The Urgent Case for Pension Reform in Brazil

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The promise of social security is to support retired workers in their old age. This promise is delivered using resources obtained from active workers, their employers, and, in some cases, general government revenue. But sometimes, as in the case of Brazil, this commitment becomes increasingly difficult to fulfill with the resources available, and the system becomes financially unsustainable. For Brazil, the only way forward is to reform its pension system.

Partial reforms

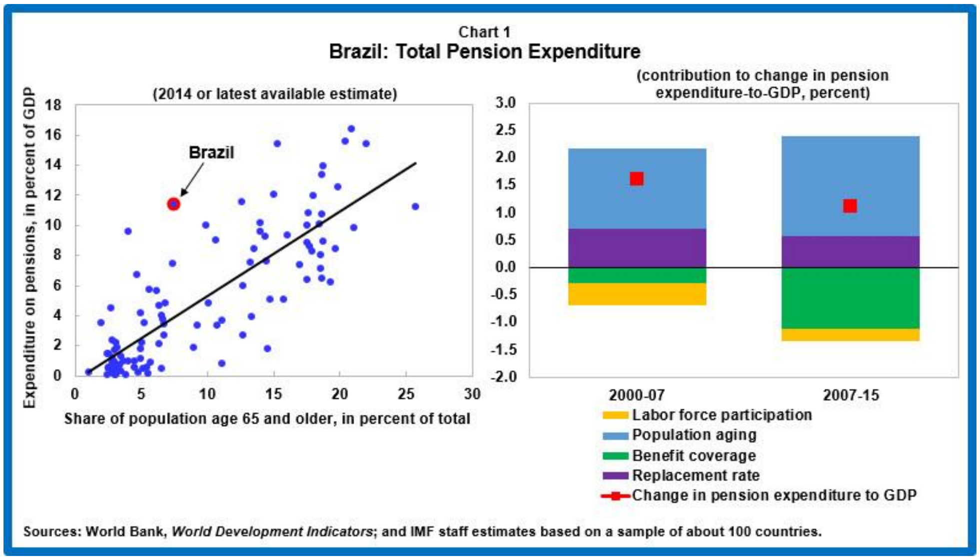
In the 1980s and 1990s, many countries in Latin America carried out radical reforms in their retirement benefit systems, which were viewed as financially unsustainable. In contrast, Brazil, whose social security schemes also harbored the seeds of financial stress, has been making partial reforms and introduced new contributions (sometimes indistinguishable from taxes on the general public) to plug the system's emerging cash deficits, delaying a deeper reform. By now, total pension expenditure in Brazil (including the regimes for private and public sector employees) is among the highest in the world at about 11.3 percent of GDP in 2015—a figure especially high for a country with Brazil's demographic structure (Chart 1, left panel).

But why has Brazil's pension expenditure grown so large, especially in the last 15 years? As shown on Chart 1, population aging in Brazil has contributed to the rise in the ratio of pension spending to GDP, like in other countries. In practice this factor is amplified by the possibility of retirement at a relatively young age (many people qualify to retire in their early or mid-fifties based on the length of their contribution records or employment category). Importantly, rising average replacement rates (defined here as the ratio of the average benefit received by retirees and pensioners to the average salary of active workers) have also driven pension expenditure up since 2000.

It is useful to see what these trends imply:

- An aging population means that the system has **fewer** active workers to sustain each retiree.
- Rising average replacement rates mean that the system needs **more** active workers to sustain each retiree.

