

# Pension Reform

Reducing fiscal deficit and improving equity 🇧🇷



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# I. Key Sectoral Challenges

## The Brazilian pension system is in deficit and it is fiscally unsustainable

- Brazil is still a young country but spends on pensions like an old country.
- The RGPS and RPPS pension deficit was already 4.2% in 2016
  - The deficit of the RGPS system reached 2.4% of GDP in 2016. Rural pensions account for 1.6%.
  - The deficit of the RPPS system reached 1.8% of GDP in 2015.
- The RGPS deficit is projected to increase steadily to over 16% by 2067
- There are no reliable projections of the federal RPPS deficit, but it is expected to peak around 2030-40, and then decrease (thanks to 2003 reform)

Figure 1: Projection of RGPS pension deficit as a share of GDP, 2017-2067

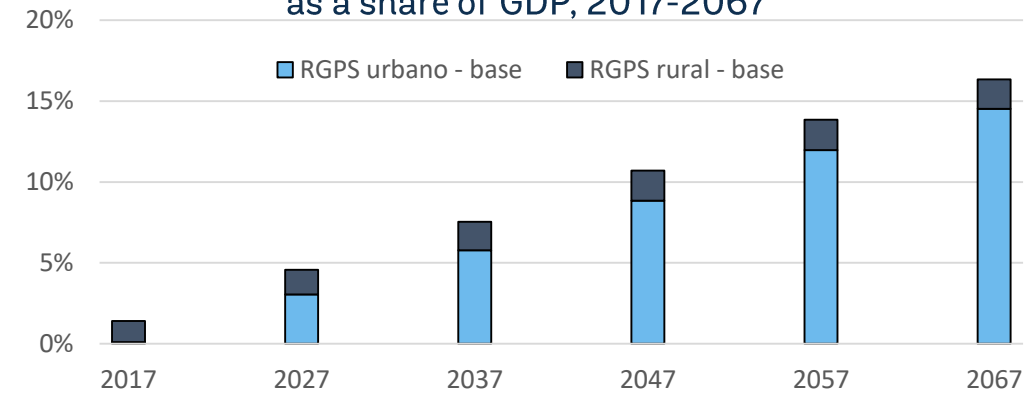
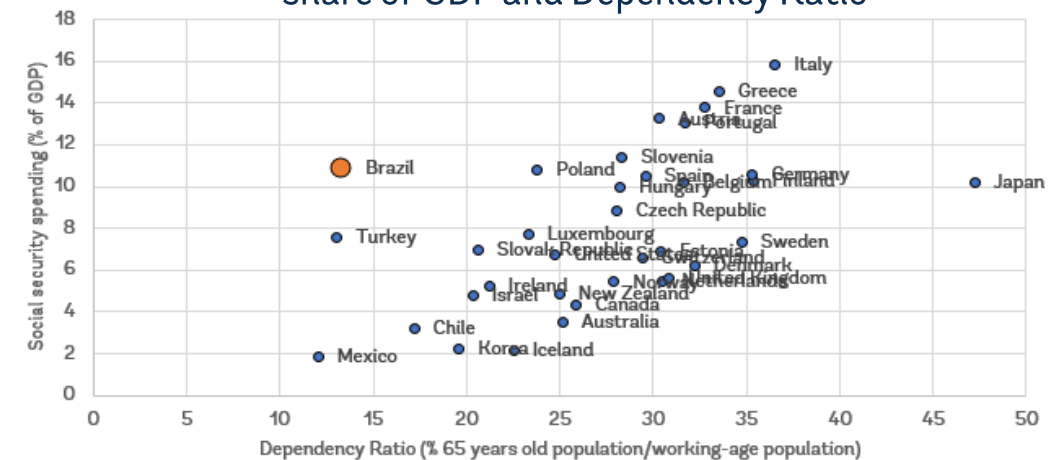


Figure 2: Total Pension Expenditure (RPPS and RGPS) as a share of GDP and Dependency Ratio

