheme, is projected to peak at the pension deficit of 13 percent of state revenues.

In parallel to politically difficult legal pension reforms, federal government has long encouraged the subnational governments to pre-fund their pension liabilities to prepare for the expected increase in pension spending. This was commonly done through a policy called “wage bill segregation” *(segregação de massas),* which diverted contributions of younger workers into pension reserve fund. At first, the slow build-up of additional fiscal pressure due to wage bill segregation was manageable, but as current deficits of the old pension funds continued to grow, many subnational governments have decided to abandon this policy. While some early adopters of the policy with still immature pension schemes, like the state of Amazonas, have clearly been able to benefit, maintaining wage bill segregation might be too costly for the states that start the process when their pension scheme maturation is already well advanced. Often, the large current costs of wage bill segregation policy effectively prohibited the local governments from adopting the more fiscally desirable introduction of complimentary individual savings accounts, which would have allowed them to reduce their long-term pension liabilities by capping RPPS pension benefits.

Deficit projection of RPPS systems by percentage of current net revenues – selected states.



Source: The World Bank projections using data provided by the state governments.

Recently, pension policy discussion has been somewhat unhelpfully focused on state transfers to cover pension scheme deficits. Unfortunately, concentrating attention solely on deficits allows celebration of "improvements" through mere accounting changes. One idea has been to require local RPPSes to prepare long term asset and liability management plans, *Planos de Custeio*, in order to reduce pension deficits and strengthen the fiscal position of pension funds in the long term. While the long-term focus of this policy is to be celebrated, it may have encouraged states and municipalities to transfer state assets to pension funds, which does not create additional fiscal space in the consolidated public accounts. Increased employer (government) contributions to deficitary pension funds suffer from the same flaw, even though such an approach might help politically constrain inefficient state spending in other areas. Meanwhile, the only true solutions to arrest crowding out of state fiscal space by personnel costs amount to finding ways of reducing wage and pension expenditures without jeopardizing provision of public services. This, in turn, involves reducing unfairly high lifetime compensation for public servants and improving service provision efficiency.

In retrospect, pension reforms of 1998 and 2003 have been able to arrest long term growth of civil servant pension expenditures. However, by applying most reform provisions only to the civil servants hired after 2003 and by exempting uniformed personnel altogether, that stabilization of pension expenditure growth is only achieved by 2035-2040. The parallel administrative reforms of wage bill segregation and narrowly focused efforts to limit pension deficits, rather than consolidated government spending on pensions, have had some limited successes but often distracted from the main focus of reducing pension expenditures in order to open fiscal space for strategic investments and improved public services.

Pension reform of 2019. Relentless fiscal pressure build-up has led to the Federal Pension Reform of 2019. New federal mandates with respect to subnational pensions include preparation of financial management plans (*Planos de Custeio*), unifying pension scheme administration of different government branches under single management unit, exclusion of short-term benefits from the RPPS benefit rolls, mandatory implementation of complimentary pension savings plans to civil servants that earn wages above mandatory insured wage ceiling in order to limit RPPS benefit amount, imposing minimum individual pension contribution rate of 14 percent, and implementing federally prescribed pension arrangements for the uniformed personnel. The compliance with these mandatory requirements will be treated as a necessary condition to obtain the Social Security Regularity Certificate, which in itself is a requirement for receiving discretionary Federal Government transfers and permissions for credit operations with federal public banks.

The pension reform has also devolved some decision power on pension policy to subnational governments, but Federal Constitution still retains the right to determine pension scheme rules applicable to federal public servants, which was immediately exercised. In addition to improving the fiscal situation of the federal civil servant pension scheme, the changes were also intended to provide a template for the follow-up subnational pension reforms. These reforms, including retirement age increase to ages 62 and 65 for females and males respectively, revision of survivor benefit formula and eligibility, increase in retiree contribution base, and allowance of extraordinary pension contributions, are optional for the subnational governments. Local governments are, in principle, allowed to strengthen their parametric reforms beyond what was approved for the federal civil servant scheme. However, so far, most of the first-mover states have opted to copy or weaken down federal civil servant reform, prioritizing political expediency.

Although 25 states have already complied with the requirement to establish complementary pension regime, 6 of them still lack the implementation. Also, very few states have consolidated the management of pensions from all their government branches into a single RPPS management unit. Some implementation delays regarding this mandatory reform have been due to the complications in integrating different IT solutions now used by separate branches to assign and monitor benefit payments. However, even the states that are making steps towards integration of pension sub-schemes tend to take a narrow view of the task, and rarely attempt a more ambitious integration of some human resource and pension assignment system functions, including pro-active benefit audits. Recent experiences from Alagoas and Santa Catarina suggest that a pension record audit, greatly simplified by improved IT solutions, could yield savings of 10 to 20 percent of pension expenditures.

The new pension rules for the uniformed personnel were also set at the federal level in 2019, with subnational governments mandated to adopt the law in its entirety. This separate law maintains more generous benefits for the uniformed personnel, including policemen and firefighters, compared to other civil servants. Their pension benefits also preserve the generous principles of integrality and parity. Given federally regulated pension rules, one of the few remaining tools for the local governments to influence subnational uniformed personnel pension deficits is human resource policy.

From the optional reform features, expansion of contribution base for pensioners has the largest potential to generate immediate reduction in pension deficits. However, only seven states in Brazil have so far lowered the exemption threshold to one minimum wage following federal government's example. The reluctance by states to adopt the expansion of contributory base for pensioners is regrettable. The 2003 reform has introduced big unfair differences in treatment between the pre-2003 and post-2003 entrants into the public service. The pensions of pre-2003 entrants are heavily subsidized by the state and the contribution base extension to them would only claw back a small portion of this subsidy. Another reform with potentially substantial savings is the adoption of proportional calculation of survivor benefits. The remaining reforms, including an increase in the retirement age and the flexibility to levy extraordinary contributions for a limited time period are also important, but not as relevant for the short-term fiscal impact.

Overall, the take up of the reform tools provided to the states through the federal 2019 pension reform has been underwhelming, possibly due to the short-term improvement to state finances in 2020 and the overwhelming urgency of COVID-19 response. It is likely that municipal governments, with lower implementation capacity, are even further behind in the reform process. Consolidation of record management and proactive audits of pension records of all government branches is a priority, as is wide expansion of pensioner contribution base and revision of survivor benefits. However, even with the extra efforts along these lines, it is clear that the 2019 reform measures are insufficient to arrest the strong growth of pension expenditures projected for the next two decades.

Reform lessons and recommendations. *Going forward, lasting solutions would be easier to find if fiscal, human resource, governance, asset management, and pension policies are viewed as integral parts of interdependent system. Local governments that feel having exhausted the legal and political pension reform space provided by the federal 2019 reform should focus on human resource policy, which still offers ample space for increased efficiency and positive spillovers into reduced pension expenses. To address expected growth in pension expenditures in the next two decades, pension policy itself would benefit from reexamining the inequities left by exemptions from 2003-reform. Some ways to devise partial claw-backs of unjustified subsidies to pre-2003 cohorts are highly progressive contribution rates, extraordinary additional contributions, and some lump sum inducements to voluntarily accept post-2003 benefit rules.*

Throughout the system, there is an urgent need for more transparency, better governance, and policy-maker friendly IT solutions. Covid-19 has also exposed a need and convenience of being able to serve clients and manage records remotely. It is neither reasonable nor efficient for all 2154 RPPS schemes to acquire or develop their own IT systems and set up their own asset management departments. Therefore, IT and asset management services should be made available, sponsored at the federal or at least state level, that could be used by smaller RRPS schemes. The requirement for all public employers to report individual level employee data into a federal eSocial database from April 2022 (already mandatory for private employers) offers unique opportunity to systematize data in a common format. It is important *to ensure that subnational RPPS also have legal authority to access this data for all government branches in order to fully perform their record management and audit duties. However, subnational governments cannot passively wait for that to happen. Temporary solutions are urgently needed, which could include cloud-based service rentals from private IT companies, or own-developed software packages that could be shared between cooperating RPPSs schemes. Sharing of asset management services is already happening and should be further encouraged with appropriate safeguards.*

2

Introduction

2. Introduction

Brazil prides itself for having a comprehensive social protection system, comprising of a wide array of labor market policies, extensive social assistance net, and a relatively high pension coverage. However, its social protection spending is heavily skewed towards older people, especially those who have served as civil servants during their career. Private sector workers are covered by the *Regime Geral de Previdência Social (RGPS)* and public civil servants belong to the *Regime Próprio de Previdência Social (RPPS)*. Unusually, in Brazil, apart from the federal RPPS regime, each subnational entity – states, the Federal District and municipalities – was allowed, until 2019, to create its own individual RPPSs, which resulted in the existence of over two thousand different RPPSs at the subnational level.

In total, currently there are 2,154 RPPSs in Brazil, as 27 states and 2,127 municipalities run their own pension schemes[1]. Together, they account for an insured population of about 8.9 million people (active civil servants, retirees and survivors) at the three levels of government – federal, states including Federal District, and municipalities. About 58 percent are active civil servants and the remaining 42 percent are pensioners or survivors (Table 1). While the total membership of RPPS only stands at about 10 percent of RGPS coverage, its spending amounts to almost half of RGPS pension outlays.

Considering Brazil's 5,597 subnational entities (27 states and 5,570 municipalities), 38 percent have their own RPPS. The rest cover their civil servants through the national RGPS pension system. Out of existing RPPS regimes, 21 are in the process of extinction, also to be replaced by RGPS arrangements.[2] Several states have large numbers of RPPSs, with many small municipalities running their own schemes: Rio Grande do Sul has 332 regimes, followed by Minas Gerais (222), São Paulo (221), Paraná (179), and Goiás (170). A few states with very small territory and population have disproportionately large number of RPPSs, such as Pernambuco (149), Alagoas (74) and Paraiba (71). RPPS are in general small in terms of assets under management: 65 percent hold assets between 1 million and 5 million BRL, and 7 percent of RPPS

1 Source: Indicador de Situação Previdenciária – Seprev (2020), accessed on May 2021. Available at https://www.gov.br/previdencia/pt-br/assuntos/previdencia-no-servico-publico/indicador-de-situacao-previdenciaria/arquivos/2020/indicador-de-situacao-previdenciaria-isp-2020-v1-03-10-2020-10h30.pdf..

2 Painel Estatístico da Previdência, accessed on June 17, 2021.

manage assets below 1million BRL. Only 1.6% of RPPSs manage more than 1billion BRL.[3]

This paper attempts to place civil servant pension schemes in a larger picture and present its importance for the country's fiscal standing. It starts by providing a historical context in which subnational civil service pension schemes were set up, discusses fiscal consequences born by the maturation of these plans, and considers influences of human resource and fiscal policies on pension scheme evolution. It further provides historical overview of pension policy thinking applied to subnational pension schemes to date and surveys the take-up of 2019 federal pension reform template by subnational governments until April 2021. The paper attempts to demonstrate the interdependence of fiscal, human resource, governance, and pension policies and argues for the search of joint solutions in the challenging quest to arrest subnational pension expenditure growth in Brazil.

Table 1 – Size of the population covered by civil servant pension regimes in Brazil in 2019.

GOVERNMENT LEVEL	ACTIVE	RETIREES AND SURVIVORS	TOTAL	SPENDING, % OF GDP, 2018
Federal government	688,778	740,997	1,429,775	
States & Federal District	2,014,773	2,064,150	4,078,923	
Municipalities	2,521,955	925,559	3,447,514	
Total RPPS	**5,225,506**	**3,730,706**	**8,956,212**	**4.1%**
RGPS	**58,156,477**	**29,089,160**[4]	**87,245,637**	**8.6%**

Source: SRPPS/SPREV/ME - CADPREV, accessed on July 2019; Boletim Estatistico da Previêência Social.

3 Sample of 1756 systems which have provided timely records of applications and investments of resources (DAIR- Demonstrativo das Aplicações e Investimentos dos Recursos) retrieved in November 2019 (reference period March 2019). Source: Seprev/ME.

4 Number of pension and survivor benefits paid in December 2019, including accident insurance.

3

Evolution of civil service in Brazil since 1988

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The 1988 Constitution is a cornerstone of current civil service in Brazil. Prior to its adoption, the rules and mandates governing civil service were not clear and were not consistent across agencies. Older and larger states have expanded their civil service during early 1980's, but it was mostly limited to increasing the capacity of administrative sectors and inspector careers. Only a handful of institutions responsible for key functions such as taxation, diplomacy, and public advocacy had already started to professionalize. The rest of the public administration, including lower levels of government, did not have established permanent corps of public employees.

The 1988 Constitution has also established the universal access to public services, which lead to increased demand and a rise in the number of public officials, especially at the municipal level. For example, until 1988, the State was not held responsible for providing universal services such as education, public health, and social assistance.[5] However, after the end of the military dictatorship in 1985, the country was experiencing an unprecedented widespread sense of optimism, accompanied by high promises of prosperity and expansion of individual rights. The push for increased access to services, and placement of these major responsibilities on subnational governments, has led to extensive hiring. In addition to teachers, health professionals, public service providers, and policemen, the creation of numerous new positions in the judiciary was noticeable, given the momentum that the Federal Constitution had provided by expanding civil rights, and triggering increases in individual litigation.

Between the 1988 and 2019, the number of civil servants grew by 211 percent at the munic-

5 The 1988 Federal Constitution explicitly shared the responsibility of service delivery with states and municipalities. Secondary education, for instance, should be provided mainly by states, pre-primary education delivered by municipalities, while primarily education should be a shared concern between them (Art.211). Health is also shared responsibility. Social assistance is planned at the federal level, while implementation is carried out at the municipal level by the *Centros de Referência de Assistência Social – CRAS.*

ipal and 30 percent at the state level (Figure 1).[6] More than a thousand new municipalities were created between 1984 and 1997, which drove extensive hiring observed in the following decade. The number of public officials in the federal government had remained remarkably stable over this period. As a result, the profile of Brazilian public service had changed profoundly. If in 1988 federal civil servants constituted 16.2 percent of all public service (Figure 2), their share has almost halved to only 8.6 percent by 2019 (Figure 3). On the other side of the spectrum, municipal civil service has grown from 36 percent to 59.7 percent of all public servants over the same period. Overall, government employees of all levels currently constitute 18 percent of all wage employees in Brazil.

Figure 1 – Number of public employees by government level.

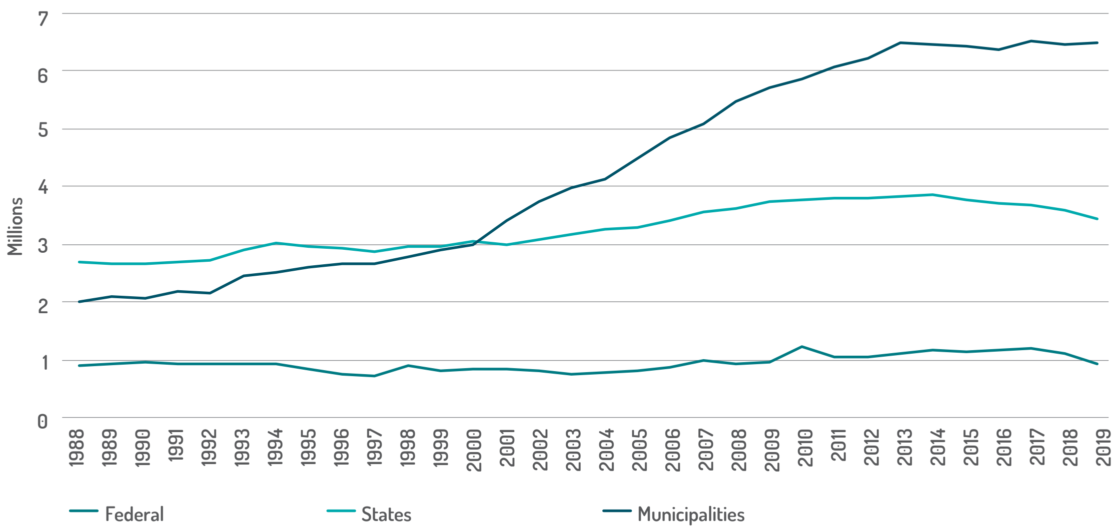


Figure 2 – Division of public employees by government level (1988).

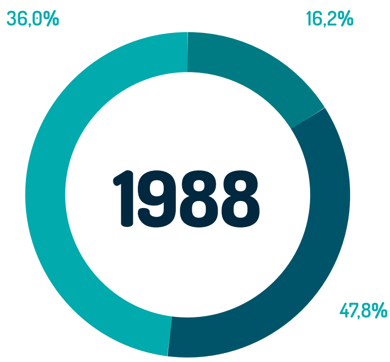
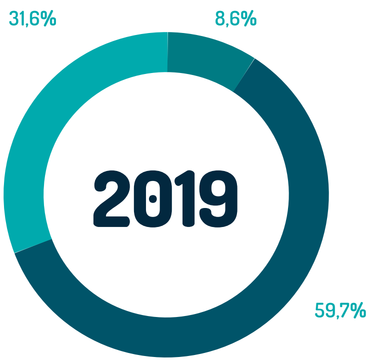


Figure 3 – Division of public employees by government level (2019).



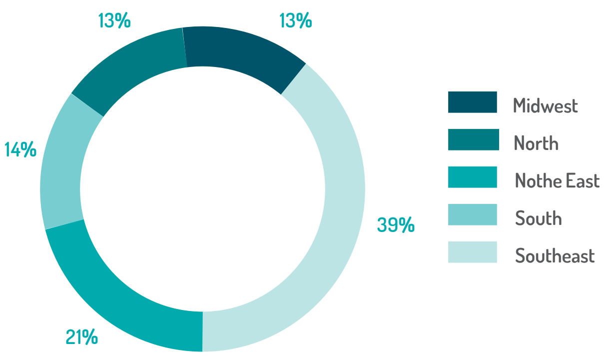
Source: Atlas do Estado Brasileiro (IPEA, 2020).

6 With the 1988 Federal Constitution, municipalities were elevated to the status of federative entities. This encouraged the division of large municipalities. Between 1984 and 1997, 1,405 municipalities were created - an increase of 34,3% compared to the previous period (Gomes and McDowell, 2000). In 1984, Brazil had 4,102 municipalities; currently there are 5,570. In 1996, stricter rules for the creation of municipalities were imposed.

While the overall growth of state employment was much lower than that of municipalities over the 1988 to 2019 period, there was substantial variation between the states. With the 1988 Constitution, three new states (Amapá, Roraima, and Tocantins) were created in the North of the country, leading to the restructuring of the public service and substantially contributing to the 116 percent growth in the number of state public servants in the region (Figure 4). In addition, the North of the country along with the Midwest (87 percent state civil service growth), were the territories with the highest population expansion in the last few decades which, not surprisingly, lead to the commensurate growth in the number of state civil servants. On the other hand, the Southern, Southeastern, and Northeastern states, with more stable populations and more established institutions, had a smaller increase in their state public service. The Southeastern region specifically, which still employs 39 percent of all state civil servants in Brazil (Figure 5,) has seen a very limited growth in hiring over the same period and has even been reducing the number of employees since 2014. Thus, compared to 1988, the overall state civil servant employment in the Southeast only grew by 9 percent.

Figure 4 – Regional growth of state public employees (index 1998 = 100).