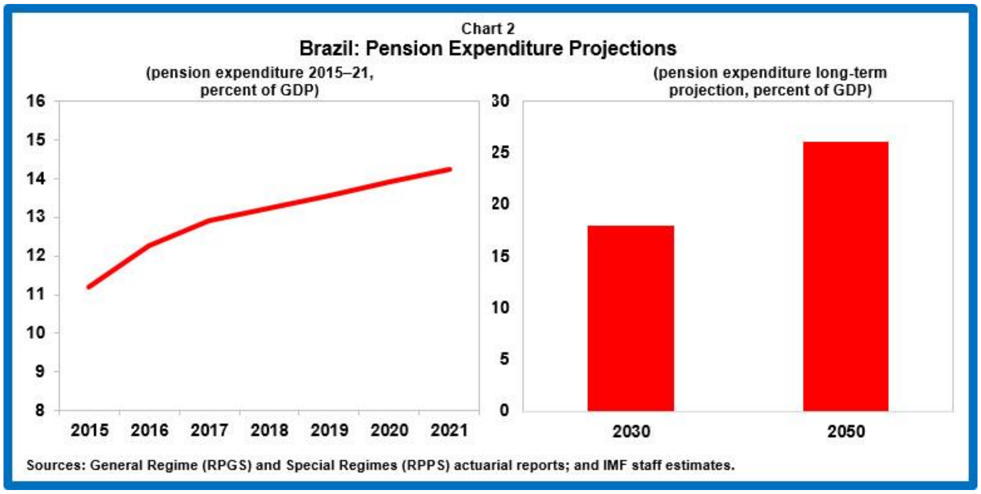
These trends have combined to create ever larger social security deficits. In the past several years, payroll contribution exemptions to various sectors have further widened social security imbalances (which the government ultimately compensates with transfers to the social security institute)—and the job losses brought about by the recession has made matters still worse in the last two years by reducing contribution revenue.



Alarming numbers

Spending on pensions and the system's deficit are expected to keep rising. Without reforms, our study finds that pension spending will rise to about 14 percent of GDP by 2021, 18 percent of GDP by 2030, and 26 percent of GDP by 2050 (Chart 2). The reasons are again population aging and the rules governing the growth in benefits:

- The Brazilian Institute of Statistics (IBGE) projects that old-age dependency (the ratio of older dependents to the working-age population) will reach 36 percent by 2050—from 11 percent today.
- Given the rule for updating the minimum wage and its link to pension benefits, individual benefits paid to most retirees' in the General Regime (RGPS)—which covers private sector workers—grow nearly as fast as nominal GDP. Thus, the growth in contribution revenue, which closely follows nominal GDP, is barely enough to finance the annual rise in the benefits paid to existing pensioners in the general regime. Effectively, very little money is left over to finance the increase in the population of retirees, which grows at 3.6 percent a year. Also, the cost of the Special Regimes (RPPS)—which covers employees of national and subnational public sector institutions—threatens to continue to increase because benefits usually increase with average salaries and important categories of employees will retire at a young age.



Measures to contain spending

Given the large size of social security spending and its projected continuous increase, reform is essential and urgent. A balanced and ambitious social security reform will need to mobilize all available policies to ensure that the effort underlying the reform is shared broadly in the population.

- The General Regime and the Special Regimes should be covered in the reform. This is an issue of both fairness and good economy, as participants in the Special Regimes tend to retire with higher pensions.
- The eligibility criteria for retirement should be revised, including by gradually raising the minimum retirement age, as has been widely discussed in Brazil. Also, duplication of benefits should be reduced.
- The rate at which benefits are accrued over participants' working lives should be moderated to ensure that the increase in retirement age results in reduced financial imbalances for the system, and not just delays pension spending.
- It is advisable to remove the automatic link between pensions and the minimum wage (and/or to change the minimum wage indexation formula).
- Rolling back payroll tax exemptions would be advisable.
- The design of the reform should ensure that individuals in vulnerable situations who might be affected by the changes are covered by other targeted social programs. Care should also be taken to address equity considerations and to maintain progress in addressing inequality.

The government has announced its intention to proceed with social security reform, and a draft proposal is expected this year. Also, the government is currently seeking a constitutional amendment to cap the growth of noninterest federal spending at a rate equal to inflation in the previous year. The success of this new expenditure rule will depend crucially on reforming the social security system. That said, in view of the rising trend in social security spending described earlier, pension reform would be a priority even in the absence of the spending cap.

Since most social security reforms tend to involve long transition periods, it is essential to start now.

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