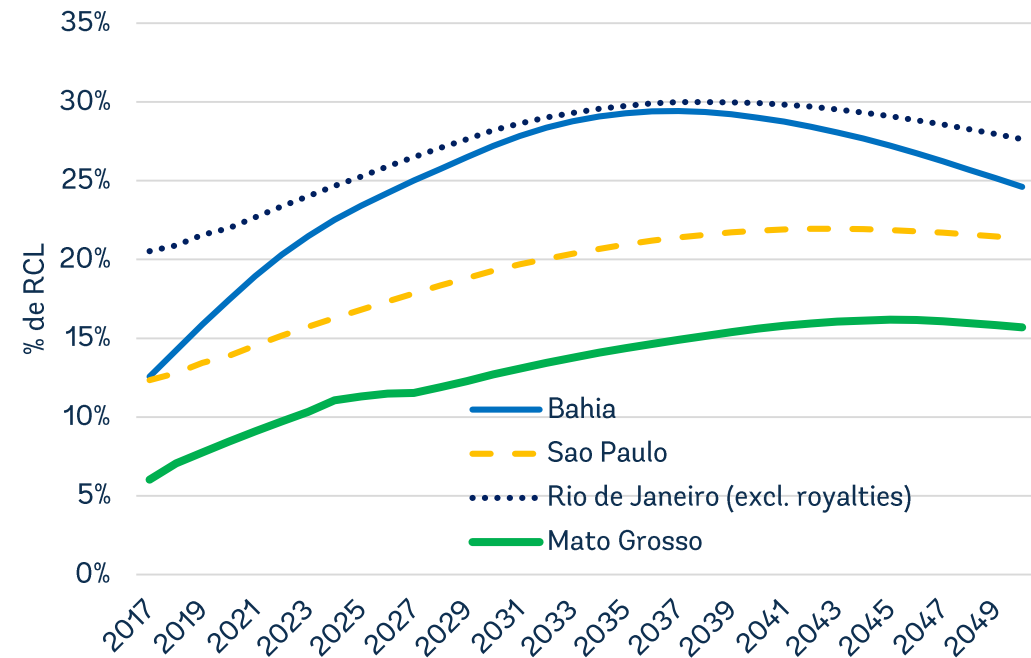


# I. Key Sectoral Challenges

## The Brazilian pension system is in deficit and it is fiscally unsustainable

- Brazil is close to a crisis in the subnational civil service systems (RPPS) pension system
- The deficits of the subnational RPPS are projected to increase rapidly in the coming decade as many public servants will retire under generous pre-2003 benefit rules.
- States are largely unaware of the severity of the upcoming crisis of their pension system:
  - Official pension subnational RPPS projections are wrongly calculated, suggesting a reduction in liabilities;
  - In fact states face a rapid increase in liabilities over the next 20 years;
  - Deficits will absorb as much as 30 percent of NCR in many states.