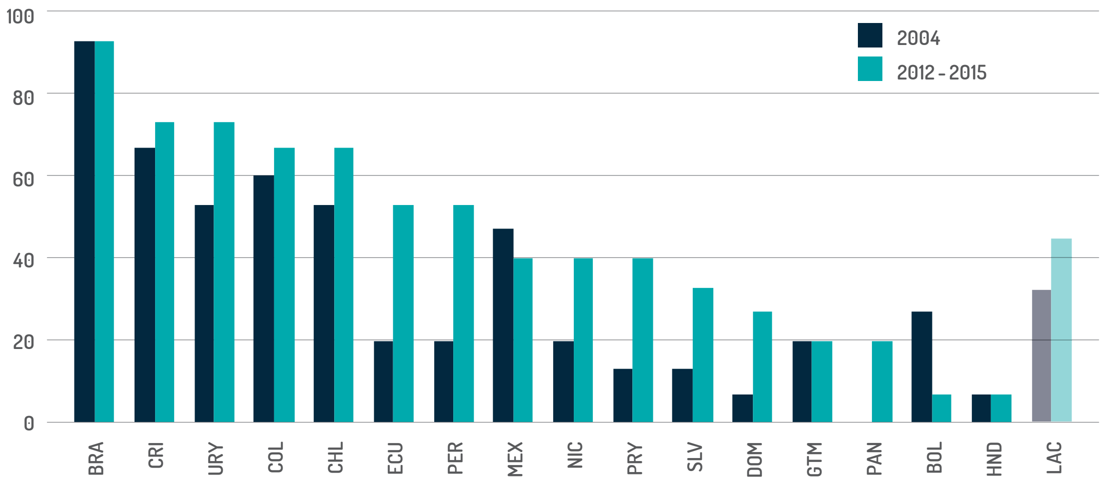
Figure 5 – Division of state public employees by region (2019).



Source: Atlas do Estado Brasileiro (IPEA, 2020).

The 1988 Constitution has also brought major changes to the way civil servants were contracted. Although the transition rules ensured the retention of some political appointees, Brazil quickly became the regional reference on public sector meritocracy[7], as shown in Figure 6. One of the newly established pillars of the meritocratic system was the hiring process which, in Brazil, is based on competitive exams, widely publicized and open to all citizens. In addition to this meritocratic access to employment, civil servants were also granted substantial legal protections and autonomy. The dismissal of a civil servant could no longer be made based on subjective criteria. The constitution defined very narrow grounds for dismissal and, after 3 years of employment, positions were considered permanent. The possibility of losing the job due to poor performance, for example, was only included in 1998, and has been tightly regulated since.

Figure 6 – Civil service meritocracy (2004, 2012-15).



Source: A decade of civil service reforms in Latin America (2004–13) (IADB, 2014)

Since 1988, the overwhelming majority of Brazilian public employees were employed under the privileged civil servant contract guaranteeing permanent employment (Figure 7). The rules governing public sector regime contracts are described in civil servant statutes, regulated by local law. In addition to the Federal government, each of the 27 states and 5570 municipalities have their own civil servant statute. However, since 2002, there was some increase in the use of temporary workforce which by now constitutes around 8 percent of the public sector employment (Figure 8). This is largely driven by hires to provide basic education, but each government level has its own legislation regulating temporary positions. At the same time, the number of government contracts regulated by the private sector employment regime (*Consolidação das Leis Trabalhistas* - CLT) has been decreasing and now constitutes only 5 percent of total public employment. This is due to the decrease in the role of state-owned enterprises, which predominantly use this contracting model.

7 The meritocracy index, developed by Longo (2006) and calculated by the IADB, is a composite index that ranges from 0 to 100 in evaluating a set of ten objective characteristics of a country's hiring and promoting system. As critical points, it includes an assessment of whether hiring to public vacancies are open and widely publicized, whether there are safeguards against arbitrariness or clientelism in hiring, and if terminations of employment in the public sector are not motivated by political leanings.

Figure 7 – Evolution of public employees by type of contract (general government).

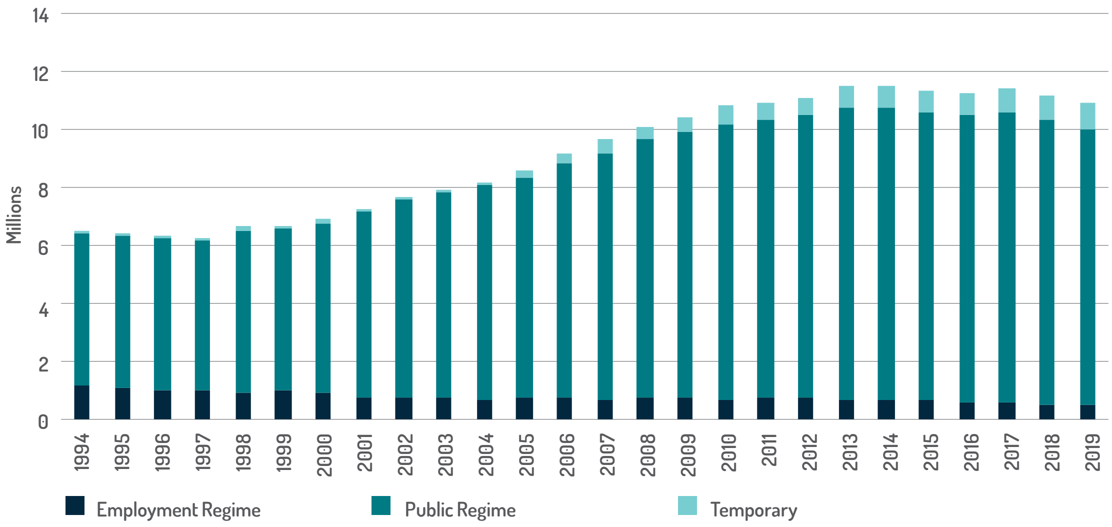
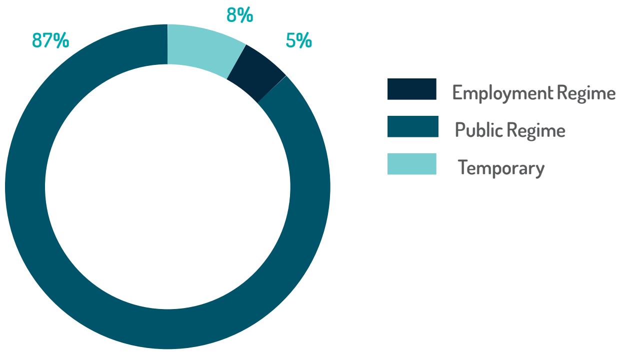


Figure 8 – Division of public employees by type of contract (general government).



Source: Atlas do Estado Brasileiro (IPEA, 2020).

Hence, civil servants under the temporary contract (regulated by Law 8745/1993, see art. 8) and those under the labor regime are enrolled in the RGPS system (Law 6647/1993), while those under the public sector regime are enrolled in the RPPS if there is such a regime at their local level employment. If a municipality does not run its own RPPS, its civil servants are enrolled in the RGPS.   Although temporary civil servants do not enjoy the same rights, often, through legislative or bargaining process, they are converted to permanent staff retroactively.

As well as providing a specific employment model for permanent government staff, the 1988 Constitution also defined an exclusive pension system for them. This system was further detailed in the 1990 federal law of *Regime Jurídico Único* (RJU). The schemes that federal government, as well as the states and municipalities, were allowed to create under this law are collectively known as the *Regimes Próprios de Previdência Social* (RPPS), or “own regimes of social security”, as opposed to the “general regime of social security” (RGPS) that covers private sector workers and some public sector workers that are not enrolled in the RPPS.

In effect, these new pension arrangements made civil servant career truly permanent as, in contrast to the private sector employees, civil servants now remained affiliated with their life-time employer even after their retirement. This strong affiliation is apparent from the term "in-active civil servants" commonly used to describe public sector retirees. It could even be argued that life-time affiliation concept also helped to create an implicit expectation that retirement should not imply any significant change in the civil servant's income stream, even if they stop discharging their civil servant duties. Therefore, many civil servant statutes foresee continuation of benefits associated with the last job into retirement, including promotion in rank for the uniformed personnel, increases in pension that mirror wage increases for the last retiree's position (continued to be called "salary" of a retiree), and monetary benefits associated with the discharging of previous duties, for example a bonus for teaching in a remote school.

For the first few decades, creation of these new generous pension regimes had very limited effect on subnational governments. Most of the civil servants hired in the first years of public service expansion were young, and therefore were not eligible to retire for at least a couple of decades. Subnational government finances were arranged accordingly, as budget was fully allocated between service provision, investment, and payment of wages for active civil servants. Pension payments were fully covered by pension contributions of a large young employee pool and did not need budget support.

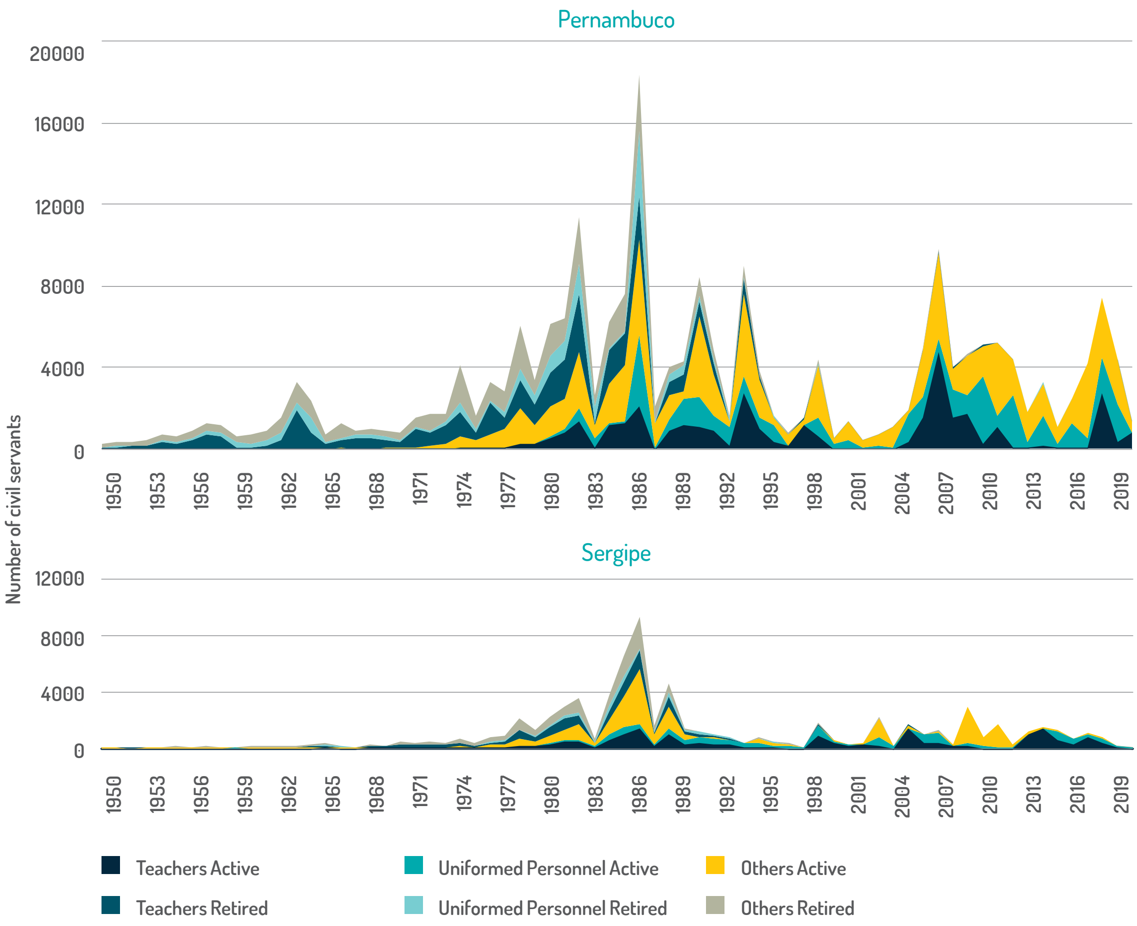
However, the beginning of the XXI century marked the start of a rapid maturation of civil servant pension schemes, as the first large cohorts of civil servants started to retire. Given that the increased hiring period in the 80s lasted for about a decade, and average pension draw period due to early retirement ages tends to last about 30 years, the full maturation of most subnational systems is not expected before 2040. Reaching full maturation of the pension schemes of younger states and municipalities might take even longer, as their hiring wave dates in the 1990s and even 2000s.

The examples of Pernambuco and Sergipe states demonstrate how hiring spikes can stress state finances and service provision (Figure 9). Both states had large hiring intakes in 1980s, with last workers hired in that period about to retire. Pernambuco seems to have had to replace most of the retirees from the first hiring wave by new increased hiring between 2005 and 2018, taking on additional cost of wages, while most of the retirees from the first wave were still drawing pensions. In contrast, Sergipe struggled to replace the retiring servants, inevitably jeopardizing provision of public services. The absence of replacement hiring, like in Sergipe, can also be seen in the age distribution of active and retired teachers in Espírito Santo and Ceará, as shown in the Figure 10 in the right-hand graphs. Mato Grosso and Rio Grande do Norte seem to have managed to stay closer to Pernambuco path, and have managed to retain a more age diverse teaching workforce.

Even though the pension scheme maturation process is not yet complete, in general, the average state's pension system currently is almost as mature as that of the federal government. Figures 11 and 12 demonstrate that, on average, the number of retirees is already exceeding the number of active workers at both of these government levels. Meanwhile, the municipalities, due to the more recent expansion of their public service, still have a much lower retiree to active worker ratio (the obvious exceptions are big municipalities of older urban centers like Rio de Janeiro and Sao Paulo).

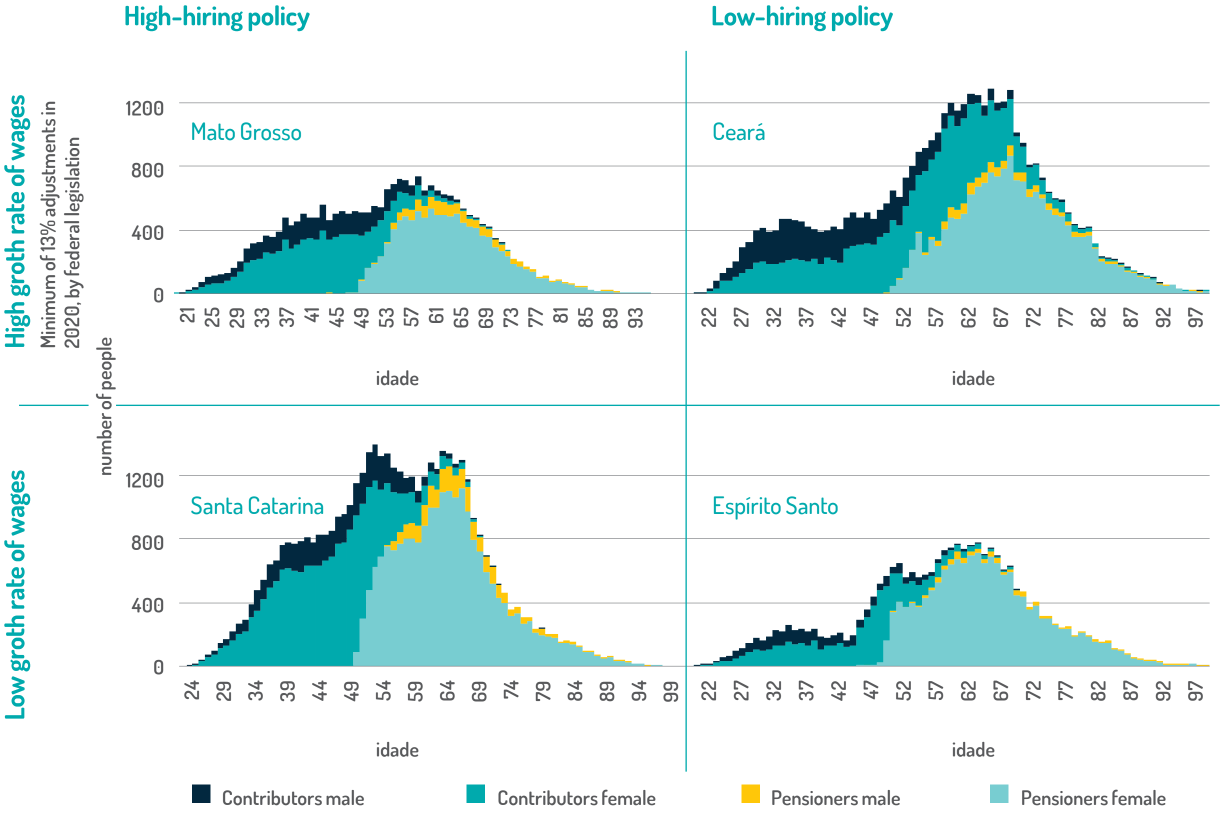
Even though state and federal governments seem to have similar retiree to active employee ratios of 1.07 and 1.14 respectively, the variability between the states in considerable (Figure 13). The proportion of retirees to active workers in the northern states is very close to the municipal average of 0.4. Note that the RO (created in 1981) and AP, RR and TO (1988) are the youngest Brazilian states, elevated from the status of federal territory to state during the 1980's, what thus explains a much younger civil service labor force and fewer retirees. On the other hand, eight states in the older South, Southeast, and Northeast regions that have seen a much more modest recent civil service expansion have a higher proportion of dependents on the system than that of the federal government itself. The states of Rio Grande do Sul and Minas Gerais stand out most, with almost 1.7 retirees and pensioners for each active professional, in comparison to 1.14 ratio for the Federal Government scheme.

Figure 9 – Hiring spikes of public servants during the 80's – Pernambuco and Sergipe states.



Source: The World Bank, based on state government data.

Figure 10 – Varied success in maintaining age-diverse teaching staff under pension cost pressure in various states.



Source: The World Bank, utilizing data provided by the state governments

Figure 11 – Proportion of retirees and pensioners to active employees by government level.

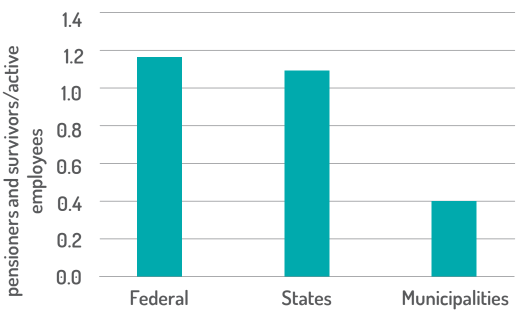
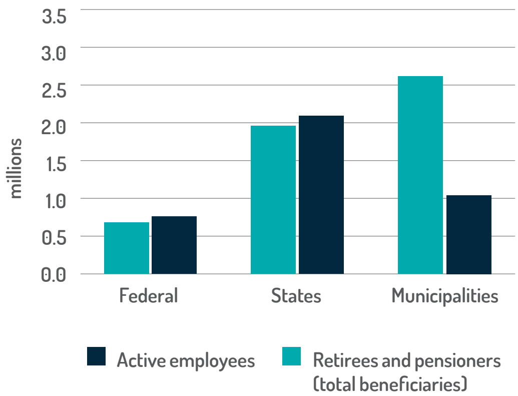
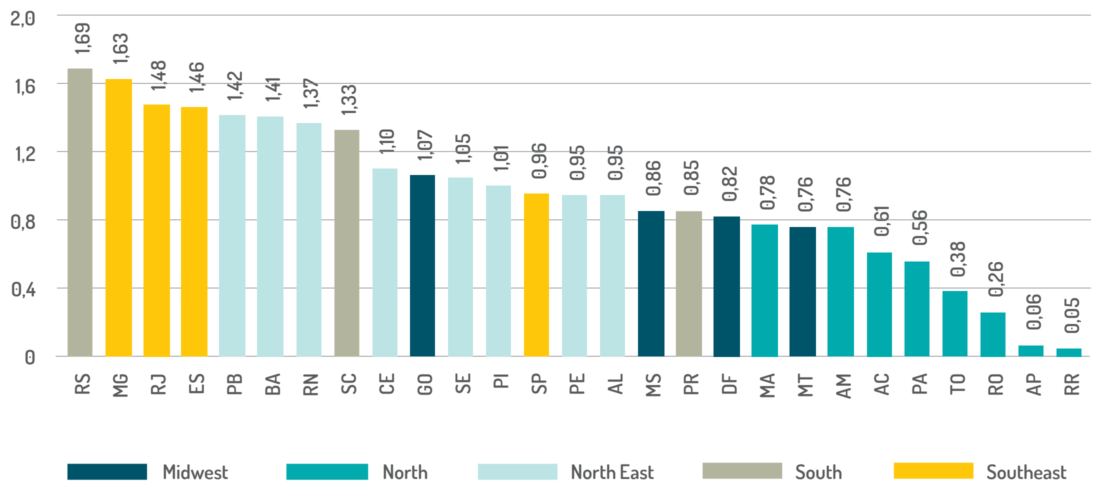


Figure 12 – Total number of retirees and pensioners as well as active employees by government level.