Figure 3: Pension deficits: World Bank Projections in 4 States

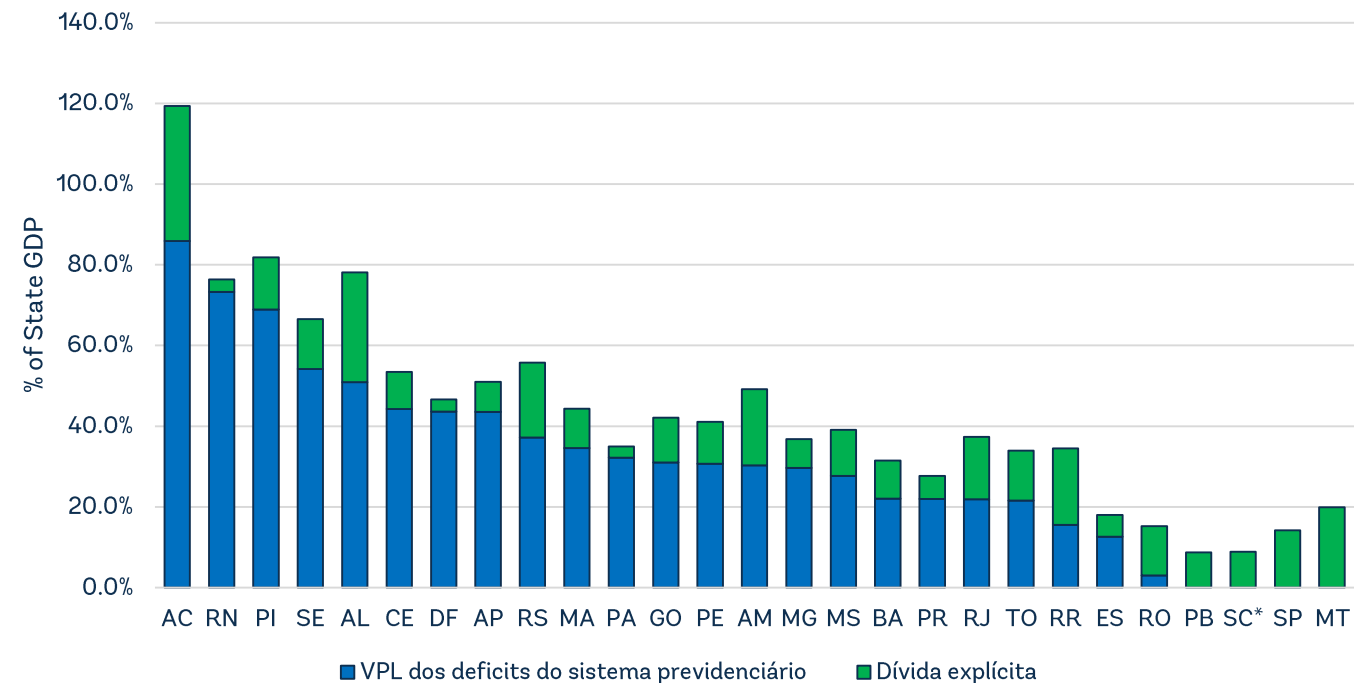


# I. Key Sectoral Challenges

## The Brazilian pension system is in deficit and it is fiscally unsustainable

- The Net Present Value of projected subnational pensions deficits is much larger than existing debt stock.
- Determinants of subnational pensions:
  - Wage policy for active civil servants has immediate repercussion on pension liabilities;
  - Federal rules do not allow subnational governments to control the cost of their RPPS systems;
  - Some states aggravate their situation by offering special perks to their civil servants.

Figure 4: Present value of future deficits of RPPS schemes Brazilian state (% state GDP)



Source: Estimates of the World Bank based on data from the Ministério da Fazenda.

Note: The NPV (VPL in portuguese) is the sum of the future déficits projected of the RPPS until 2088, discounted a real rate of 5%.

Note: Data on NPV of projected pension déficits is not available for PB, SC, SP and MT.

# I. Key Sectoral Challenges

## Why? First: the Brazilian pension system is generous

- The current pension system is generous by international standards.
  - Both the RGPS and RPPS allow retirement by length of service with generous parameters, which allow workers to retire early and with high benefits.
- These pensions are fiscally costly as they can involve 100% replacement rates and horizon payment of 25 to 30 years.
  - Replacement rates are high in Brazil as most workers at the end of their working years receive a pension equivalent to their final salary (aposentadoria integral), compared with replacement ratios of around 70% in most OECD countries.

Figure 3: Retirement age (estimated, 2040), International Comparison

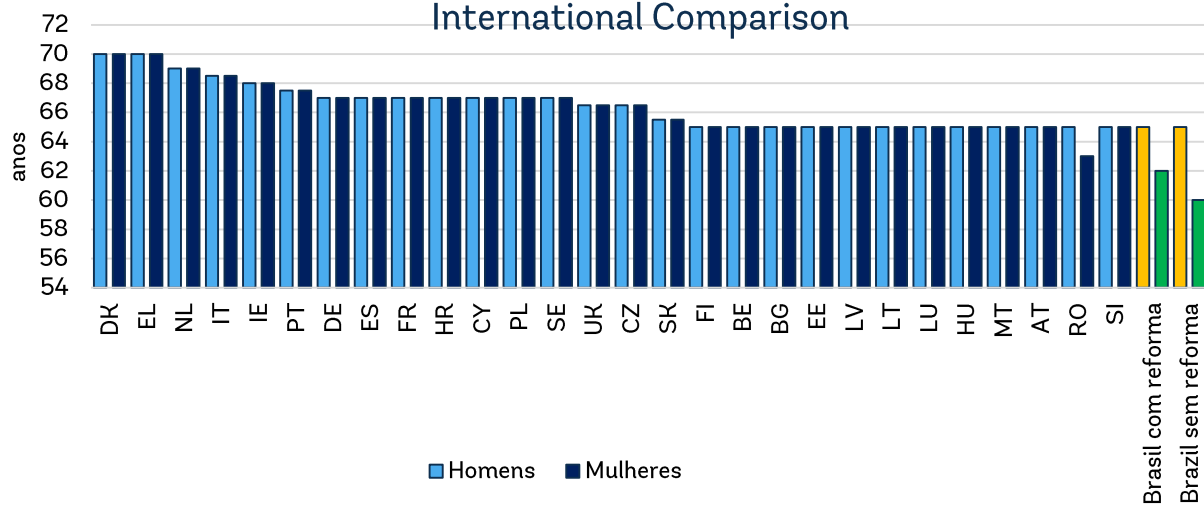
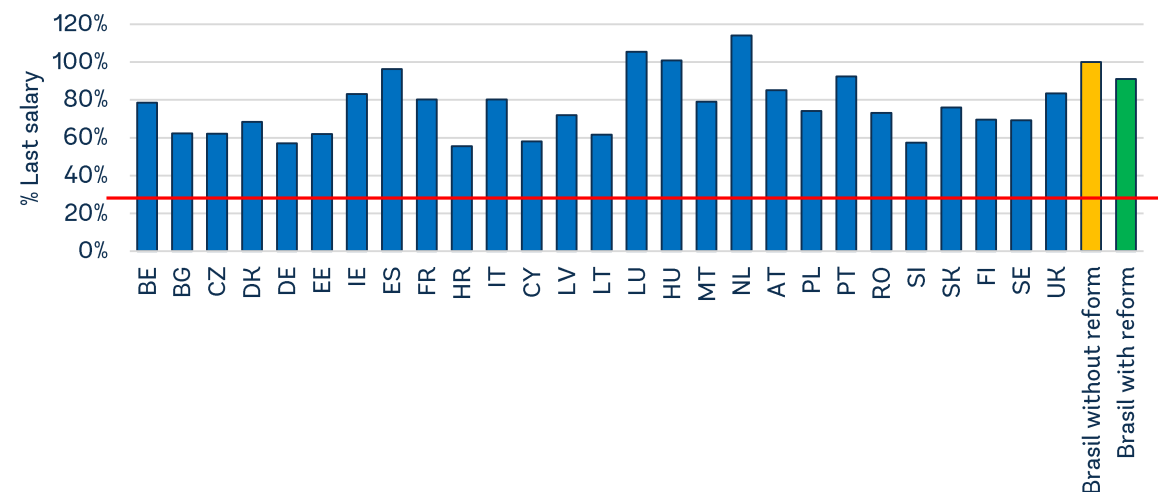


Figure 4: Theoretical Replacement Rates (Men, 40 Years of contribution), International Comparison