Source: Anuário Estatístico de Previdência Social do RPPS (ME, 2020).

Figure 13 – Proportion of retirees and pensioners to active employees in State governments.

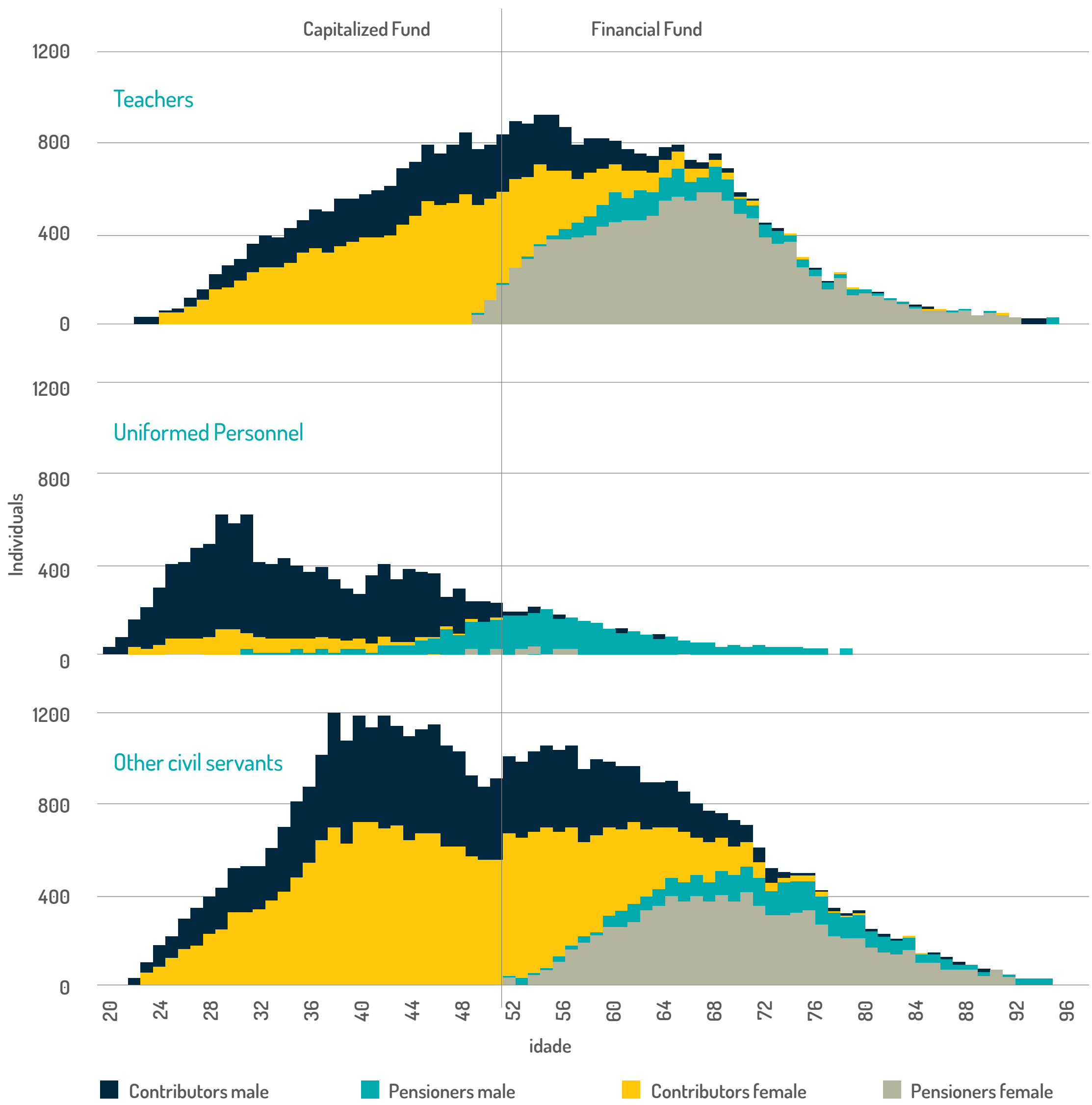


Source: Anuário Estatístico de Previdência Social do RPPS (ME, 2020).

Further disaggregation of the maturity[8] level per worker category within a state reveals that imbalances are usually more prominent in specific careers. Amazonas offers a typical example of a pension system with diversified maturity levels across categories, where teachers belong to a most mature member distribution (Figure 14). Other categories of civil servants, and especially military, reveal still immature age distributions, as they do in most states, with larger concentration of members below the average pension age. Relative immaturity of uniformed personnel schemes is especially common across Brazil. Given that their young age structure and associated increases in future pension liabilities is often not well documented and known to the executive branch government, and that these sub-schemes do not yet generate big pension expenditures, the building up of this unfunded fiscal liability is not yet fully recognized by most subnational governments.

8 Maturity level of a pension system refers to the relative sizes of retiree and contributor cohorts. The scheme is considered mature when its oldest pensioner cohorts, adjusted by survival probability, are similar in size to the average contributor cohort.

Figure 14 – Different maturity level of pension scheme membership by career - Amazonas.



Source: The World Bank using data provided by the state government.

4

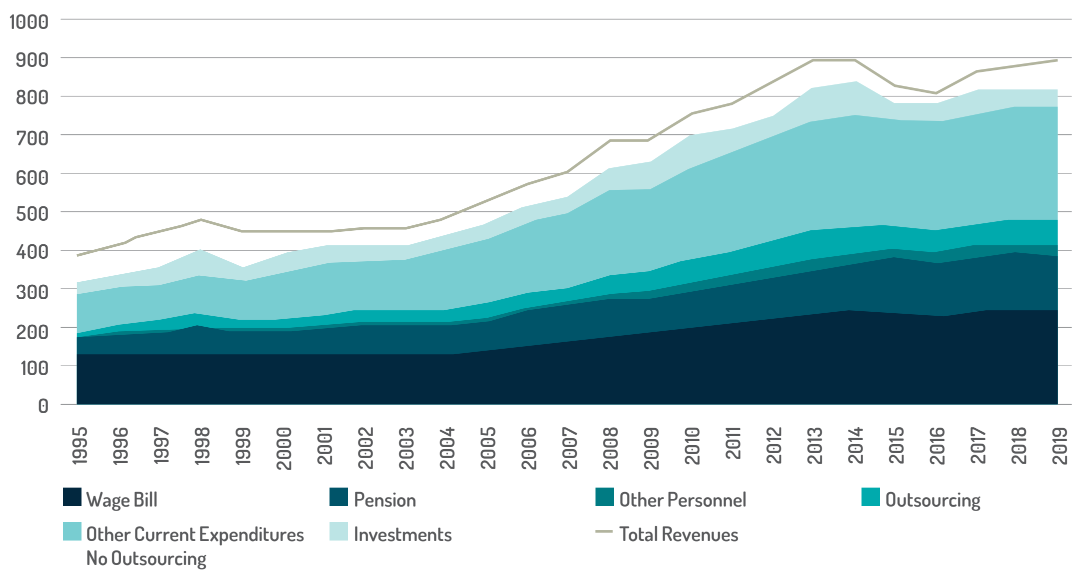
The fiscal consequences of civil service expansion and pension scheme maturation

4. The fiscal consequences of civil service expansion and pension scheme maturation

The expansion of subnational civil service and maturation of pensions schemes that followed a few decades later have had a strong impact on subnational government finances. In aggregate, half of state revenues are spent on wages, pensions, and other personnel costs (Figure 15). Generally, state level personnel spending, wage and pension spending included, increased just below the growth rate of state revenue over the last two decades (Figure 16). However, personnel spending has increased faster than the stock of government debt, especially after 2009. This suggests that some of state borrowing in the last decade was used to meet growing personnel spending obligations.

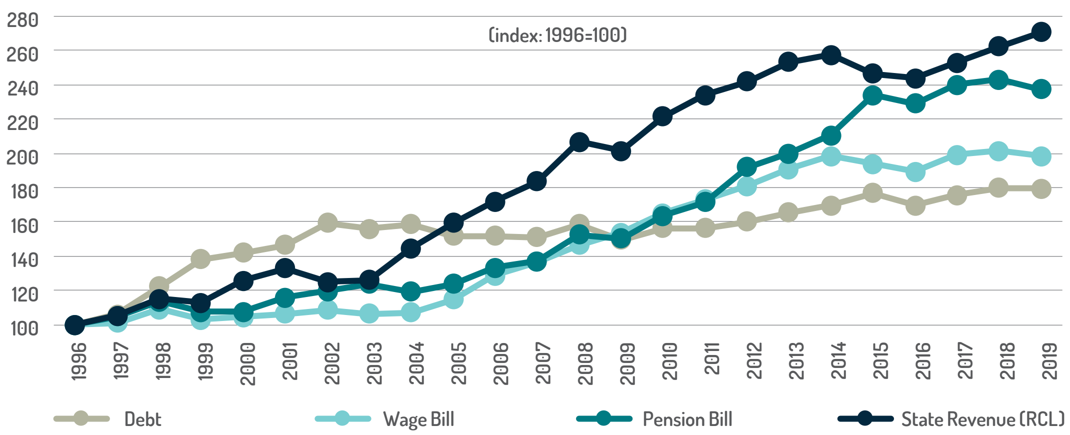
In 2015, the Brazilian economy went into the crisis, with GDP falling 3.5 percent in 2015 and 3.6 percent in 2016. Tax revenues have decreased, for the first time in recent history. The governments needed to adjust their public accounts, but it soon became clear that personnel spending could not meaningfully adjust due to its rigidity. This was because an overwhelming majority of employment contracts were permanent, and important seniority-related wage increases were largely automatic, governed by complicated and legally insulated civil servant statutes. Pension system also lacked any discretionary adjustment mechanisms apart from pension indexation, which was legally linked to the growth of senior position salaries from which former civil servants have retired. Therefore, the only remaining personnel cost adjustment tools were reduction of the base wage growth and hiring freeze.

Figure 15 – Aggregate state revenues and spending, 2020, in BRL billion



Source: The World Bank using data from Plano de Ajuste Fiscal (PAF), National Treasury Secretariat

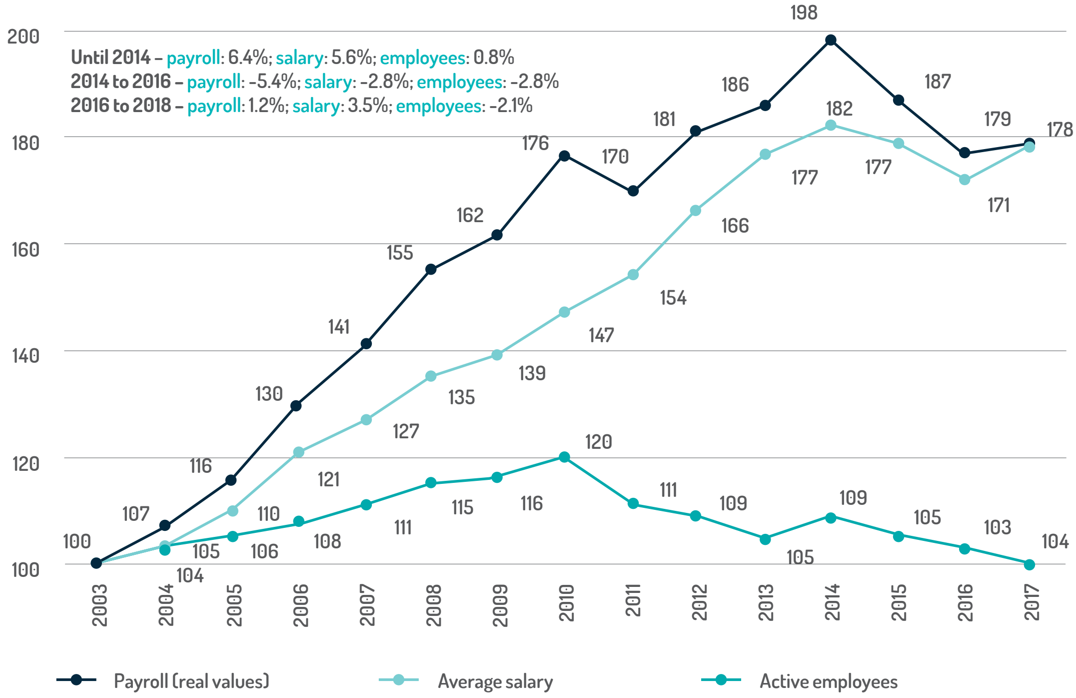
Figure 16 – Comparison between the growth rates of aggregate state revenue, debt, and personnel expenditures in Brazil.



Source: The World Bank using data from Plano de Ajuste Fiscal (PAF), National Treasury Secretariat.

Since all wage structures were partially determined by base wage, and pensions in turn depended on salary growth of senior employees, it was assumed that the freezing, or at least reduction, of base wage will translate into large wage and pension bill savings. However, overall wage growth component attributable to base wage increase turned out to be rather small. In addition, base wage was in itself not fully insulated from union influences and civil servant statute rules. For example, in some states, the statute stipulates that base wage growth cannot be lower than last year's inflation, and unions often sign multi-year pacts with the government, fixing future base wage increases a few years into the future. In nominal terms the salaries still grew, powered by automatic promotions and related automatic salary increases. Therefore, overall effect of the reform on wage growth was muted (Figure 17).

Figure 17 – Growth of payroll, average salary and active employees, state public sector (2019).



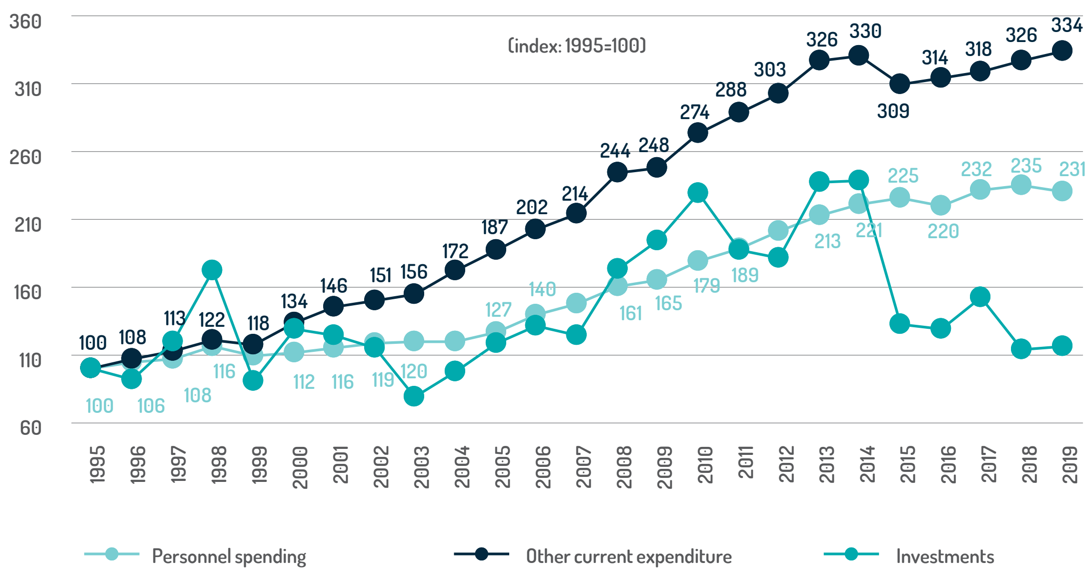
Source: Gestão de pessoas e folha de pagamentos no setor público brasileiro (Word Bank, 2019).

Hiring freezes could not provide a significant dent in personnel expenditures either, as wages of newly hired still low-paid employees constitute a very small part of personnel budget. At the first glance, hiring freezes were somewhat successful, as the number of active servants did decrease somewhat through attrition. However, given that the reduction of employees over this period is almost exclusively driven by retirements, the overall pension and wage bill could not have changed by much due to this policy. Overwhelming majority of 2014 and 2015 retirees were hired before the pension reform of 2003 and have been retiring with pensions equal to 100 percent of their last salary.

In the absence of the ability to meaningfully cut personnel spending, cuts in investment, followed by some reduction in other current expenditure, mainly health and education, took the brunt of the adjustment (Figure 18). While outsourcing, a rather new hiring modality, could be expected to absorb some reduction in revenues in 2015-16, it did not do so (see Figure 15). This demonstrates that outsourced services in Brazil also contain some real or perceived rigidities, stemming from legal and/or political processes. Outsourcing has been growing in popularity since 2000 and has been replacing some of the public servant hiring, mainly in health and education, with great promise of increased flexibility. Instead, in a crisis, subnational governments primarily adjusted by cutting investments, jeopardizing economic growth and future tax revenue. Given how little Brazilian states already spend on investment, a deeper or more protracted crisis could not have continued to be handled this way. Thus, spending on public services such as education and health, which is generally indexed to revenues, was next in line for expenditure cuts, partially as an automatic consequence of lower revenues.

Looking back, federal policies have historically played a big role in shaping subnational government fiscal trajectory at a macro level. The period between the signing of the new Federal Constitution of 1988 and 1995 was marked by the centralization of tax revenues in the federal government and a lack of mechanisms to constrain the fiscal behavior of subnational governments. Big part of state expenditure in that period was financed by explosive increase in external and internal debts.

Figure 18 – Cumulative growth of aggregate state spending on personnel, investment, and other current expenditure in Brazil.



Source: The World Bank using data from Plano de Ajuste Fiscal (PAF), National Treasury Secretariat.

The institution of CAPAG, in 1997, introduced by the Ministry of Finance through Senate Resolution 78/1998, imposed limits to subnational government indebtedness, and allowed federal oversight of subnational spending, effectively allowing spending to increase at the pace of increases in state revenues. The analysis of the payment capacity (CAPAG) ascertains the fiscal situation of subnational entities that aim at taking out new loans with the guarantee of the federal government. CAPAG unveils whether a new indebtedness represents a credit risk for the National Treasury, based on three indicators: indebtedness, current savings, and liquidity ratio. Hence, by assessing the degree of solvency, the relationship between current income and expenditure and the cash position, a diagnosis of the fiscal health of the state or the municipality is made. Increased percentage of net current revenue spent on personnel expenses worsens both the liquidity indicator and the current savings indicator of a state, leading to lower CAPAG grades and, consequently, difficulties in obtaining loans. In addition, the debt refinancing associated with a fiscal adjustment plan and a credible rule to avoid default in debt payment (direct withdrawal from the debtor's account) seem to have also been decisive in controlling subnational indebtedness.

The Fiscal Responsibility Law, enacted in 2000 in the aftermath of subnational government bailout, constituted another 'milestone in the management of public finances in Brazil' (Mendes 2020). It set a cap on personnel spending at 60 percent of state revenue (*Receita Corrente Líquida*, or *RCL*). If total expenditure on personnel exceeds 95 percent of that limit, the law prohibits any human resource action that implies an increase in expenditure, such as hiring or career promotions, providing a counterweight to some provisions of civil servant statutes. The law also established unprecedented provisions forbidding inter-government financial support, including from state banks, which was an instrument widely used by states to finance fiscal debts.

Under the new law, elevated personnel spending also threatened the state's eligibility to receive discretionary federal transfers, as these were suspended in case the subnational entity fails to comply with minimum investments in health and education. The Brazilian Constitution determines that states, the Federal District, and municipalities must invest at least 25 percent of the revenue resulting from taxes (including transfers received from the federal and state governments) in maintaining and developing education and qualifying education professionals, as well as spending a minimum of 15 percent in public health. Failure to comply with these regulations might ultimately even result in the intervention by the Federal Union.

As a consequence of the vigorous economic growth between 2008 and 2014, CAPAG and Fiscal Responsibility Law allowed some flexibilization in borrowing limits, some of which found its way into the expansion of civil service wage bill. Moreover, there was also a gradual relaxation of rules and creation of exceptions for contracting debt through both Senate resolutions and National Treasury regulations. While state governments have not experienced an explosive growth in the number of civil servants comparable to that of municipalities, their payroll still grew substantially, almost doubling in real terms in the decade from 2003 to 2014. In the same period, the average salary increased by 82 percent in real terms and the number of personnel grew by 9 percent.

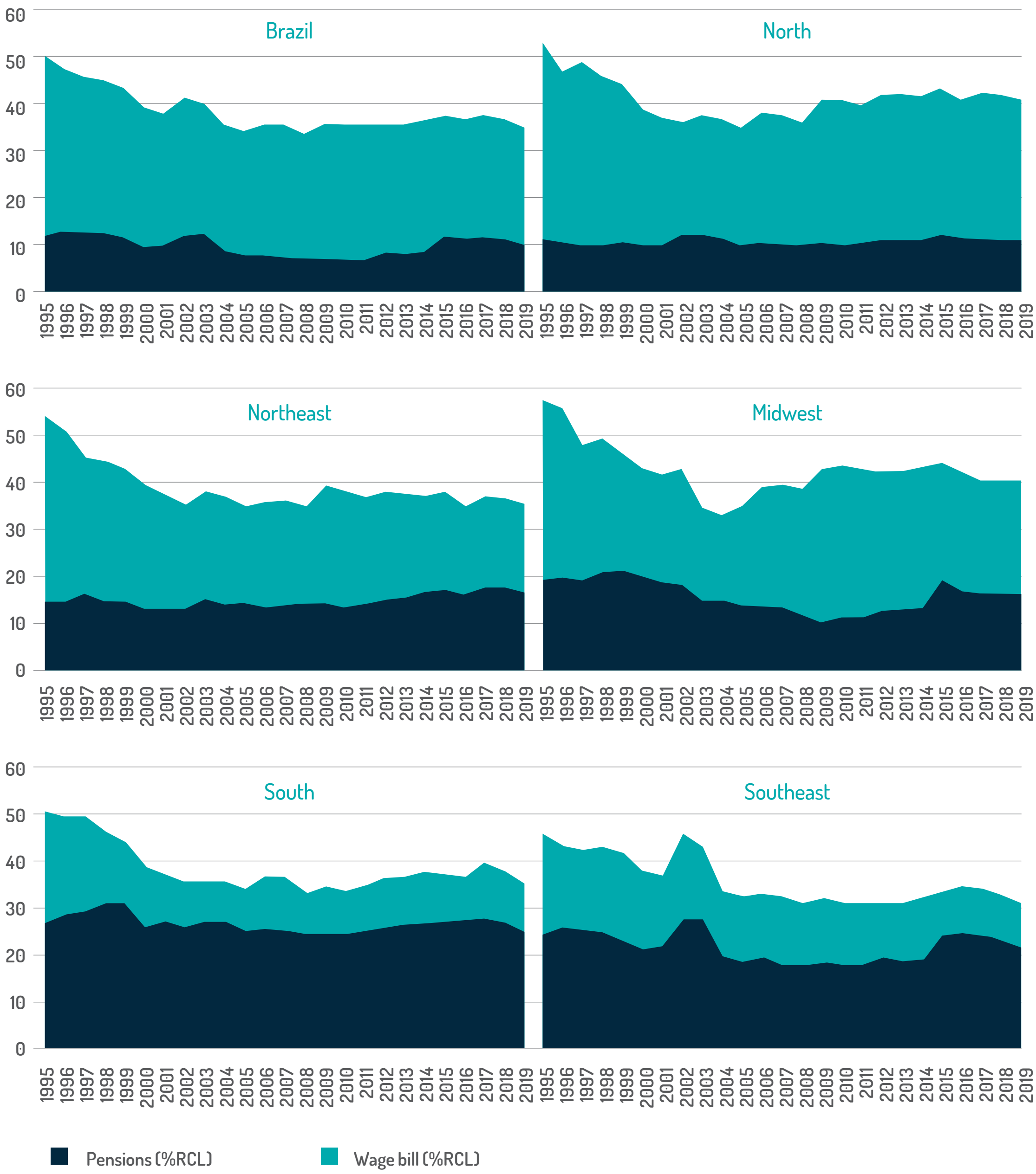
The regional effects of Fiscal Responsibility Law and 2008-2014 credit expansion can be seen in Figure 19. Brazil, as a whole, has approached the 60 percent personnel spending limit in 2015-2017 period, led by the Southern and Southeastern states, where pension bill alone already hovers around 20 percent of state revenues. However, Fiscal Responsibility Law has clearly had an effect in this region, keeping its wage bill to around 35 percent of state revenues over the last 15 years. Northeastern states have also felt maturation of their pension schemes with progressively increasing share of revenues spent on pensions, which, through fiscal pressure, has contributed to the stability on wage bill spending. However, Midwestern and Northern states, with still immature pension schemes and free of constraints of Fiscal

Responsibility Law, have seen significant wage bill expansions in the 2000s, now spending 40 percent of state revenues on wages alone, substantially higher than older states. This spells trouble ahead, once pension schemes of these states inevitably mature and exposes the flaws of Fiscal Responsibility Law.

To overcome immediate delicate fiscal situation born by 2015-2016 crisis, and to avoid breaking any fiscal responsibility rules, the harder hit states also adopted some temporary solutions. They included accumulation of payment arrears and engagement in debt renegotiations with the federal government. However, rolling of debts is nothing else than a postponement of the fiscal problem in the absence of reforming the underlying structural fiscal drains. The economic crisis of 2015-2016 showed the necessity to improve the processes of managing and financing responsible subnational spending in general and pension scheme spending in particular.

Reliable municipality data is harder to collect, but in some ways their situation is even more alarming for the long term. There is no reason to believe that explosive doubling of salaries, seen at the state level over the 2003-2014 period, would not be replicated at the municipal level. This, combined with the doubling of municipal labor force between 1988 and 2003, and additional 50 percent growth after that, spells an explosive recent growth of the wage bill at the municipal level. Most municipalities, especially younger ones, may have handled the crisis of 2014-2015 a little bit easier than the states, given that they were not yet burdened by high pension payments at the time and therefore were not strongly restrained by Fiscal Responsibility Law. However, about half of current active municipal employees are hired before 2003 and will retire with extremely generous pension benefits, rapidly swelling pension expenditures in the next couple of decades. The municipalities will need much more flexibility than the current civil servant statutes and pension rules allow to be able to navigate this fiscally challenging period.

Figure 19 – Wage and pension spending as proportion of state revenues by region.



Source: The World Bank using data from Plano de Ajuste Fiscal (PAF), National Treasury Secretariat.

The suboptimal fiscal adjustment mechanism, observed in 2015-2016, partially stems from current fiscal framework, which is mostly conceptualized in relation of current spending to current revenues and does not encourage states to think ahead. When spending increase decisions affecting personnel spending are made, the impacts of these decisions are generally not assessed for the long term. For example, Fiscal Responsibility Law only demands three-year long projections. Thus, low current pension expenditures are taken as an indicator that further hiring and wage increases are fiscally responsible as long as increased personnel costs can be paid for the next three years. Unfortunately, highly backloaded civil servant contract, with high seniority-related wage increases and generous pensions, translates current human resource policy decisions into large rigid fiscal liabilities in future years and decades. Younger subnational entities with low pension bills can already see the future by observing older states, struggling to keep their fiscal health and flexibility under the high pension cost burden.

By 2019, state revenues were starting to increase, and fiscal authorities could afford to turn their attention from immediate crisis management to ensuring longer term fiscal sustainability. The procyclical nature of fiscal rules, which force fiscal adjustment during recessions but permit fiscal flexibilization during periods of growth, also allowed governments to start looking ahead. Federal pension reform of 2019 was an important expression of that shift in focus. It gave the states an important policy tool to adjust their long term pension expenditures, and a few pioneering states have done so in late 2019 and early 2000. However, in a few months, COVID-19 crisis has forced federal and subnational governments back into the crisis mode.

Looming COVID-19 health and economic crisis has shocked Brazilian authorities into quick action. Federal government has rolled out a well-funded emergency cash transfer program *Auxílio Emergencial*, which helped to maintain economic activity during the crisis and contributed to the tax revenue increases. The subnational governments have also received direct federal transfers to combat the COVID-19 pandemic in the amount of R$ 97 billion, or 1.4 percent of GDP. Finally, the second half of 2020 have also seen increasing commodity prices, which significantly contributed to improved economic outcomes and state revenue in commodity producing states. In all, paradoxically, subnational governments have experienced a fiscally strong 2020. As result, a somewhat backward looking CAPAG indicator is projected to reach A or B level for 20 states in 2021, compared with only 10 states in 2020.

However, positive outcomes in 2020 do not change the fact that the subnational fiscal outlook is continuing to deteriorate since before the pandemic. Prior to the COVID-19 crisis, more than half of the 27 Brazilian States were in a critical situation and have delayed payments to public servants and providers. In 2020, public investment was approximately 15% lower in comparison to 2015, even after 15% increase in 2020 is factored in. The emergency cash transfer program has already been significantly curtailed in 2021, and it is unlikely that direct federal emergency transfers will continue. Therefore, fiscal pressures, experienced before the pandemic, are likely to return to the forefront of subnational government agenda.

To help subnational governments to face the fiscal challenges, the Ministry of Economy recently launched several programs to support states in debt and/or fiscal distress, in exchange for the commitment to fiscal reforms: (i) Fiscal Recovery Program (*Regime de Recuperacao Fiscal*), to support the states in serious fiscal distress; (ii) Fiscal Sustainability Program (*Plano de Equilibrio Fiscal*), which aims to help subnational governments in fiscal distress to recover CAPAG B rating; and (iii) Expenditure Management Program (*Pro-Gestao*), which aims to contribute to the improvement of the fiscal, budgetary and patrimonial management of the Brazilian public administration, increasing the efficiency and effectiveness of the expenditure. Strong commitment to control personnel expenditures is a major part of all three of these programs.

To summarize, growing personnel expenditures are unbalancing the fiscal framework and creating a vicious cycle of fiscal unsustainability and constrained economic growth in the Brazilian subnational entities, which are forced to reallocate spending from other sectors. The subnational entity is left with a very narrow fiscal space for investments and a limited decision-making power over the remaining budget, which eventually leads to non-compliance with the Fiscal Responsibility Law the constitutional minimum spending requirements, or low CAPAG score. It makes it nearly impossible for states and municipalities in such situation to invest in credit operations, hire new civil servants, or improve infrastructure. Finding ways to reduce personnel costs could allow them to refocus and redirect resources where they are really needed for growth and improved public service delivery. **During the 2015-2016 crisis episode, blunt macro-level policies aimed at controlling the growth of the wage and pension bill have been shown ineffective, which requires more detailed examination of micro-level issues contributing to the rigidity and elevated growth rate of these expenditures.**

5

Contribution of HR policies to growth in wage and pension spending

5. Contribution of HR policies to growth in wage and pension spending

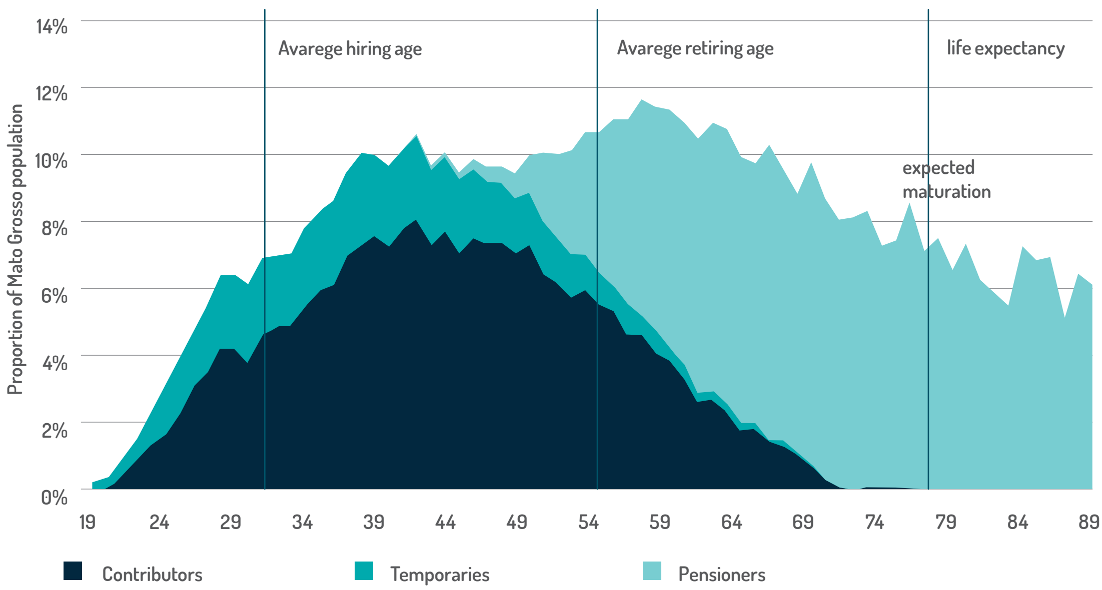
While rapid personnel expenditure growth in recent years has been primarily driven by pension scheme maturation after the hiring waves of 80s and 90s, it has also been strongly influenced by micro-level human resource policies. Apart from the obvious influence of these policies on the growth of wage bill, these decisions are also key in determining pension spending trajectory. For example, average hiring ages, retention of workers with right to retire, use of temporary workers, and the number of hours for which civil servant contracts are issued all contribute to the elevated ratio of retirees to workers. Similarly, remuneration policies suffer from excessive fragmentation which hinders equal treatment and oversight, inviting abuse and complicating control of wage bill growth. Furthermore, while the appropriateness of average salary level of civil servants can be debated, the overall employment contract is heavily backloaded with steep wage increases and generous pensions, clearly making it by far a safer and financially superior option to private sector employment in many cases. This hinders job mobility between private and public sectors, harming economic growth. Big variation in remuneration among different government levels and branches adds to the complicated picture in need of reform.

Current rules of public hiring favor a late start of civil servant career. Given meritocratic approach to hiring and high competition for public posts that offer exceptional job security, the process tends to require a lot of effort from job applicants. Preparation for public examinations can take years, as can gathering of all the credentials that might help secure the coveted position. Figure 20 for Mato Grosso shows a typical situation, where on average people are hired in their early 30s.

The high proportion of retired RPPS members in subnational pension schemes can also in part be explained by low retirement ages. Even though, until recently, civil servants had to make 35/30 years of contributions for men/women respectively before reaching retirement age eligibility, some of those years could be accumulated in private sector employment before joining public service. The requirement for teachers is 5 years shorter, advancing retirement eligibility even more. Uniformed personnel have even more generous requirement reductions. Finally, while most states allow postponed retirement in return to suspended pension contributions, given the very generous pensions and limited financial inducement to prolong careers, many civil servants tend to retire at the first opportunity and continue to enjoy their pre-retirement income. For example, average retirement age in Mato Grosso, as in most states, has recently hovered around age 55 (Figure 20). Combined with a rather late average hiring age of 30, early retirement implies that the length of public servant working life is similar to the length of his or hers pension receipt, while pension receipt can continue even after pensioner's death in a form of survivor benefit. Simple math suggests that a scheme that requires a member to pay contribution rate of 11 to 14 percent of wage for 25 years and then promises to pay back 100 percent of retiree's last wage for an even longer period is bound to run into financial trouble once it fully matures.

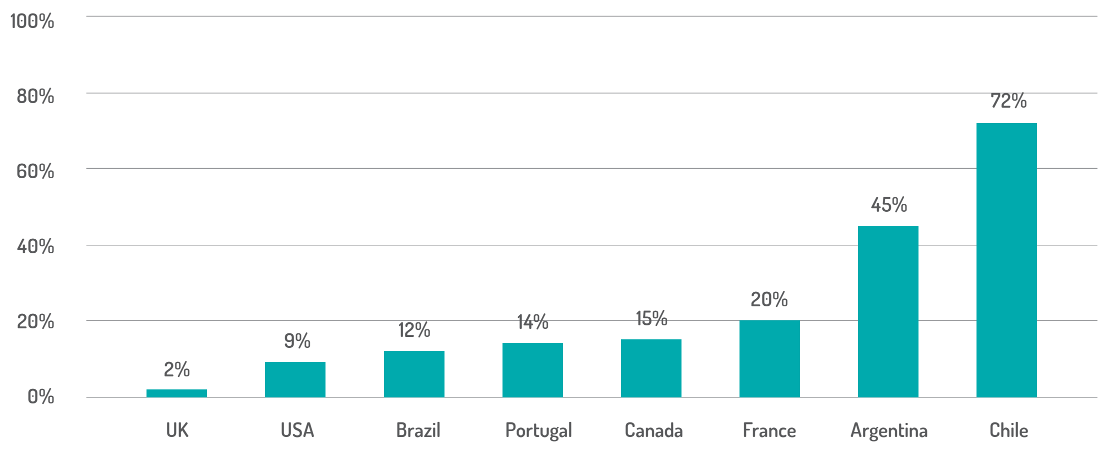
If each permanent civil servant position generates a new pension recipient every 25 or so years, it would be logical to hire some personnel under the general labor contract, which until recently offered much less generous pension benefits. Such approach would be particularly sensible when needed skills are not government-specific, and where the need for services might be temporary. However, the percentage of temporary staff in the Brazilian public administration is low in terms of international perspective. While the federal government's use of temporary staff is close to that of countries with consolidated public civil services (Figure 21), it stands out in comparison to Argentina and Chile, both of which heavily depend on temporary staff.

Figure 20 – Age structure of Mato Grosso civil servants and retirees.



Source: The World Bank using data provided by the state government.

Figure 21 – Percentage of temporary workforce in central governments (2019).



Source: Atlas do Estado Brasileiro (IPEA, 2020).

Some studies[9] have pointed out that the use of state and municipal temporary contracts has been hampered by legal uncertainty. Subnational governments have been exposed to lawsuits by temporary workers seeking the recognition of rights such as maternity leave, stability of employment for pregnant women, and the 13th salary, among others. In some situations, lawsuits have even resulted in the judicial interruption of the use of such contracts. As a result, it is still unclear what is the set of minimum labor rights of these employees. Political pressures by organized labor is another hurdle for subnational governments seeking greater flexibility of labor contracts. For example, Mato Grosso has been increasingly relying on temporary teacher contracts, accumulating 20 million of temporary teachers by 2018. However, the government had to agree to a mass conversion of 5 million of these contracts to permanent positions from 2020, retroactively recognizing their past service as temporaries for the purposes of salary determination and civil servant pension eligibility.

Mato Grosso also brings another interesting example of how human resource policies can be used to limit pension spending in the medium run, without the changes to pension policy. Through the Complementary Law 662/2020, the state has extinguished more than 4,000 civil servant positions reducing the current wage bill as well as future pension liabilities. The policy has built in the strategy of rearranging the structure of service provision through permanent civil servants already in office, compensating for the dispensing of additional functions by a gratification smaller than the full wage paid to the former positions. By canceling existing careers and hiring new civil servants only into newly created careers, wage adjustments given to active personnel do not apply to current pension beneficiaries retired from the old roles.

Senior management positions are dominated by political appointees. In general, any leadership position across government agencies can be filled through a political appointment, despite the

9 The study of Brazilian Public Law Society is the main example of temporary work legal analyses. Available on: https://movimentopessoasafrente.org.br/nossos-temas/matriz-de-vinculos-e-seguranca-juridica/

provision that a portion of these posts need be occupied by career public servants. As a result, Brazil does not have a professional senior management system like, for example, the United Kingdom. This has resulted in a high management position turnover in Brazil to the order of 30 percent per year, elevated further during political transitions (Lopez & Silva, 2020). This practice also substantially elevates pension expenses, as highly paid pre-retirement positions generate a new pensioner with all the position-specific additional benefits every few years. The have also been known practices of senior level pacts, where with the understanding that this is done with the expectation of prompt retirement, so that the lucrative pre-retirement position is bequeathed to the next member of the pact. Since 2019, there have been some initiatives to change this reality. On a small scale, the federal government and some states have initiated competency-based selection processes for senior management positions.[10]

Another human resource policy greatly affecting pension expenses is related to part-time contracts. Among teachers and, to the lesser extent, health professionals, partial employment is often a reality of service provision, for example in a one-shift school. It is customary in such cases to issue a 20-hour per week contract, rather than a 40-hour one. However, sometimes such hiring can be rigid. For example, if a school has a 25-hour per week shifts, but only 20-hour and 40-hour contracts are available, the school would often issue a 40-hour contract, which would later convert into 40-hour based pension calculation. The system would also sometimes encourage gaming, where a 20-hour contract is converted into 40-hour contract a few years prior to retirement, so that 40-hour based pension is generated. It is also not uncommon that some pensioners receive multiple pensions, all from the same or from different subnational governments, where all of the pensions have originated from long-time partial contracts.