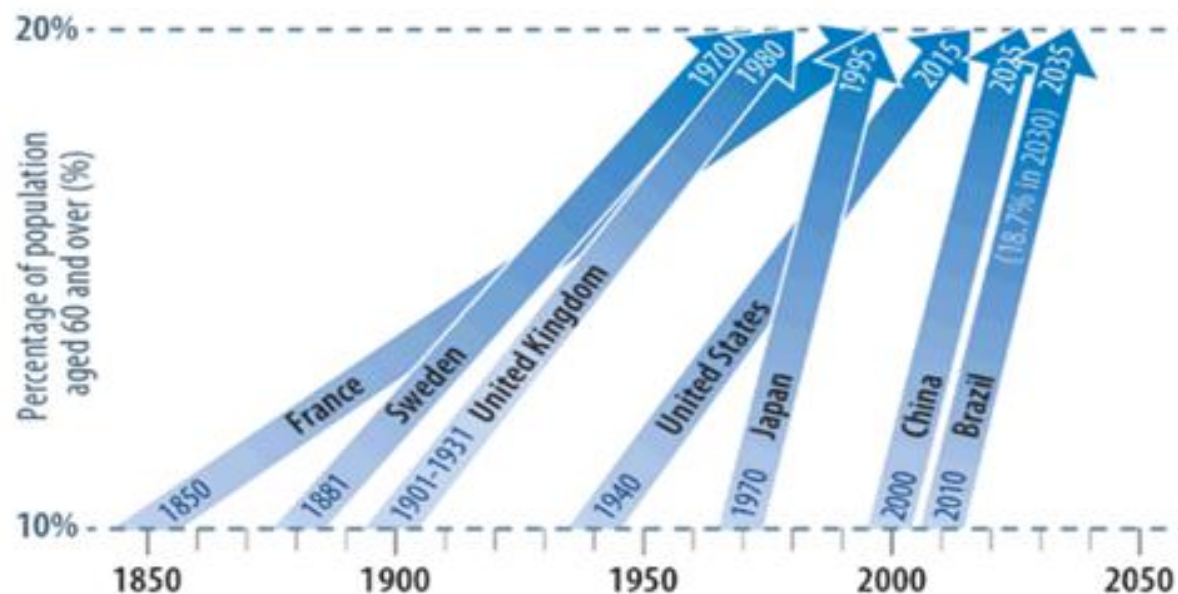


# I. Key Sectoral Challenges

## Second: Brazil's population is aging fast, aggravating the imbalance

- By early 2050, Brazil's dependency ratio is going to be similar to the one in European countries.
- In less than 2 decades, the number of pensioners of the RGPS is going to double, while the number of contributors is going to reduce.

Figure 5: Time period for doubling the population 60+

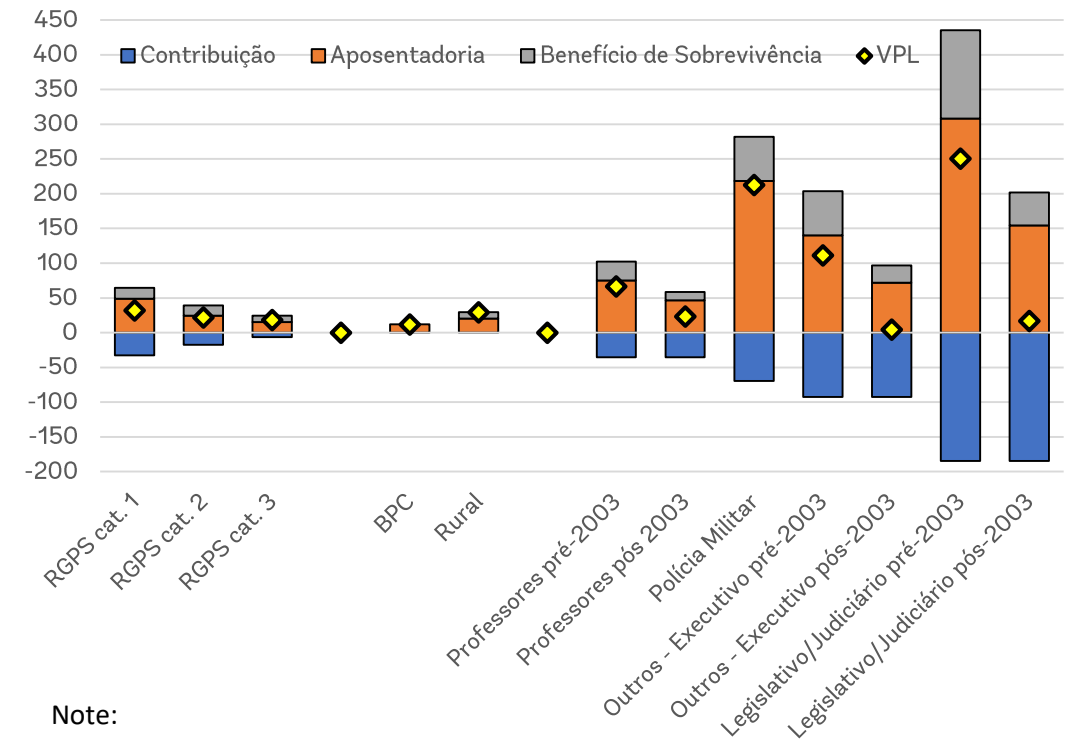


# I. Key Sectoral Challenges

## Pension spending is not pro-poor

- The deficit of the pension system implies a subsidy from taxpayers to retirees who are relatively well-off:
  - 82% of current pension subsidies benefit the top 60% of society, and 35% accrue to the top quintile alone.
  - Only 4% of pension subsidies accrues to the bottom 20%.
- In particular, net-transfers (subsidies) to pre-2003 civil servants are extraordinarily large:
  - While subsidies to RGPS workers vary between 20-30 minimum wages, subsidies to pre-2003 civil servants are above 200-300 minimum wages
- The non-contributory pensions (BPS and rural pensions) pay benefits that are high relative to average incomes
  - Poverty rates among the elderly are less than half the country average
  - Lack of coordination among social policies means many receive multiple transfers