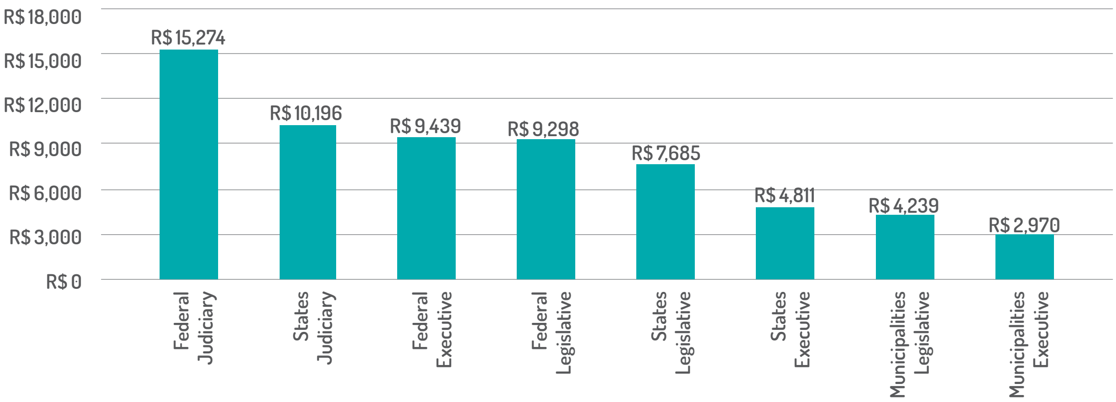
Although the admission to the public service is generally meritocratic, there is room for improvement. Partly due to the fear that any flexibility will make political capture possible, the selection process in the Brazilian public sector can be extremely bureaucratic. The main hiring method are objective tests which only allow the assessment of hard skills (Fontainha et al., 2014). Processes such as interviews, curriculum analysis, and practical tests are scarcely conducted. Thus, behavioral and soft skills competences are not considered. In addition, the selections happen at an unstable frequency, even during periods of economic growth, emphasizing the lack of strategic workforce planning. Workforce planning is generally input and process-driven, and largely focused on responding to new current needs rather than strategic and long-term planning. Civil servants are hired in one job category and must pass competitive public examinations to change into another career stream. Many job categories, even for similar functions, are ministry-specific, and sectoral pressures have resulted in differentiated work conditions across different bodies even for similar functions.

Turning to remuneration policies, there is a big civil servant wage variation between Brazilian government levels and branches, including a substantial public sector wage premium at the federal government and the judiciary (Figure 22). Overall, the average remuneration at the

10 This issue is being discussed in the National Congress.

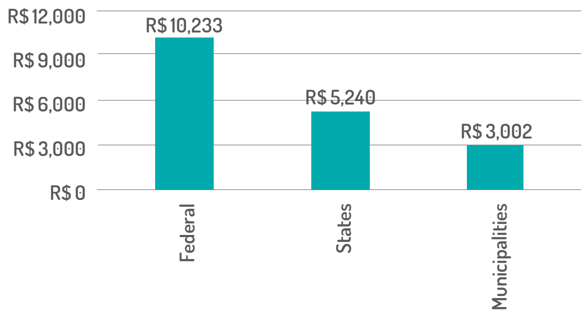
federal level is almost twice that of the states and more than three times that of the municipalities (Figure 23). As a result, the salary premium paid to the federal government is almost 100% higher than that of the private sector (Figure 24). The state level public sector wage premium is close to 40% and there is no premium for municipal public sector employees. The average premium for the entire Brazilian public administration is approximately 20%, close to the average premium observed internationally.

Figure 22 – Average salary by government level and branch (2019).



Source: Atlas do Estado Brasileiro (IPEA, 2020).

Figure 23 – Average salary by government level (2019).

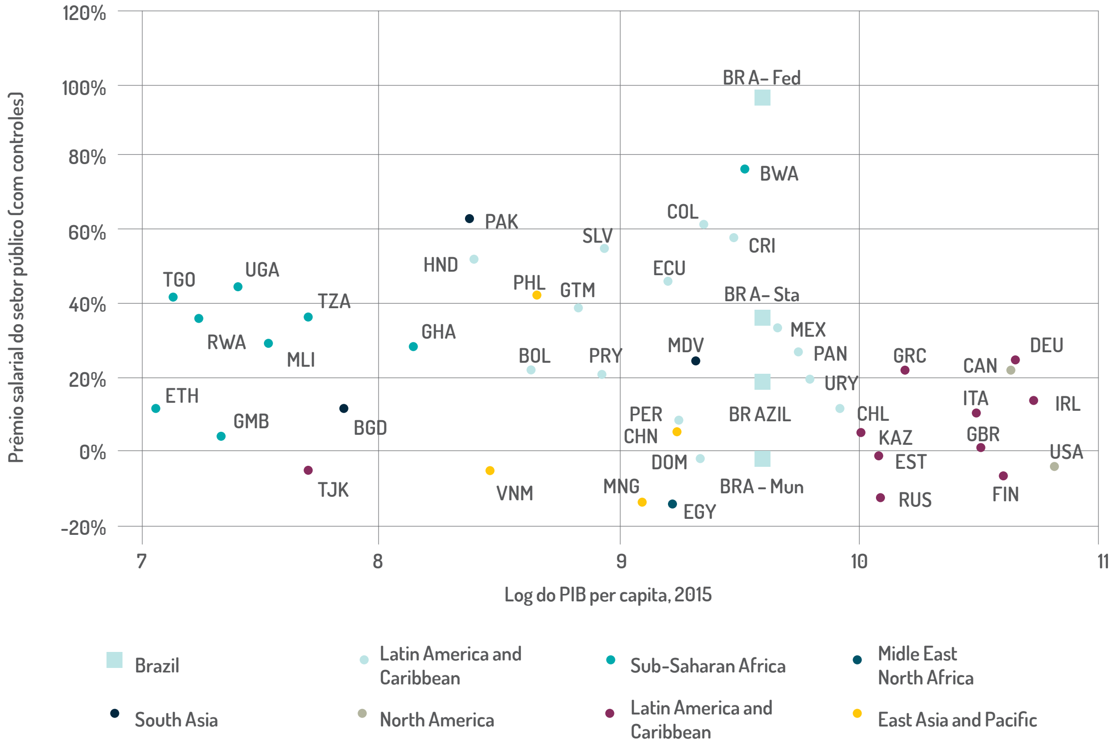


Source: Atlas do Estado Brasileiro (IPEA, 2020).

The civil service is organized in a career system with high fragmentation of salary rules. In the public sector, in general, each career has its own pay scale and particular criteria for salary progression. For example, it is estimated that the federal government has approximately 300 remuneration schemes. Although there have been some attempts to simplify, there are wage differences even between careers with similar job descriptions, e.g. in the case of analyst careers shown in Figure 25. This lack of standardization favors an unequal remuneration policy, in which some specific groups are privileged.[11]

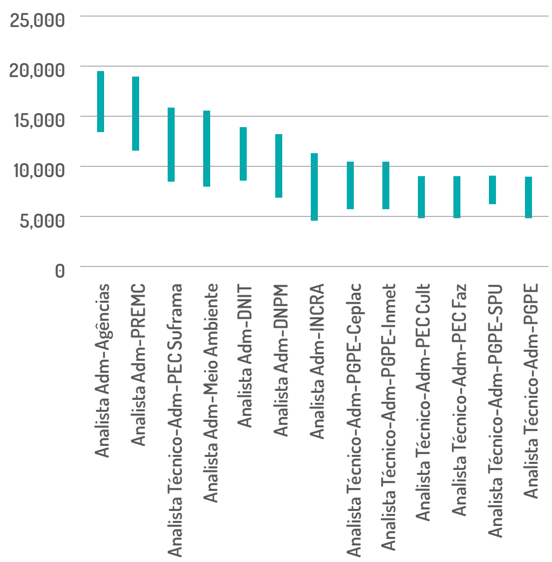
11 For example, in the last two decades careers close to the government center and the security area are more benefited more than the others.

Figure 24 – Public sector wage in relation to the private sector by country.



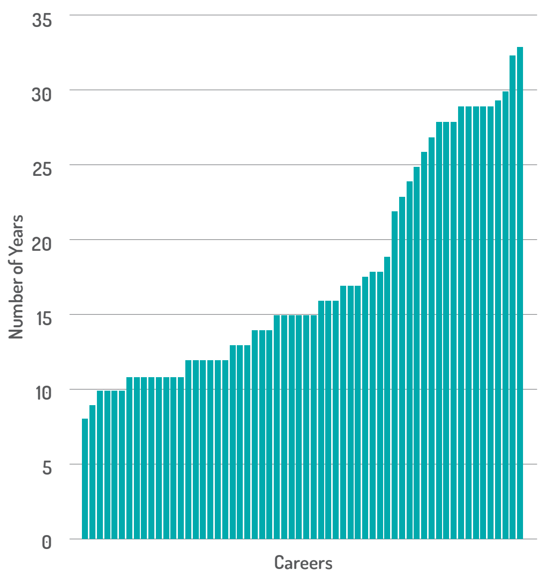
Source: Worldwide Bureaucracy Indicators (Word Bank, 2019).

Figure 25 – Salary range of different analyst careers in federal government (2019).



Source: Nova Administração Pública - Diagnostico Força de Trabalho Governo Federal (ME, 2019)

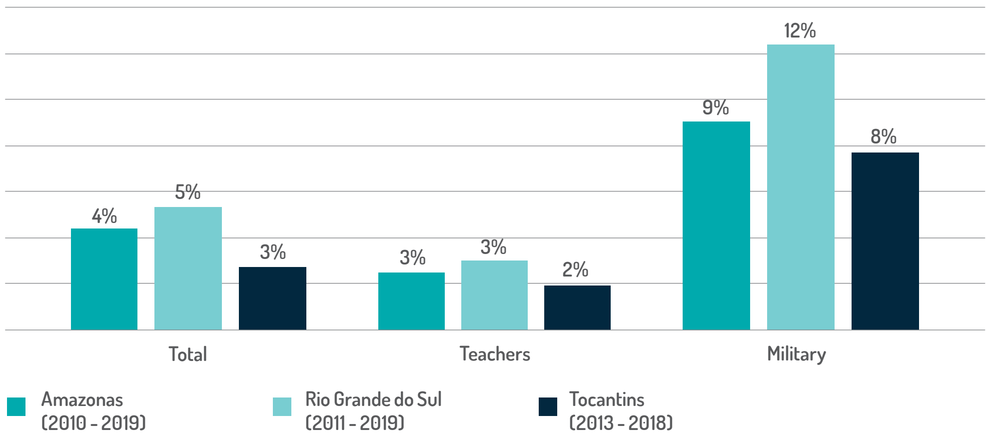
Figure 26 – Average service time until the last career salary level is reached (2019).



Source: Gestão de pessoas e folha de pagamentos no setor público brasileiro (Word Bank, 2019)

In addition, automatic promotions within numerous careers allow employees to reach the top salary in a relatively short period, with two thirds of careers in federal civil service topping out in less than 20 years (Figure 26). States and municipalities generally follow federal public administration rules, but have also introduced many different salary tables and specific progression rules for each career. While progression policies vary across states, there are also important commonalities. Workers are typically not only issued automatic bonuses every three years (trienniums,) but can also submit various continuing education certifications which can move them into a higher salary bracket, not necessarily with a commensurate increase in responsibilities. Uniformed personnel commonly experience especially steep wage growth with seniority (Figure 27), which in many states culminates in one last automatic promotion in rank on the day of retirement, so that the pension benefit equals to that of an immediately superior position. These automatic seniority-related wage increases make it difficult to control the wage and pension bill, as replacements with less experienced and less expensive workers are short-lived. Replacements by young better educated workers might even increase costs, as often happens in education sector, which started hiring teachers with higher credentials and correspondingly higher wages in many states. In those cases, higher pensions should be expected in the future.

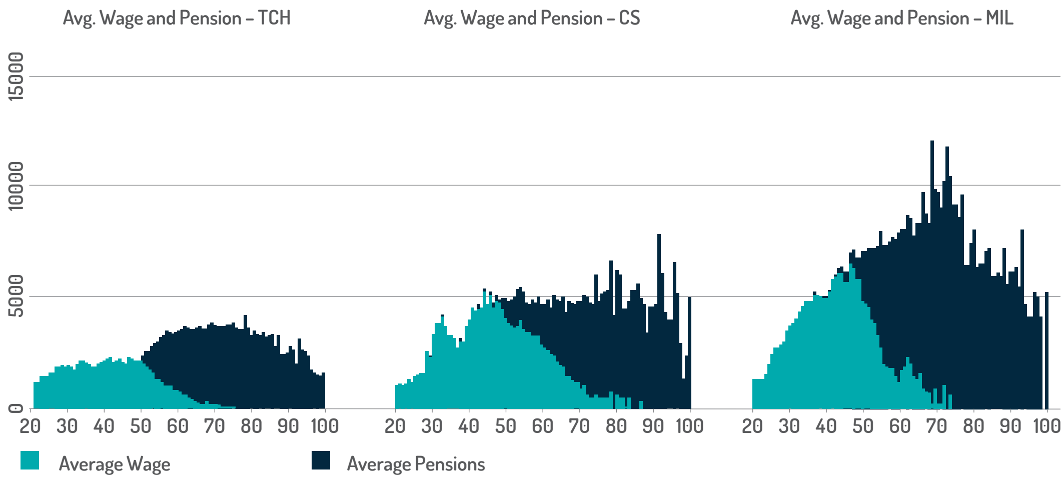
Figure 27 – Recent real wage growth experience in three states with longest time series.



Source: The World Bank using data provided by the state governments.

Due to remuneration policies described above, pensions in Brazil often are higher than wages, as is illustrated with Alagoas data in Figure 28. The graph on the left of the panel shows that average retired teacher incomes at ages 70 to 80 are almost twice as high as those of presumably already experienced teachers at age 50, which is likely an outcome of part-time contracts converted into full-time working arrangements just before retirement. Other civil servants, shown in the middle of the graph, achieve high pension to average wage ratio by means of especially steep wage progression due to seniority. Finally, uniformed personnel enjoy both a steep career progression and pre-retirement boost in income due to pre-retirement increase in rank.

Figure 28 – Average wage and pension income by civil servant age cohort and category of workers – teachers (TCH), Other civil servants (CS) and uniformed personnel (MIL) in Alagoas.



Source: The World Bank using data provided by the state government.

In addition to the problems with career design, other characteristics of the public employment system also make it difficult to control personnel spending. Each of the 5,570 municipalities and the 27 state governments have prerogatives to regulate their civil service. This gives rise to the multitude of different rules and schemes, generally more favorable than the private sector, hard to oversee and regulate, which might encourage abuse. Some examples include poorly accounted leave permissions and holidays, which are often easy to claim second time in the form of monetary payments. A plethora of bonuses and variable remuneration payments further swell the wage bill. Some of such payments are deemed "pensionable" and get entrenched as increased pensions to be paid for many years into the future. The federal government and some states have tried to curb these expenses, but oversight is even laxer at municipal level. It is hard to see how more sensible, efficient, and fairer human resource policies can be achieved without greater unification and simplification of civil servant employment rules, as well as increased transparency and accountability for their implementation.

6

Previous pension policy response to pension spending increases

6. Previous pension policy response to pension spending increases

Rapidly increasing civil servant pension costs at subnational level have long made pension policy a focus of reform discussions geared towards limiting overall personnel expenditure growth. In sharp contrast to human resource policies, which have been lightly regulated at the federal level and, therefore, hard to reform at scale, pension scheme rules that apply to all RPPS schemes have been enshrined in the federal Constitution from the date of its signing in 1988. Two of the original principles, integrality and parity, made those schemes especially expensive. Integrality principle ensured that retirement earnings and survivor benefits correspond to the totality of the servant's last salary as an active worker, often with bonuses associated with the particularities of the last job, for example a bonus for working in a remote school. Parity meant that retirees, and their survivors, had a right to all salary increases, associated with the position from which they retired.

The combination of these two original principles results in extremely generous pensions still in payment today, regardless of numerous pension reform efforts. This could be illustrated by the ratio of retiree benefits to salaries, which is particularly elevated for some careers and states, and is especially prominent among the uniformed personnel (Table 2). However, there is also remarkable diversity in outcomes, underscoring how different human resource policies for various careers in different states can influence overall pension expenses under essentially the same federally prescribed pension rules. For example, the overall pension to salary ratio stands at 67 percent in Ceara and Pernambuco but rises to 125 percent in Mato Grosso do Sul.

Diversity of outcomes is also in part due to the fact that each branch of government at each government level commonly run parallel semi-independent pension schemes, often only using executive branch pension scheme as a payment agency. For example, an internal department of the judiciary or legislative branch of government would have sole access to employee data, decide when an employee is eligible to retire, would calculate his or her pension, and would only ask the executive branch RPPS administrator to pay the stated amount to a certain person from a certain date. This sometimes results in lack of uniformity of benefit assignment rules, when some government branches would include aggregation of certain career-related special benefits into the pension amount, while others would not. Since the data on contributors would not typically be shared with the executive branch, it would not be possible to assess full pension liabilities of the state or audit pension assignment processes and records of other government branches.

Table 2 – Ratio of average benefits and average wages in select states and careers.

STATE	TOTAL	UNIFORMED PERSONNEL	TEACHERS	OTHERS EXECUTIVE	TOTAL EXECUTIVE	OTHERS NON-EXECUTIVE
CE	0.67	1.32	0.54	0.68	0.72	0.96
ES	0.84	1.65	0.9	0.96	0.92	1.32
MS	1.25	1.49	1.06	1.45	1.3	1.51
PB	0.67	1.09	1.14	0.72	0.84	-
PR	0.99	1.27	0.99	0.97	1	1.33
RN	1.04	1.35	1.31	1.05	1.13	1.12
RR	1.21	0.75	0.75	1.94	1.3	-
SC	1.08	1.49	1.22	1.12	1.19	-

Note: The ratios are calculated for different groups of workers and states for which data was available. Source: The World Bank using data from SPREV/Ministry of Economy.

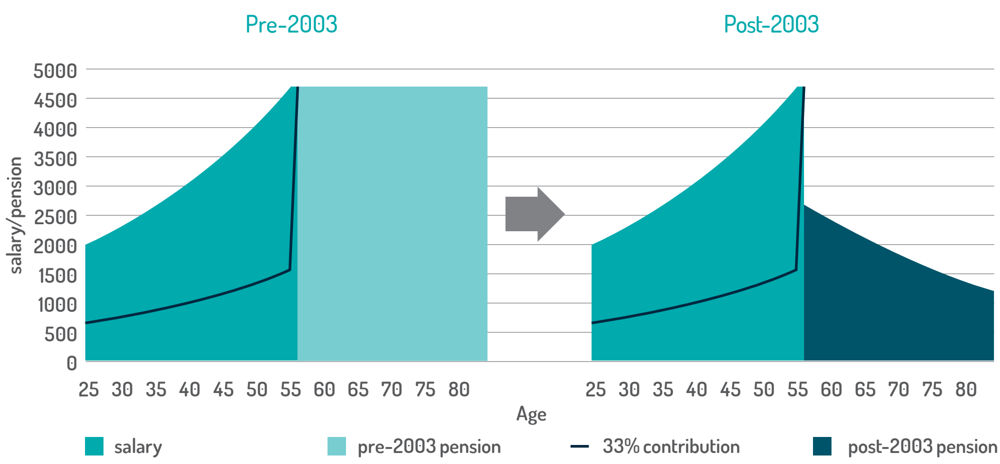
Even though the RPPS pension schemes since their inception were managed separately at each level of government, most of the civil servant retirement rules, including benefit eligibility, amount, and indexation, were initially specified in the Federal Constitution. The entities directly sponsoring specific RPPSs were only allowed, within limits, to set member contribution rates and set some rules for managing the scheme assets. The first pension reform affecting the RPPS took place in 1998 through the Constitutional Amendment 20. The amendment somewhat tightened benefit eligibility conditions, but generous benefit formula was maintained in the Constitutional text. The amendment also determined that eligibility for special pension and survivor benefits would be regulated by ordinary federal level laws, however these did not materialize. However mild, this reform opened the way for further civil servant pension scheme revisions in 2003.

The 2003 reform, through Constitutional Amendment 41, abolished both integrality and parity principles for civil servants. However, the new rules only applied to civil servants that entered public employment after the year 2003. Crucially, the reform also completely excluded uniformed personnel. The major changes in pension rules were 1) to institute the minimum retirement age of still very generous 55/60 for women and men respectively, with 5 year reduction for teachers, 2) to apply the 100 percent replacement rate not to the last salary, but to the average of 80 percent of the highest annual salaries earned over a person's career, indexed to past inflation, 3) switch to inflation indexation of benefits, 4) to levy pension contribution of 11 percent at a minimum on wealthier pensioners who receive benefits that exceed the national insured salary income ceiling threshold, and 5) to allow the establishment of a said insured salary ceiling for civil servants, as long as individual pension savings accounts *(Fundos Complementares)* were offered to civil servants with earnings above that ceiling.

Although on the surface the reform measures might appear mild, they had considerably decreased life-time pension benefit generosity for post-2003 hires. Figure 29 illustrates this effect for a typical civil servant, showing average wage growth indexed life-time salary income in dark blue, 11 percent individual pension contribution plus 22 percent employer pension contribution in a black line, and expected life-time pension benefits in red and light blue for pre- and –post 2003 hires respectively. While for pre-2003 hires life-time pension contributions under the black line in dark blue were clearly significantly lower than life-time retirement benefits, these two areas for post-2003 hires are more comparable in size.

The gains and drawbacks of 2003 reform can be seen in pension expenditure and revenue projections for Mato Grosso generated prior to the latest pension reform of 2019 (Figure 30). The projections separate pre- and post-2003 civil servant pension expenditures, clearly showing that the reform did arrest the growth of these expenses for teachers and other civil servants hired post-2003. However, it is also clear from the graph that the saving-generating effects of the reform have been delayed for a few decades at the time of reform implementation, and that the effects of pre-2003 pension rules will only start to wain around 2040. The long-term cost of exempting uniformed personnel from 2003 reform is also plainly visible from the graph.

Figure 29 – Pension benefits of a typical civil servant before and after the 2003 reform.

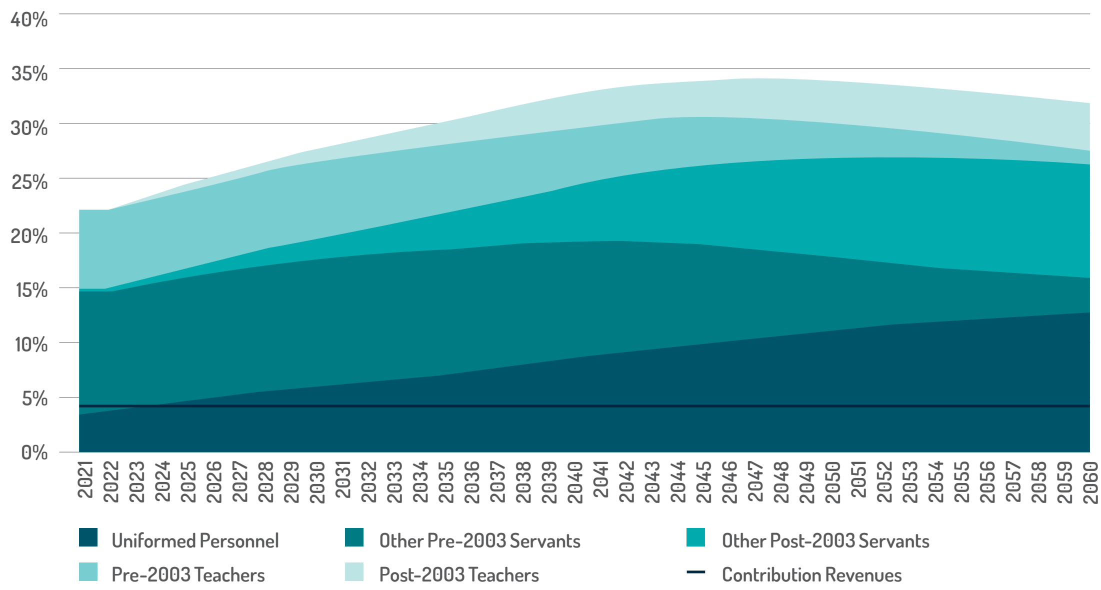


Source: The World Bank.

The projected path of pension deficits for other states follows a similarly shaped trajectory (Figure 31). On average, increase in state pension outlays is projected to rise around 50 percent, from current 15% of the state revenues to 22% in the next 15 years. However, there is a wide dispersion across the state. For example, pension deficit is expected to reach 35 percent of state revenues in Rio Grande do Norte, while the state of Amazonas, which has put a lot of effort in fostering fiscal sustainability of its pension scheme, is projected to peak at the pension deficit of 13 percent of state revenues.

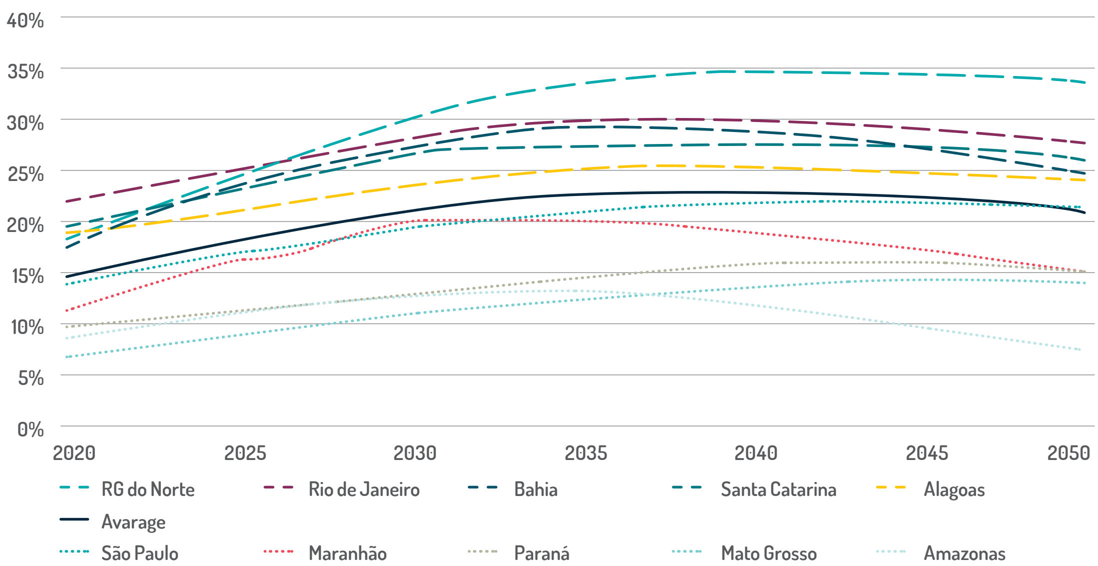
In parallel to politically difficult legal pension reforms, federal government has long encouraged the subnational governments to pre-fund their pension liabilities to prepare for the expected increase in pension spending. The hope also was that, by diverting part of government revenues and assets into RPPS asset build-up, the state will be too fiscally constrained to continue with the pace of profligate hiring and wage increases, which would also indirectly limit pension liability growth. Mechanically, this policy of "wage bill segregation" *(segregação de massas)* worked as follows: new hires would migrate to a new capitalized pension system (*Fundo Previdênciario*), where, due to the initial absence of older members, contribution revenues would exceed expenditures for a few decades, allowing for pension asset build-up to guarantee the future benefits. As the bulk of pensioners remained enrolled in the old system (*Fundo Financeiro*) of the pay-as-you-go type, without a steady influx of new contributors, it was inevitable that, at some point, contributions will no longer be able to cover the benefit payments. The ensuing deficits will then have to be covered by the state, fiscally constraining its expansionary policies. The additional decades-long fiscal effort required from the state to implement this policy of RPPS asset build-up is commonly called "transition cost" and is considered fully paid only after the death of the last member of *Fundo Financeiro*.

Figure 30 – Projection of pension expenditures and revenues, in terms of state revenue (RCL), for the state of Mato Grosso, based on 2017 data.



Source: The World Bank using data provided by the state government.

Figure 31 – Deficit projection of RPPS systems by percentage of current net revenues – selected states.



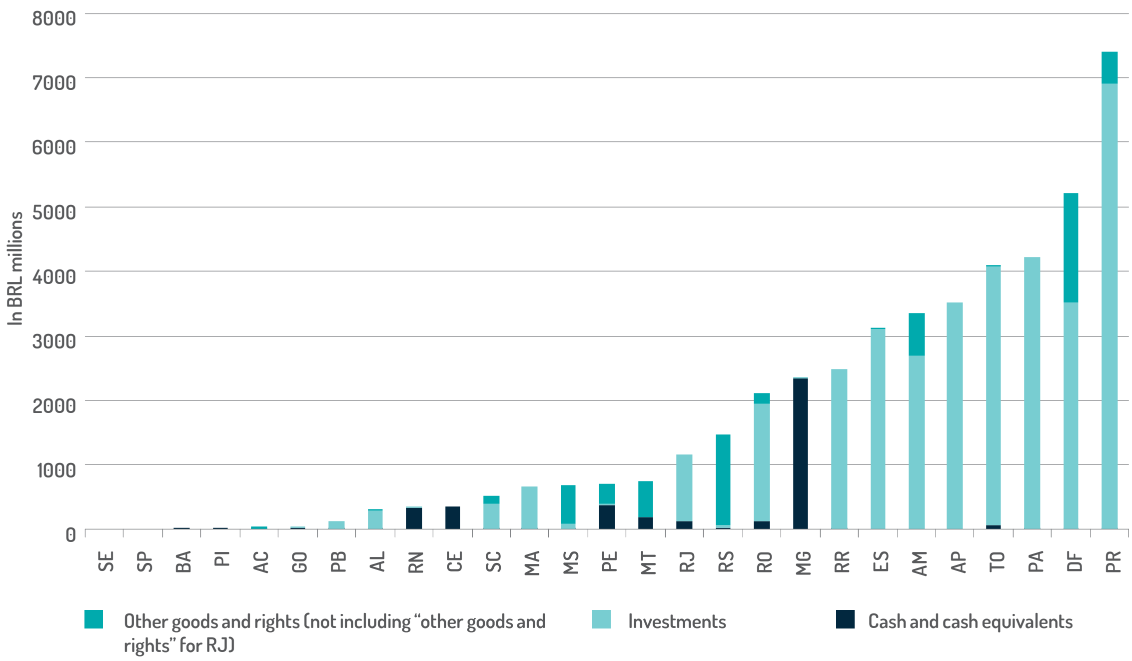
Source: The World Bank projections using data provided by the state governments.

At first, the slow build-up of additional fiscal pressure due to wage bill segregation was manageable, but as deficits of *Fundo Financeiro* continued to grow, many subnational governments have decided to abandon this policy. They have reassigned the resources accumulated in *Fundo Previdenciario* for the payment of *Fundo Financeiro* benefits, which would now cover all civil servants. It usually took just a few years to completely use-up earlier accumulated pension assets, which provided a short-term relief for the state budget. Recently, the decision to abandon asset accumulation in *Fundo Previdenciario* has been made by Minas Gerais (in 2013), Rio Grande do Norte (2014), Santa Catarina (2015), Distrito Federal (2017), and Sergipe (2017). Goiás has extinguished its *Fundo Previdenciario* in 2017 and has recreated it in 2020, with slower pace of accumulation. The total assets accumulated in *Fundos Previdenciarios* by 2017 are shown in Figure 32.

Some states, like Amazonas, have decided to slow asset accumulation in *Fundos Previdenciarios* based on actuarial assessments, which deemed those funds to be overfunded. The complicated process of shifting some soon-to-be paid liabilities from *Fundo Financerio* to *Fundo Previdenciario* was termed "buying of lives", or *Compra de Vidas*. However, the actuarial assessments used to justify this policy are notoriously dependent on a few key assumptions, including the ability of the state to reduce future wage growth of civil servants, and maintain its historically high profitability of investments, which have benefited enormously from the increases of government bond prices in recent past. Just as importantly, *Compra de Vidas* was motivated by extreme budget pressures felt by the states that attempted to maintain their adherence to wage bill segregation policy in the fiscally constrained post-crisis environment.

State of Amazonas remains one of the earliest and most dedicated adherents to the wage bill segregation policy, since year 2003. Still low level of pension scheme maturation in 2003 undoubtedly was one of the important factors that allowed the state to sustain this policy, as pension financing obligations were still relatively low at the time, and transition costs associated with wage bill segregation were not as difficult to accommodate compared to older states. Having maintained pre-funding discipline for 18 years, Amazonas is close to starting to reap the rewards. As retirement flow starts shifting from *Fundo Financeiro* to *Fundo Previdenciario* in a few years, the pension pressure on the state budget will start to decrease. As shown in Figure 31, the peak of the deficits is projected for the year 2032.

Figure 32 – Asset composition of state level pension funds in Brazil – year 2017.



Source: Relatório Resumido da Execução Orçamentária (RREO).

However, maintaining wage bill segregation might be too costly, especially for the states that start the process when their pension scheme maturation is already well advanced. For example, the 2003 pension reform legislation stipulates that the establishment of complimentary individual savings accounts (*Fundo Complementar*) allows the state to impose the ceiling on civil servant wages insured through Previdenciario or Financeiro funds (because the wage above that ceiling could be insured through *Fundo Complementar*), which later leads to capped RPPS benefits. Similarly to wage bill segregation policy, establishment of *Fundo Complementar* also involves transition costs, as some contributions of higher paid civil servants are diverted from *Fundo Financeiro or Previdenciario* to complimentary individual accounts. However, crucially, this policy is combined with the cutting of future pension liabilities to those same higher income civil servants. Unfortunately, high transition costs associated with maintaining wage bill segregation policy have previously precluded a few states, including Amazonas, from taking on additional costs of also transitioning to individual pension savings accounts, at the expense of forgoing an opportunity to reduce their pension liabilities.

The states that have adopted individual pension savings accounts under Complementary Pension Funds usually establish them for newly appointed employees, but a few have also

made it possible for old employees to migrate to the complementary fund. Federal civil servant regime has been one of the entities to offer such switch to employees hired before the establishment of the complimentary fund. In order to entice the workers to switch, it has offered a Special Benefit, to be paid in the form of additional pension, to compensate switching employees for the contributions made before the switch. The Special Benefit has been calculated by prorating generous pre-2003 pension promises to the proportion of contributions paid before the switch. While this still allowed to reduce accumulation of new pension liabilities towards the switchers, liabilities accumulated to date were fully honored. This has established a precedent for the other subnational governments. However, the state of Goias is now preparing a proposal for the Special Benefit based on post-2003 promises, which would be offered to all switching employees, including those hired before 2003. Depending on the take-up rate of this offer, the new approach might allow Goias to cut some of its pension liabilities. Another incentive for the older employees to switch to the new arrangements is the possibility of the difference in contribution rates, with non-switchers required to pay higher extraordinary contributions to finance the growing deficits of *Fundo Financeiro*.

The 2019 federal reform of the pension system has included a mandatory implementation of a complementary regime for all subnational entities, as very few have adopted them following the 2003 reform. The 2019 Subnational Entities Finance Bulletin from the Nacional Treasury Secretariat shows the adoption of wage bill segregation as well as complimentary funds by each state in Brazil (Table 3).

Table 3 – Efforts at RPPS pre-funding: Years of institution and abandonment of wage bill segregation, and year of creation of the complementary pension regime.

STATE	MASS SEGREGATION	EXTINCTION OF MASS SEGREGATION	COMPLEMENTARY REGIME*
AC	No	-	Law authorized
AL	2009	No	Yes
AM	2001	No	Yes
AP	2005	No	Law authorized
BA	2007	No	2017
CE	2013	No	Yes
DF	2008	2017	2019
ES	2004	No	2013
GO	2013 (recriated in 2020)	No	2017
MA	No	-	Law authorized
MG	2002	2013	2015
MS	2012	No	2020
MT	No	-	Yes

PA	2016	No	2016
PB	2012	No	Law authorized
PE	2013	No-	Law authorized
PI	2012	No	2020
PR	2012	No	Law authorized
RJ	2012	No	2013
RN	2005	2014	Law authorized
RO	2012	No	2018
RR	Yes	No	No
RS	Yes	No	2016
SC	2008	2015	2017
SE	No	2017	2019
SP	No	-	2013
TO	-	-	No

Source: 2019 Subnational Entities Finance Bulletin - National Treasury Secretariat. Note: *Authorized: the regime was authorized by local law, but has yet to be implemented.
Note: Year of creation of complementary regime not available for all applicable states.

Policy discussion on containing state pension costs has recently been somewhat unhelpfully focused on state transfers to cover pension scheme deficits, called *Aportes* (see Table 4). These payments amounted to a record BRL 111,6 billion in 2019 and are paid in addition to the resources already allocated to pension schemes in the form of employer contributions and state asset transfers. Between 2016 and 2019, *aportes* grew at the annualized rate of 11 percent, compared to an average annual inflation rate of 4.3 percent. However, concentrating attention solely on *aportes*, or pension deficits, allows celebration of "improvements" through mere accounting changes as is suggested by several pension financing options shown in Figure 33.

Table 4 – Social security cost: unpaid expenses with resources linked to Social Security.