Figure 5: Net Present Value of Pension Benefits (benefits – contributions) in RGPS and RPPS, in annual min. wages for different categories of workers



Note:

RGPS Cat 1: Earns 3 min wages, contributes 25 years until 65

RGPS Cat 2: Earns 2 min wages, contributes 25 years until 65

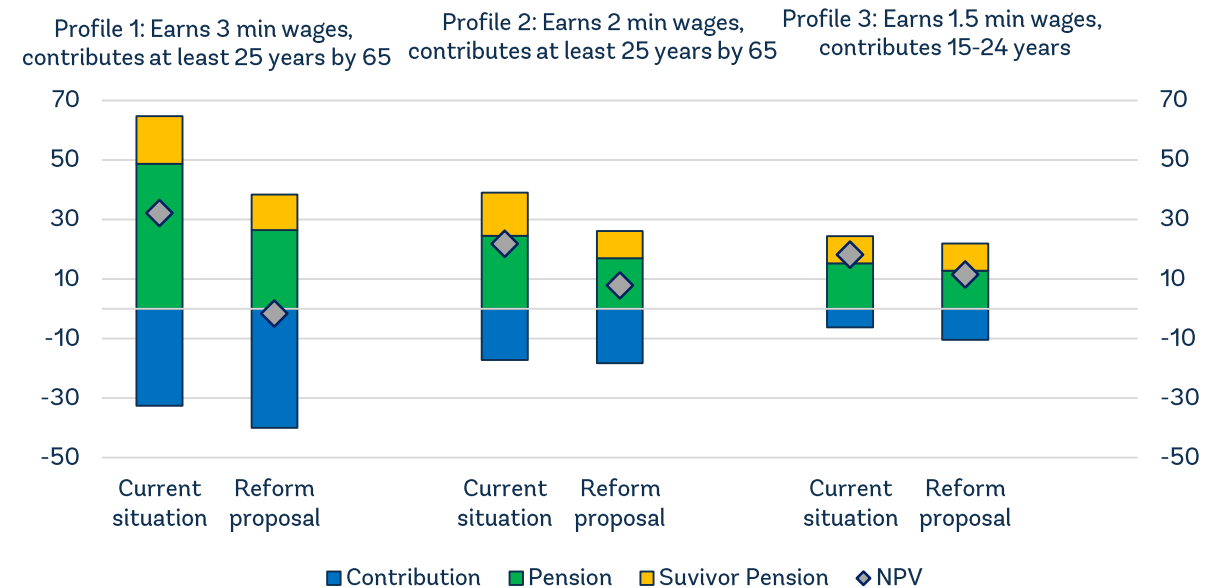
RGPS Cat 3: Earns 1.5 min wages, contributes between 15 to 24 years

## II. Policy Recommendations

# The proposed pension reform is an important step forward

- The 2017 reform proposal should have been approved:
- It would reduce RGPS replacement rates and increase minimum retirement age in line with advanced economies.
- It would reduce the projected RGPS pension deficits by about half, generating savings of approximately 1.8% of GDP in 10 years
- It would help make the pension system fairer and more progressive, as it reduces benefits mostly for RGPS workers who earn relatively more (largely eliminating the net transfers they receive from tax payers). In this sense the reform is progressive.