COST OF THE SOCIAL SECURITY SYSTEM TO THE STATE TREASURY (IN MILLIONS)

STATE	2016	2017	2018	2019
AC	R$ 287.57	R$ 408.93	R$ 423.00	R$ 616.67
AL	R$ 1,140.07	R$ 1,285.24	R$ 1,347.44	R$ 1,442.86
AM	R$ 998.82	R$ 1,154.49	R$ 1,252.99	R$ 1,435.36
AP	R$ 34.39	R$ 13.64	R$ 0.82	R$ 0.38
BA	R$ 2,536.86	R$ 3,223.94	R$ 3,656.52	R$ 4,239.64
CE	R$ 1,448.96	R$ 1,576.49	R$ 1,463.65	R$ 1,530.20
DF	R$ 1,211.60	R$ 564.00	R$ 232.94	R$ 643.34

ES	R$ 1,802.43	R$ 1,993.89	R$ 2,283.80	R$ 2,443.30
GO	R$ 2,220.46	R$ 2,613.11	R$ 2,622.55	R$ 3,415.53
MA	R$ 763.46	R$ 1,137.08	R$ 838.01	R$ 993.08
MG	R$ 13,401.81	R$ 15,321.64	R$ 17,363.29	R$ 18,099.53
MS	R$ 1,135.72	R$ 1,658.24	R$ 897.18	R$ 1,208.09
MT	R$ 1,104.92	R$ 1,395.85	R$ 1,619.54	R$ 1,740.05
PA	R$ 2,227.59	R$ 1,423.78	R$ 1,265.90	R$ 1,936.75
PB	R$ 1,135.03	R$ 1,302.74	R$ 1,418.30	R$ 1,501.53
PE	R$ 2,132.31	R$ 2,562.64	R$ 2,650.04	R$ 3,079.16
PI	R$ 573.36	R$ 456.91	R$ 1,405.95	R$ 1,715.28
PR	R$ 2,299.45	R$ 4,449.74	R$ 4,915.45	R$ 6,021.94
RJ	R$ 10,821.08	R$ 13,063.00	R$ 12,312.85	R$ 13,390.06
RN	R$ 1,398.06	R$ 1,502.36	R$ 2,295.50	R$ 2,333.85
RO	R$ 8.20	R$ 8.19	R$ 6.77	R$ 92.13
RR	R$ 26.77	R$ 5.27	R$ 5.30	R$ 0.56
RS	R$ 9,748.63	R$ 10,699.11	R$ 11,089.54	R$ 11,880.51
SC	R$ 3,070.13	R$ 3,665.12	R$ 3,820.84	R$ 4,164.67
SE	R$ 896.84	R$ 946.42	R$ 762.93	R$ 986.32
SP	R$ 19,796.65	R$ 21,339.70	R$ 24,081.00	R$ 26,302.35
TO	R$ 0.04	R$ 214.47	R$ 548.74	R$ 455.26
Total	R$ 82,221.20	R$ 93,986.01	R$ 100,580.85	R$ 111,667.29

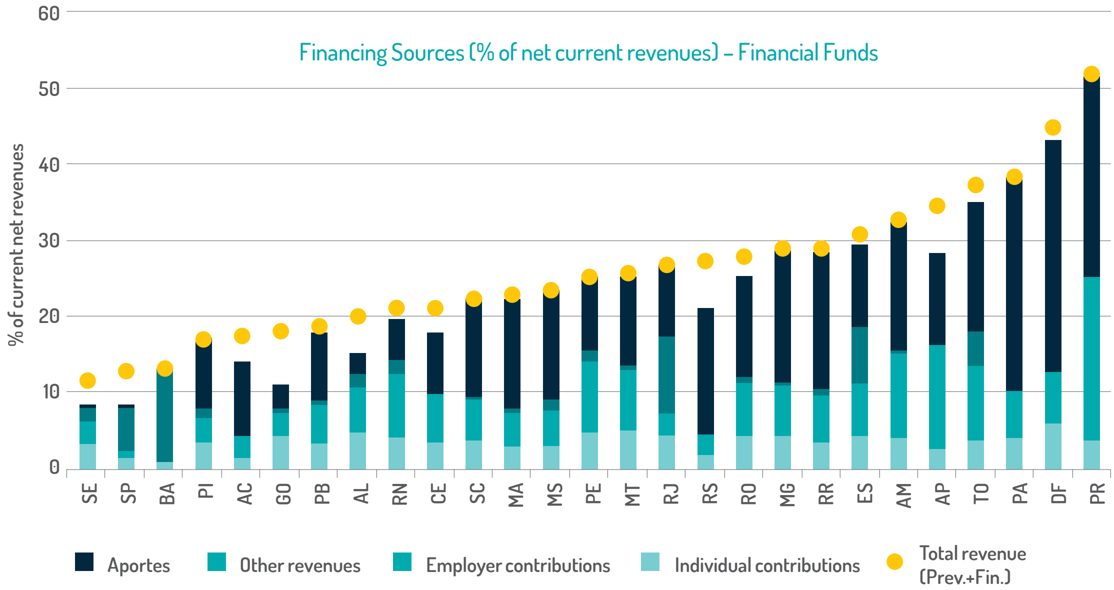
Source: 2020 Subnational Entities Finance Bulletin - National Treasury Secretariat.

One idea has been to require state RPPSes to prepare long term asset and liability management plans, *Planos de Custeio*, in order to reduce pension deficits and strengthen the fiscal position of RPPS pension funds in the long term. While the long-term focus of this policy is to be celebrated, it may have encouraged states and municipalities to transfer state assets to RPPS pension funds. For example, Rio de Janeiro state has transferred the ownership of some state oil assets to state RPPS, and in so doing has "diminished" civil servant pension scheme deficits to be financed by the state. While the asset transfer has formally kept the state in compliance with Fiscal Responsibility Law, the state annually transfers large share of the petroleum royalties directly into the state RPPS budget (seen as other revenue in Figure 33), having directed over BRL 9,7 billion in first four months of 2021 alone.[12] While from a narrow perspective of RPPS's fiscal sustainability this approach might be tempting, it only amounts to accounting exercise and does not create additional fiscal space for state investments and provision of public services. Increased employer contributions to deficitary

12 http://www.fazenda.rj.gov.br/petroleo/despesa/2020.html, accessed on May 27 2021.

pension funds suffer from the same flaw, even though such approach might help politically constrain inefficient state spending in other areas. Meanwhile, the only true solutions to arrest crowding out of state fiscal space by personnel costs amount to finding ways of reducing wage and pension expenditures without jeopardizing provision of public services. This, in turn, involves reducing unfairly high life-time compensation for public servants and improving service provision efficiency.

Figure 33 – Financing sources of Fundos Financeiros of state RPPS schemes, 2017.



Source: Relatório Resumido da Execução Orçamentária (RREO).

7

Adoption of Federal 2019 reform by subnational governments

7. Adoption of Federal 2019 reform by subnational governments

The political consensus for 2019 Pension Reform in Brazil grew out of the realization that Brazil's pension spending was unfairly distributed and was one of the major contributors to the increasing indebtedness of the country, both at the federal and subnational levels. Subnational governments were also increasingly frustrated by various spending limitations imposed by the Fiscal Responsibility Law on one hand, and federally mandated generous pension parameters on the other. Therefore, federal pension reform of 2019 has devolved some decision power to the states and municipalities, but also included provisions to promote fiscal sustainability and better governance of pension schemes. The list of the most important reform elements is presented in Table 5. While expected fiscal impact of these measures will vary across subnational entities, some qualitative assessment is possible, and is discussed below in greater detail.

The Federal Constitution text now only defines limits within which state and municipal entities must issue their own local laws in order to organize their civil service pension schemes. These limits also include the requirement that subnational entities implement certain *mandatory changes*, including preparation of management plans (*Planos de Custeio*) to inform how pension liabilities will be financed in future years, unifying pension scheme administration of different government branches under single management unit, exclusion of short term benefits, like maternity and sickness, from the RPPS benefit rolls, offering complimentary pension savings plans to civil servants that earn wages above mandatorily insured wage ceiling, imposing minimum individual pension contribution rate of 14 percent[13], and implementing federally prescribed pension arrangements for the uniformed personnel[14].

13 The exception only applies to subnational entities without actuarial deficits.

14 Constitutional Amendment 103/2019: (a) art 1 (alters art.40 §20 of the CF88); (b) art. 9 §4 and art. 11; (c) art. 9 §6; (d) art. 10 §1; (e) art 1 (alters art.201 §10 of the CF88) and art. 9 §2 and §3; (f) art 1 (alters art. 149 §1-A of the CF88); (g) art. 23.

Table 5 – Most important elements of 2019 pension reform:

	EXPECTED CONSOLIDATED FISCAL IMPACT
MANDATORY REQUIREMENTS FOR ALL SUBNATIONALS	
Preparation of Planos de Custeio	None, but allows better planning
Unifying administration of pensions of all government branches	Enables benefit audits, potentially saving up to 20% of expenditures, according to the experience in the states of Alagoas and Santa Catarina
Exclusion of short term benefits from RPPS	None, but adds transparency
Instituting complimentary pension funds	Some cost short term, savings long term
Minimum contribution rate of 14% or equivalent progressive rates	Increases revenues by 27% for entities that had 11% contribution rate
Uniformed personnel pension reform	Costly short term, limited savings long term. Involved rolling back some of the fiscal gains due to earlier reforms in some states.
MEASURES IMPLEMENTED FOR FEDERAL CIVIL SERVANTS AND OPTIONAL FOR THE SUBNATIONAL ENTITIES	
Retirement age increase to 62/65	Minimal savings short term, savings in very long term
Revision of survivor benefits	Important immediate and lasting savings
Increase in pensioner contribution base	Strong immediate and lasting increase in revenue and improvement in equity
Allowance for extraordinary contributions	none now, but easier to raise revenue when needed

However, Federal Constitution retains exclusive power to determine pension scheme rules applicable to federal public servants, which was immediately exercised in 2019 with a list of important parametric changes. In addition to improving fiscal situation of the federal civil servant pension scheme, these changes were also intended to provide an optional template for the follow-up subnational pension reforms. The changes, including retirement age increase to ages 62 and 65 for females and males respectively, revision of survivor benefit formula and eligibility, increase in retiree contribution base, and allowance of extraordinary pension contributions, are referred to as *optional*, as they can be adopted by the subnational entities at their own discretion, and should be implemented through the local laws (Table 6). Subnational governments are, in principle, allowed to strengthen their parametric reforms beyond what was approved for the federal civil servant scheme. Some older states in weaker fiscal position might need to exercise that option. However, so far, most of the first-mover states have opted to copy or weaken down federal civil servant reform, prioritizing political expediency. The adoption of mandatory and optional reforms to date is summarized in Table 6.

By January 2022, all states had adjusted their pension contribution rates or already had rates appropriate to the provisions of Constitutional Amendment 103. In addition to federal civil servant scheme (see Box 1), seven states have adopted progressive contribution rates: Bahia, Maranhão, Minas Gerais, Rio Grande do Norte, Rio Grande do Sul, Roraima and São Paulo. Piauí state has set a flat rate for active civil servants and progressive rate for the pensioners. The Federal District chose a linear contribution rate for active civil servants and progressive rate for pensioners and survivors. Finally, Goiás has adopted a flat rate of 14.25%, higher than the contribution rate of federal civil servants (see Box 2).

Table 6 – Adoption of the parameters of the Constitutional Amendment 103/2019 by states (by January 2022).

UF	Mandatory					Recommended			
	Single management unit[1]	Contribution rates at 14% (or progressive)		Complementary regime	Exclusion of short term benefits from RPPS	Age of retirement (female/male)[2]	Increase of contribution base: Pensioners' limit for exemption of contribution	Legal provision for extraordinary contribution	Proportional survivors benefits
AC	no	linear	14%	law authorized	yes	62F/65M	RGPS ceiling	no	yes
AL	no	linear	14%	yes	yes	62F/65M	1MW	no	yes
AM	yes	linear	14%	yes	yes		RGPS ceiling	no	
AP	no	linear	14%	law authorized	no		RGPS ceiling	no	
BA	no	progressive	14%, 15%	yes	yes	61F/64M	3 MW%	no	yes
CE	no	linear	14%	yes	yes	62F/65M	RGPS ceiling	no	yes
DF	yes	linear (active CS), pregressive (pensioners, survivors)	14% (active civil servants); 11% from 1 MW up to RGPS ceiling and 14% above RGPS ceiling (pensioners and survivors)	yes	yes		1 MW	no	
ES	no	linear	14%	yes	yes	62F/65M	RGPS ceiling	no	yes
GO	no	linear	14.25%	yes	yes	62F/65M	1 MW	no	yes
MA	no	progressive	7.5%, 9%, 12%, 14%, 14.5%, 16.5%, 19%, 22%	law authorized	yes		RGPS ceiling	no	
MG	yes	progressive	11%, 12%, 13%, 14%, 15%, 15.5%, 16%	yes	yes	62F/65M	3 MW%	yes	yes
MS	yes	linear	14%	yes	yes	62F/65M	1 MW	yes	yes
MT	yes	linear	14%	yes	yes	62F/65M	RGPS ceiling	no	yes
PA	no	linear	14%	yes	yes	62F/65M	RGPS ceiling	no	yes
PB	no	linear	14%	law authorized	yes	62F/65M	RGPS ceiling	no	yes
PE	no	linear	14%	law authorized	yes		RGPS ceiling	no	
PI	no	linear	14% (linear actives) 11%,12%,13% e 14% inactives	yes	yes	62F/65M	RGPS ceiling	no	yes
PR	yes	linear	14%	yes	yes	62F/65M	3 MW	no	yes
RJ	no	linear	14%	yes	yes		RGPS ceiling	no	
RN	yes	progressive	11%, 14%, 15%, 16%, 18%	law authorized	yes	60F/65M	RGPS ceiling	no	yes
RO	no	linear	14%	yes	yes		RGPS ceiling	no	
RR	yes	progressive	11%, 11,5%, 12%, 12,5%, 13%, 13,5%, 14%	no	no		RGPS ceiling	no	

UF	Mandatory					Recommended			
	Single management unit[1]	Contribution rates at 14% (or progressive)		Complementary regime	Exclusion of short term benefits from RPPS	Age of retirement (female/ male)[2]	Increase of contribution base: Pensioners' limit for exemption of contribution	Legal provision for extraordinary contribution	Proportional survivors benefits
RS	no	progressive	7.5%, 9%, 12%, 14%, 14.5%, 16.5%, 19%, 22%	yes	yes	62F/65M	1 MW	no	yes
SC	yes	linear	14%	yes	yes		RGPS ceiling	no	
SE	no	linear	14%	yes	yes	60F/65M	1 MW	no	yes
SP	yes	progressive	11%, 12%, 14%, 16%	yes	yes	62F/65M	1 MW	yes	yes
TO	yes	linear	14%	no	yes		RGPS ceiling	no	

Notes: (1) Declared by the entities or in the official webpages of the subnational pension system. (2) States that did not reform the age limit remain at the age thresholds of 55 for women and 60 for men. (3) States that did not reform maintain the exemption limit at the RGPS ceiling (BRL 6,433.57). Source: The World Bank using data from SEPREV/Ministry of Labor, data provided by the state governments and data available in official webpages of the subnational entities.

Very few states have consolidated the management of pensions from all their government branches into a single RPPS management unit. Some implementation delays regarding this mandatory reform have been due to the complications in integrating different IT solutions now used by separate branches to assign and monitor benefit payments. However, even the states that are making steps towards integration of pension sub-schemes tend to take a narrow view of the task, and rarely attempt a more ambitious integration of some human resource and pension assignment system functions. Nevertheless, such integration would be crucial in order for 1) human resource policy decisions to be informed about their pension cost implications in the short, medium and long term; 2) pension liability monitoring to be more precise by early forecasting of new retiree inflows and their expected benefits.

The difficulties at technological integration are also likely to sometimes become scapegoats for the reluctance of different government branches to share power and information. Nevertheless, integrated IT solutions are fundamental in improving efficiency and fairness of the pension scheme. The requirement for all public employers to report individual level employee data into a federal eSocial database from April 2022 (already mandatory for private employers) offers unique opportunity to systematize data in a common format. It is important to ensure that subnational RPPS have legal authority to access this data for all government branches in order to fully perform their record management and audit duties. Recent experiences from Alagoas and Santa Catarina suggest that pension record audit, greatly simplified by improved IT solutions, could yield savings of 10 to 20 percent of pension expenditures.

Box 1 – Federal RPPS contribution rate progressivity implemented by the 2019 reform.

While the 2019 Reform brought a progressive contribution rate varying between 7.5 percent and 14 percent to private sector workers, rates applied to federal civil servants are even more progressive (art.11 §1º). From January 2021, federal civil servants started contributing between 7.5 percent and 22 percent of their salaries. Rates are applied on the portion of the salary that fits into each contribution range. The exception to these 'higher level' rates were made for the federal servants hired before 2013 who contribute to the complimentary individual pension accounts. For these, their contribution remained limited to the 14 percent rate, to incentivize the take up of complimentary funds.

SALARY RANGE	RATE
Up to 1 minimum wage (R$1,100.00)	7.5%
From R$1,100.01 to R$2,203.48	9%
From R$2,203.49 to R$ 3,305.22	12%
From R$3,305.23 to the national insured wage ceiling (R$6,433.57)	14%
From R$6,433.58 to R$ 11,017.42	14.5%
From R$ 11,017.43 to R$22,034.83	16.5%
From R$22,034.84 to R$ 42,967.92	19%
Above R$ 42,967.93	22%

Source: INSS and Agência Brasil. Note: Salary ranges are subject to adjustments at the same date and by the same index used to adjust the RGPS benefits, which are themselves currently indexed to inflation; except for the minimum wage threshold, which follows specific legislation.

Twenty-five states have already established a complementary pension regime or approved the legislation for its implementation. The creation of complementary pension funds had been previously allowed by the 2003 pension reform. However, they were not implemented by the subnational entities until early 2010's. The oldest complementary pension funds were started in 2013 and 2014 (SP, RJ and ES), and most of the funds were created very recently, between 2019 and 2020, thus fostered by the 2019 federal reform. The Constitutional Amendment 103/2019 determined that subnational entities should establish complementary pension regimes by November 2021.

Regarding the last mandatory item of the 2019 pension reform, 22 states removed short term benefits from RPPS benefit rolls. The excluded benefits consist of maternity benefits, occupational accident insurance benefits, and similar, which will be paid by the same entities that administer payments of worker wages. The aim of the reform is focusing RPPS exclusively on the payment of retirement pensions and survivor benefits (Constitutional Amendment 103/2019 art.9 par.2).

To enforce the adoption of the mandatory rules by the subnational entities, ordinance n.18,084 of July 29, 2020 determined that states, the Federal District, and municipalities should report to the federal Social Security Secretariat on the compliance with these requirements. The compliance with these rules will be treated as a necessary condition to obtain the Social Security Regularity Certificate, which in itself is a requirement for receiving discretionary Federal Government transfers and permissions for credit operations with federal public banks. The summary of mandatory reforms adopted so far by the states is shown in Figure 34. The progress of reform by municipalities is discussed in Box 3.

Box 2 – State of Goiás - the first adopter of the 2019 federal pension reform.

By January 2019, Goiás' RPPS had 67,249 retired civil servants compared to 62,940 active workers, a 73 percent growth in retirees over the last 10 years. The 2019 payroll was about BRL 2.9 billion and was projected to reach BRL 6 billion within a decade, in the absence of a pension reform. According to the state's Secretariat of Economy, spending on civil servants' pensions and survivor benefits was larger than the state's investments in education and health. In late 2019, the state government sent to the Legislative Assembly a Pension Reform bill for public sector employees, which was quickly analyzed. In December of that year, immediately after passage of the federal law that allowed the state to implement its own reform, the State Constitution Amendment 65/2019 was enacted, taking advantage of the political momentum generated by the federal reform discussion.

Goiás adhered almost entirely to the federal pension reform, except for the adoption of progressive contribution rates and allowance of the extraordinary contribution rates. The state has determined that, given lower salaries in Goiás in comparison to federal civil servant wages, a progressive contribution rate schedule identical to that of the federal government would result in lower overall contribution revenues. In fact, the contribution rate in Goiás was set to 14.25%, the only state in Brazil to have set a higher contribution rate than the required floor of 14% determined by the Federal Constitution.