Figure 7: Pensions by types of RGPS worker and NPV of net subsidies, baseline and 2017 reform scenario



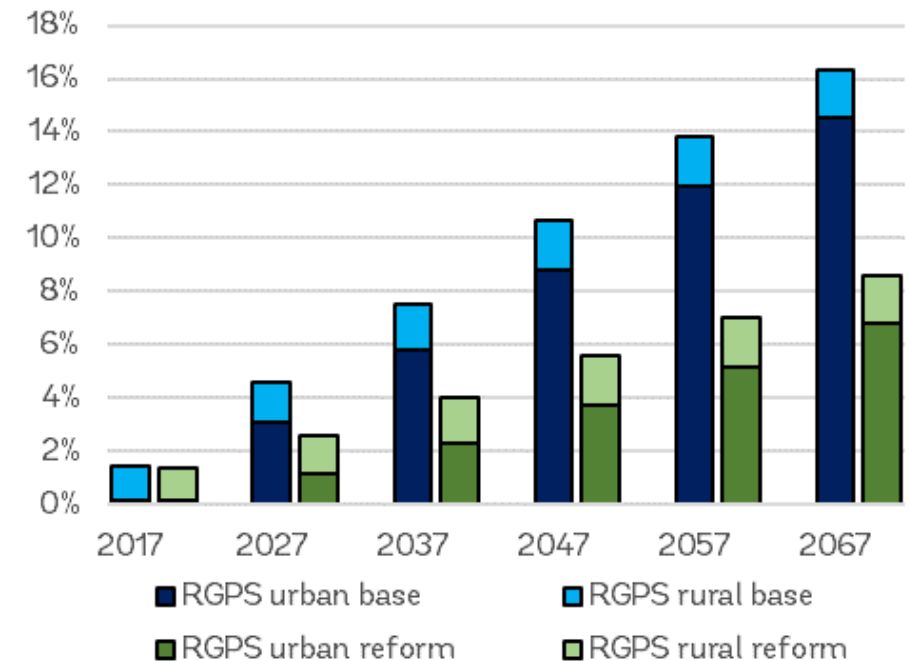


## II. Policy Recommendations

### However, the proposed reform fails to address several issues

- The reform is insufficient to balance the pension system: Additional reforms will be needed soon.
  - Due to demographic pressure, pension deficits will continue to increase even with the reform, to reach 8.6% of GDP by 2067.
- The key remaining challenge in the RGPS is that benefit levels are high relative to earnings with around 50 percent of contributors earning little more than 1 minimum wage and receiving the minimum pension when they retire.
- There may be scope for a reduction in replacement rates by delinking the min pension from the min wage, without risking an increase in old age poverty.
- This would require reviewing non-contributory benefit levels at the same time, to avoid exits from the system.
- However, such an adjustment could be perceived as highly inequitable unless generous benefit levels in the RPPS are addressed first.

Figure 8: Projected RGPS deficit (% of GDP): Baseline Scenario and Adjusted Reform proposal (of May 2017)