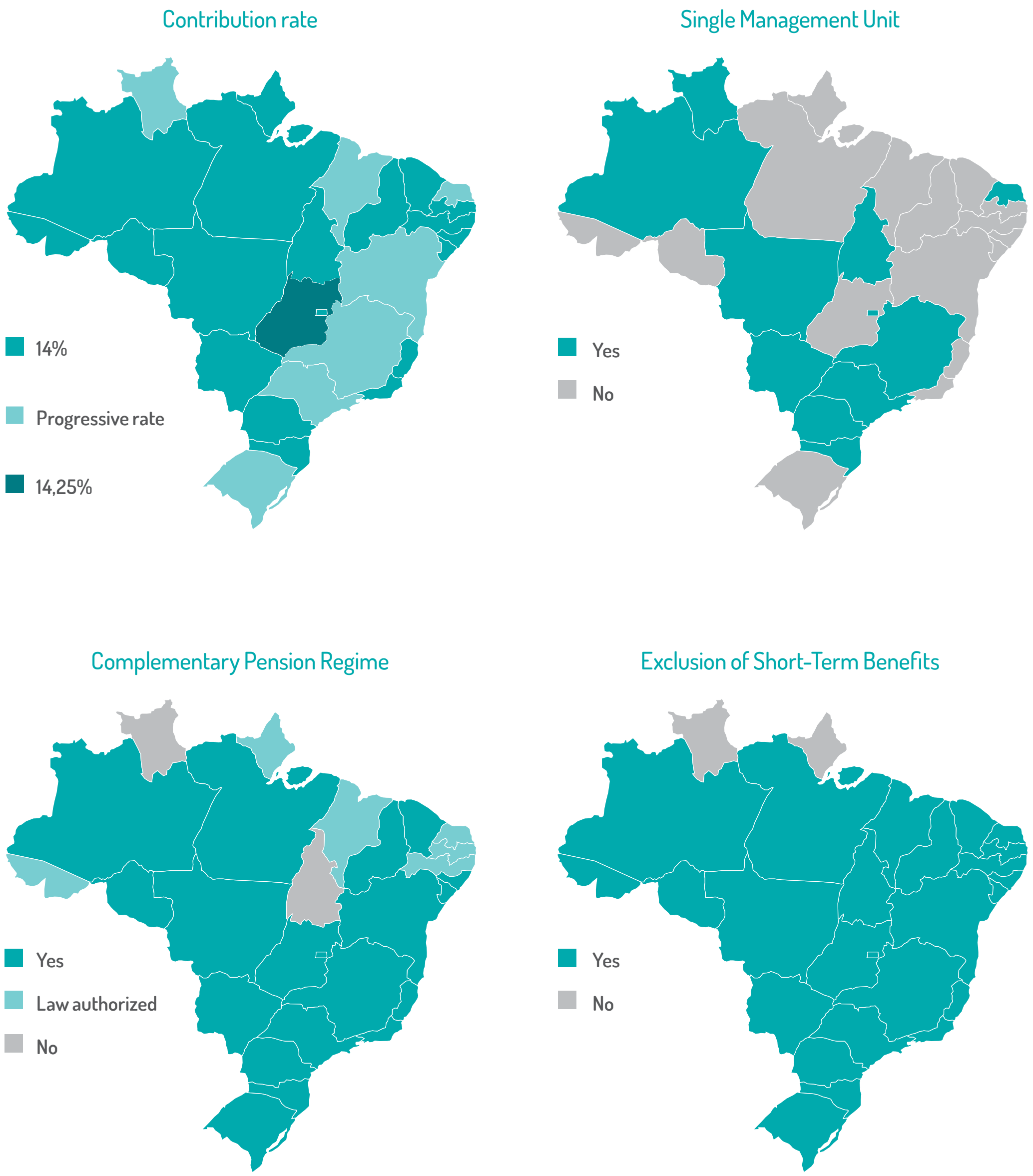
At the same time, Goiás has also implemented complimentary individual account system with accumulated assets, for efficiency purposes, managed by an already operational Sao Paulo scheme. Furthermore, Goiás is proactively organizing its municipalities to join its complimentary fund, reducing the overall costs of asset management. This sets a great example for other states to follow.

Source: https://www.goiasprev.go.gov.br/, accessed on May 2021.

The pension rules for the uniformed personnel have also been reformed through a separate Law 13954 in 2019 but, in this case, parameter changes were set at the federal level, with subnational governments mandated to adopt the law in its entirety. This separate law maintains more generous benefits for the uniformed personnel, including policemen and firefighters, compared to other civil servants, due to two distinct rules: 1) after 35 years of work, uniformed personnel can request retirement regardless of their age; the eligible length of service can include up to 5 years of work in private sector and, in some states, can be augmented by fictitious time, where unutilized vacation time is multiplied by two and added to the length of service; and 2) pension benefits preserve the principle of integrality and parity, setting retiree pension to equal to the last years' salary indexed to the salary growth associated with the last position.

The Law 13.954 has also expanded pensioner contribution base to the whole pension amount and reduced contribution rate to 9.5 percent for 2020 and 10.5 percent for 2021 onwards for uniformed personnel. Survivor pensions were also made subject to contributions for the first time, starting in 2021. The federal law will set new contribution rates after 2025. There are, however, states that obtained court decisions ensuring that the rates can be determined by local laws and not by the federal legislation (e.g. Rio Grande do Sul) Thus, the reform of the military will have strong and varied fiscal impacts on the subnational entities, requiring them to cover the deficits of the scheme, while at the same time taking away decision power to set pension rules. In the case of Mato Grosso, the pension deficits of this sub-scheme have increased immediately after the reform, as shown in the right panel of Box 4. One of the few remaining tools to influence uniformed personnel pension deficits through subnational policy is human resource policy. For example, a state could potentially hire all soldier level recruits as temporaries, and only convert them to permanent personnel if and when they are promoted in rank.

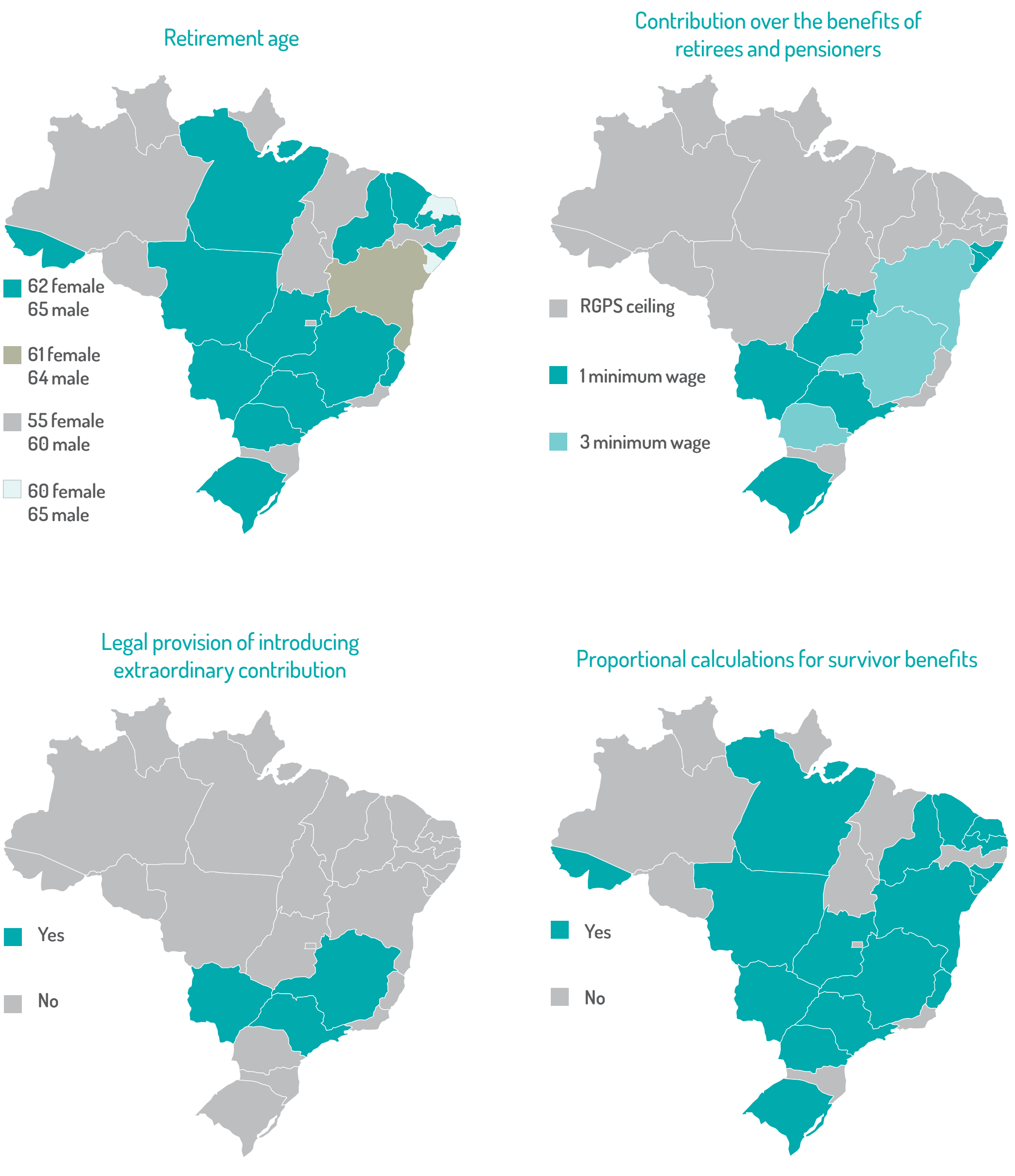
Figure 34 – State level implementation of mandatory federal reform features.



Source: The World Bank, using data from SPREV/Ministry of Economy, data provided by state governments and consultation to official webpages.

From the optional reform features (see Figure 35), expansion of contribution base for pensioners has the largest potential to generate immediate reduction in pension deficits. Contribution assessed on the benefits of retirees and pensioners was already established as part of the reform of 2003, but it only applied to the portion of the pension that was above the national insured wage threshold. An important measure of 2019 federal civil service reform allowed to expand that contribution base to pension payments above minimum wage. However, only seven states in Brazil have so far lowered the exemption threshold to one minimum wage (about USD 200). The immediate effect of this reform on pension deficit can is illustrated in Box 4 for Mato Grosso.

Figure 35 – State level implementation of optional federal reform features.



Source: The World Bank, using data from SPREV/Ministry of Economy, data provided by state governments and consultation to official webpages.

Box 3 – The adoption of the 2019 reform measures by municipal governments.

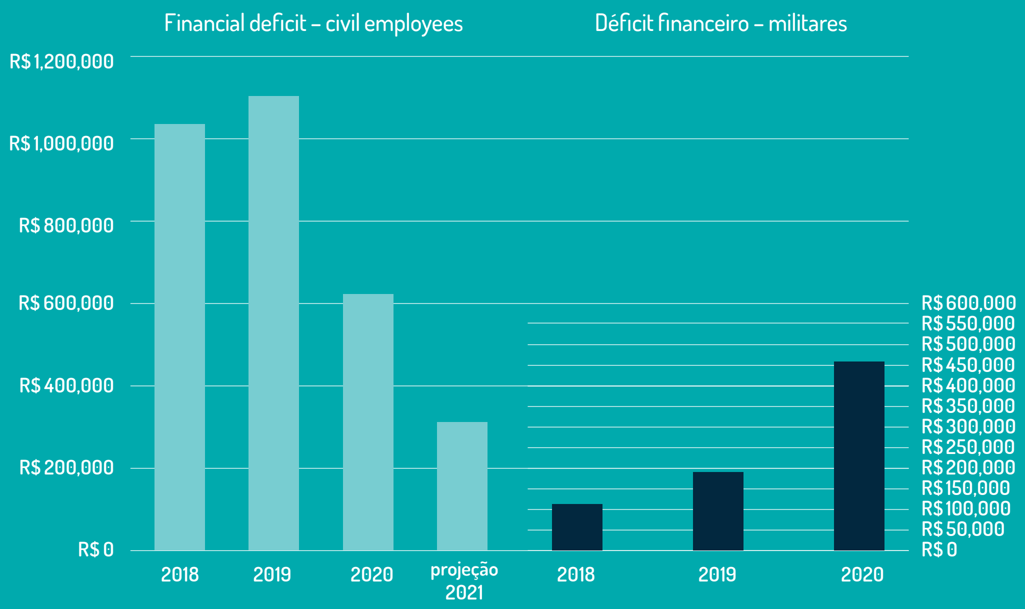
By 2020, thirty eight percent of Brazil's 5,570 municipalities run their own RPPS regimes; 74% of these 2,151 RPPSs have equated their contribution rates to the 14% threshold or implemented an equivalent progressive contribution rate schedule, and eliminated short term benefit payments from their books, following the determination of the Constitutional Amendment 103. While many municipalities maintain that their actuarial balances are positive and 14 percent contribution is not necessary, the validity of these actuarial assessments can often be disputed. The assessments can be substantially influenced by optimistic assumptions about the ability of municipal governments to contain future wage growth and maintain profitably of its investments, which has recently greatly benefited from the run-up of government bond prices.

STATE	QUANTITY OF RPPSS IN THE STATE	CONTRIBUTION RATES AT 14% (OR PROGRESSIVE)	%	EXCLUSION OF SHORT TERM BENEFITS FROM THE RPPS ROLL	%
AC	2	1	50%	0	0%
AL	74	5	7%	3	4%
AM	4	0	0%	0	0%
AP	27	0	0%	0	0%
BA	37	3	8%	4	11%
CE	65	3	5%	4	6%
DF	1	1	100%	0	0%
ES	35	9	26%	6	17%
GO	171	18	11%	9	5%
MA	47	0	0%	1	2%
MG	107	28	26%	13	12%
MS	51	3	6%	4	8%
MT	222	22	10%	22	10%
PA	30	1	3%	1	3%
PB	71	4	6%	1	1%
PE	179	22	12%	17	9%
PI	149	9	6%	4	3%
PR	70	5	7%	3	4%
RJ	80	7	9%	2	3%
RN	40	2	5%	2	5%
RO	332	92	28%	54	16%
RR	30	8	27%	3	10%
RS	2	0	0%	0	0%
SC	70	19	27%	12	17%
SE	221	43	19%	17	8%
SP	4	0	0%	0	0%
TO	30	0	0%	0	0%
Total	2151	305	14%	182	8%

Source: 2020 Subnational Entities Finance Bulletin - National Treasury Secretariat.

Box 4 – Immediate results of the Pension reform adopted by the state of Mato Grosso.

The pension reform in the state of Mato Grosso was implemented from the 2nd quarter of 2020 through the adoption of four items of the federal reform: (i) the contribution rate was raised to 14% (Complementary Law 654, of 02/19/2020; (ii) retirement age was increased to 62 (female) and 65 (male) years old, (iii) 2019 federal civil service reform of survivor benefits was adopted (State Constitutional Amendment 92, of 08/18/2020); and (iv) complementary regime was established (Complementary Law 670, of 09/04/2020). The fiscal impact of the reform was felt within the same fiscal year, almost exclusively from expanding the contributory base.



Source: MTPrev, May 2021.

The reluctance by states to adopt the expansion of contributory base for pensioners is a loss of opportunity for a more effective adjustment. The 2003 reform has introduced big unfair differences in treatment between the pre-2003 and post-2003 entrants into the public service. The pensions of pre-2003 entrants are heavily subsidized by state and the contribution base extension to them would only claw back a small portion of this subsidy. The importance of the measure is also underscored by the fact, that state pension costs will be rapidly increasing for the next two decades – exactly the timing of pension payments for the pre-2003 entrants. More creative solutions for reducing treatment differences between the highly subsidized pre-2003 entrants and their younger colleagues may also be possible. They would involve designing some inducements, possibly including up front lump sum payments, to entice pre-2003 entrants to accept post-2003 pension benefit package, which under some conditions might reduce overall subnational pension liabilities.

The increase in the retirement age has a potential to result in strong long term fiscal impact on subnational finances, if it is accompanied by the slowdown in hiring of new civil servants. These two combined policies would allow to reduce the frequency at which each civil service position generates a pensioner, reducing long term pension deficit. The federal reform substantially increased the retirement age to 65 for males and 62 for females, from the previous 60/55 thresholds. However, given the slow phase-in of the new policy and the fact that delayed retirement decisions have a very limited fiscal effect on overall personnel costs in the civil servant setting, where both workers and pensioners cost the government similarly, the overall fiscal effect of this policy in the next couple of decades is not projected to be very significant. Furthermore, until April 2021, only 17 of the 27 states adjusted the age limit in line with the federal reform.

The federal civil service reform has also introduced the legal provision of allowing an extraordinary contribution for a limited time period. The increase is not to exceed 20-year period and is only applicable in case of negative actuarial balances (Constitutional Amendment 103/2019 art.9 par.8). Adopting this provision by local legislature would not necessarily mean immediate increase of contributions but would allow pension scheme administrators to increase contribution rates in the future as needed without a cumbersome legal process. This legal arrangement was incorporated into Sao Paulo state's RPPS legislation, although not widely adopted by other states. In addition to being a tool in reduce pension deficits, the extraordinary contributions, that would potentially be applied only to *Fundo Financeiro*, can act as a tool to iron out some unfair treatment differences between pre-2003 and post-2003 entrants to public service, as well as act as an inducement for the older civil servants to switch to the *Fundo Complementar*.

Finally, several states in Brazil have followed federal government in adopting proportional calculation of survivor benefits. Under the old formula, survivor benefits stood at 100 percent of the deceased person's full retirement benefit or, in the case of active worker's death, full permanent disability benefit. With the reform, the proportional benefit is now composed of a benefit of 50 percent plus 10 percent per each dependent, up to a 100 percent in total for a family (Constitutional Amendment 103/2019 art. 23). The benefit is now also limited in duration, based on characteristics of the dependents. Furthermore, the reform restricts the possibility of combining full survivor benefit with own pension benefits.

Overall, the impact of the federal 2019 reform on state finances is likely to be mixed. On one hand, the federal government has handed subnational governments some useful tools to achieve moderate short term relieve from fiscal pension pressure, especially by allowing them to extend pensioner contribution base, reduce survivor pensioner expenditures, and unify their different pension schemes for greater control and transparency. However, so far, the take up of these tools by states has been underwhelming, possibly due to the short term improvement to state finances in 2020 and the overwhelming urgency of COVID-19 response. It is likely that municipal governments, with lower implementation capacity, are even further behind in the reform process. It is also clear that the 2019 reform measures are insufficient to arrest the strong growth of pension expenditures projected for the next two decades, that is driven by strong forces of continued maturation of the pension system and generous pre-2003 pension benefit rules.

8

Lessons and recommendations

8. Lessons and recommendations

Pensions are the fastest growing large item in subnational government budgets and have received a lot of attention from federal and state policy makers. The federal reforms of 1998, 2003, and 2019 have required to achieve difficult political consensus and have yielded some important solutions. However, some of the most important measures of the last reform are yet to be approved and implemented by subnational governments. It is expected that the return to pre-pandemic fiscal pressures in 2021 and beyond will accelerate the adoption rate of these reforms. Making full use of the optional parametric reform package that includes expansion of the contribution base for pensioners, revision of survivor pension rules, increase in retirement ages, and introduction of a possibility of extraordinary contribution rates is especially important. However, while these reforms are critical for containing short term growth in pension expenditures, they alone are unlikely to arrest pension expenditure and, therefore, overall personnel expenditure growth in the next two decades.

Going forward, lasting solutions would be easier to find if fiscal, human resource, governance, asset management, and pension policies are viewed as integral parts of interdependent system, requiring close coordination between different agencies and adoption of smart IT solutions, both at the federal and at the subnational level. From macro-fiscal management standpoint, rules designed to ensure fiscal sustainability of subnational entities would benefit from adopting a more forward-looking perspective. Simplification and standardization of atomized career structures and strategic approach to hiring are necessary for more efficient public service provision, as well as control of pension expenditure growth. The complicated system of automatic promotions and additional benefits, currently blind to long term implications for wage and pension expenditure growth, also needs to be revised. Greater use of temporary workers, insured under the same contract as private sector workers, would not only decrease pension expenses, but also introduce more desirable flexibility for migration between private and public sector.

To address expected growth in pension expenditures in the next two decades, pension policy would benefit from reexamining the inequities left by exemptions from 2003-reform. Some ways to devise partial claw-backs of unjustified subsidies to pre-2003 cohorts are highly progressive contribution rates; extraordinary additional contributions for *Fundo Financeiro* with possibility to “escape” by switching to post-2003 rules and complimentary funds; and some lump sum inducements to accept post-2003 benefit rules.

Throughout the system, there is an urgent need for more transparency, better governance, and policy-maker friendly IT solutions. These, on their face mundane changes, can lead to surprisingly big savings. As the experience of Alagoas and Santa Catarina record audits have shown, the savings can reach 10-20 percent of pension spending. Covid-19 has also exposed a need and convenience of being able to serve clients and manage records remotely. It is neither reasonable nor efficient for all 2154 RPPS schemes to acquire or develop their own IT systems and set up their own asset management departments. Therefore, IT and asset management services should be made available, sponsored at the federal or at least state level, that could be used by smaller RRPS schemes. In addition to technological solutions, legal basis for RPPS access of integrated employee databases for all government branches is also needed. However, subnational governments cannot passively wait for that to happen. Temporary solutions are also urgently needed, including cloud-based service rentals from private IT companies, or own-developed software packages that could be shared between cooperating RPPSs schemes. Sharing of asset management services is already happening and should be further encouraged with appropriate safeguards.

9

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