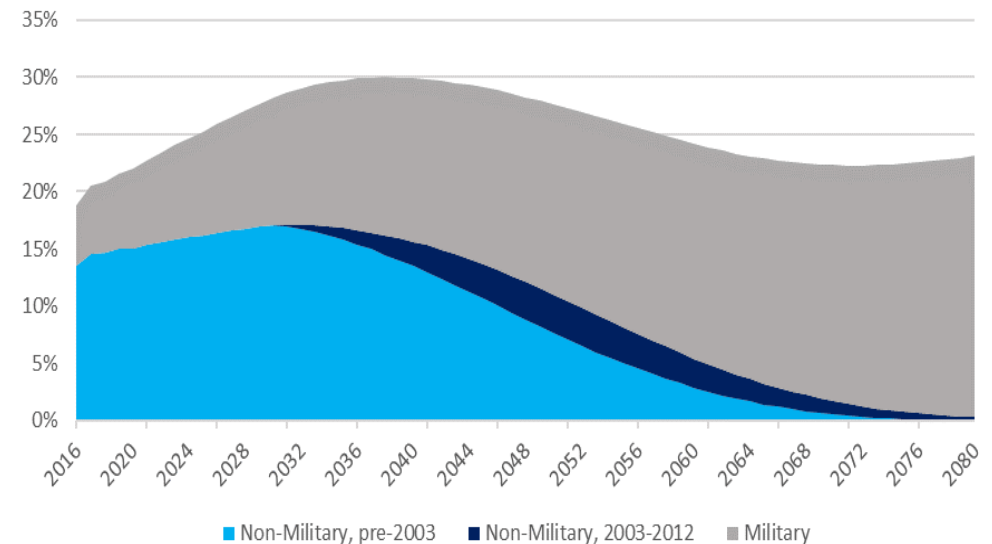


## II. Policy Recommendations

### However, the proposed reform fails to address several issues

- The reform hardly touches the main problem with RPPS, that is the civil servants that entered before 2003 and it does not affect the military.
- The generous package for pre-2003 civil servants is at the heart of the subnational RPPS solvency crisis. As a result, the current reform proposal also does not significantly address the crisis of the subnational RPPS.
- A reduction of RPPS benefits for pre-2003 civil servants would dramatically improve the fairness of the social security system and could thus help to increase the reforms' overall acceptance.
  - It should be noted that there is no legal impediment to a reform of the RPPS benefits for pre-2003 civil servants still in active service.

Figure 9: Composition of projected RPPS deficit (as percent of current net revenues) in the State of Rio de Janeiro



Note: “Non-military pre-2003” and “Military” are largely NOT affected by the reform. Hence the reform has almost no impact on projected subnational RPPS deficits

## II. Policy Recommendations

### However, the proposed reform fails to address several issues

- **There is also scope to increase the RPPS contribution rate well beyond 14%.**
  - There is no ruling of the STF that contributions cannot increase beyond 14%. It is urgent to work with the STF to agree on a reasonable (non-confiscatory) level of contributions to address the current fiscal imbalance of the pension system.
- **The proposed reform would not affect current retirees and includes transition rules for those near retirement. Yet fairness would entail sharing the deficit burden among all generations when implementing reforms:**
  - Transition rules may need to be tightened in the interest of burden sharing.
  - Under the 2017 proposed reform, those already retired or eligible for retirement under current rules would be able to maintain their benefits, since those are considered legally protected “acquired rights”. The only way to reduce net transfers would be to increase income taxes on pension incomes above the INSS threshold.
- **It would be desirable to have a more pragmatic discussion about “acquired rights” in order to ensure intergenerational burden sharing of the reform.**
  - In fact in the middle of a fiscal crisis in 2013, the Supreme Court of Portugal refined the concept of “acquired rights” to make it consistent with fiscal sustainability.

## II. Policy Recommendations

### Additional options for pension reform

- **Creating voluntary funded schemes are part of the solution for younger cohorts**
- **Conservative human resource policies for the federal and subnational government would help stabilize future pension expenditures.**
  - Wage policy has a significant impact on the RPPS pension deficits at federal and subnational level.
  - There is also a need to implement a conservative policy of the “floor wage” for teachers
- **Recognizing social pensions and rural pensions as non-contributory and consolidating them in the context of the social assistance system to reduce duplication of benefits**
  - Contributions to the rural pension program are too insignificant to consider it as a contributory program. By considering rural pensions as a non-contributory scheme, the program could become more manageable, as benefits might be targeted to individuals that need the support.
- **A reform to the minimum wage policies (e.g. to link to productivity, instead of GDP growth) would also have significant impact on restraining the future evolution of the pension deficit.**
  - Delinking the minimum pension benefit from the minimum wage, or implementing conservative indexation policies of the minimum wage would help restrain the pension deficits

- **While the proposed pension reform helps to alleviate the fiscal burden of the federal government, it is insufficient to make the pension system financially sustainable in the medium term. A revised reform proposal should include additional reductions in benefits.**
  - The proposed reform would help to reduce the deficit of the RGPS pension system by half over the next 50 years and save around 1.8% of GDP over the coming decade.
  - The proposed reform would impose higher adjustment costs on richer workers and thus make the system more equitable.
  - However, the most inequitable part of Brazil's pension system are the civil servant pensions, which are extremely generous, particularly for those who entered before the 2003 reform, and the military—these are not affected much by the proposed reform.
- **Solving the problem of RPPS pension system at subnational level should be a priority: A reform should include further intergenerational burden sharing (including reconsidering acquired rights).**
  - The deficits of subnational governments' pension systems are expected to increase dramatically over the next decade, bringing several state governments to the brink of bankruptcy.
- **While federal rules limit the space of subnationals to control pension benefits, in fact policies related to human resources (notably wage policy) at subnational level can be very effective in reducing their medium-term pension liabilities.**



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