Ten common misconceptions about Brazil’s Pension reform (PEC 287)

Throughout 2017, the Brazilian congress will be debating the Pension reform proposal (PEC 287) recently submitted by the government as the next step in the country’s structural fiscal adjustment, which began with the approval of the spending cap. This report aims to correct ten common misunderstandings about the proposal and about the current situation of Brazil’s Pension and Social Security systems, in order to encourage an informed debate in Congress.

1. Do the Pension and Social Security systems run on surpluses?

No. Both the Pension and Social Security systems yield deficits. In 2016, the Pension system ran a deficit of 2.5% of GDP and the Social Security system ran a deficit of 4.3% of GDP (see table at the end of the report).

The Pension results apply only to the Pension system for private sector workers, which is managed by the INSS (Instituto Nacional do Seguro Social) and is also known as the General Pension System (or RGPS in Portuguese). Pension revenues, which are composed of payroll contributions by employers and employees, amounted to 5.7% of GDP in 2016. Pension expenses, composed of Pension payments and allowances paid by the INSS, totaled 8.2% of GDP in 2016.

Social Security expenses include, in addition to the RGPS, the pension system for civil and military public sector employees (known as the Particular Pension System, or RPPS in Portuguese) and health and social care expenditures, including wages of active public employees in these systems. In addition to Pension revenues, Social Security revenues include social contributions such as CSLL, PIS/COFINS, CPSS and the cost of military pensions, which are taxes constitutionally earmarked to Social Security. In 2016 these revenues amounted to 10.0% of GDP (5.7% from RGPS and 4.3% from others), while expenses came to 14.3% of GDP (8.2% from RGPS and 6.1% from remaining expenses).

Why are there reports that the Pension system and Social Security run on surpluses?

Reports that contest the Pension and Social Security deficits rely on mistaken assumptions. The three most common mistakes are: i) excluding the public employee pension results (or RPPS); ii) including tax waivers in Social Security revenues; and iii) excluding the impact on the Social Security budget of the de-earmarking of federal revenues (DRU) from Social Security. Each of these points is addressed below, but it is worth noting that, even by these miscalculations, the Pension and Social Security systems still posted deficits of 1.9% and 1.1% of GDP, respectively, in 2016.

2. Is it correct to exclude the public employee pension results from Social Security?

No. Both pension systems – the one for private sector workers and the one for public employees – are included in the Social Security budget, and both are running deficits. For 2016, the former will likely post a deficit of 2.5% of GDP, and the latter a deficit of 1.2% of GDP. Both systems need to be reformed, and there is no reason to exclude one of the two from the Social Security results.
Two basic goals of the Social Security reform proposal to be considered by Congress are the equalization of the benefit-granting rules and the definition of benefit values for the entire civilian population. Thus, by the end of the transition period, the pension rules for the private sector workers’ pension system will be the same as the rules for the public employee pension system – an objective which underlines the importance of considering the public employee pension results as part of Social Security.

Additionally, it is worth noting that the revenues and expenditures of the public employee Pension (RPPS) are already included in the annual Social Security budget. This is because even without the reform, public sector pensions, like private sector pensions, are mandatory, contributory and solidarity-based and entail the use of public resources. This norm is re-endorsed by Congress and the Federal Court of Accounts every year when they approve the federal government’s budget and the public accounts.

3. Is it correct to include tax waivers in the Pension results?

No. Tax waivers have led to lower revenues and actually increased the Pension deficit over the years. The Pension reform may address the debate on the merits of waivers and whether it would be better to reverse them (which would result in an effective increase in the country’s tax burden). But we emphasize that such a reversal would not resolve the Pension system’s imbalances, which are a problem created by spending growth and not by revenues from waivers.

A number of discounts and exemptions from employer payroll contributions have been established over the years. In 2016, according to the Federal Revenue Service, these various waivers resulted in a reduction of pension revenues of BRL 40 billion (0.6% of GDP). The most important waivers are: i) the simplification of the “Simples Nacional” tax system from 2007 onward; ii) the exemption for rural production exports guaranteed in the constitution and regulated in 1994; iii) the reduction of mandatory contributions for individual micro-entrepreneurs in 2006; and iv) the exemption for charities guaranteed in the constitution, with rules last amended in 2009. Such exemptions were implemented to foster economic activity and employment, or to meet the demands of specific segments of society. Regardless of their merits, all of the exemptions were approved by Congress; they are laws, not accounting effects. Therefore, it makes no sense to exclude them from the calculation of Pension and primary results.

An assessment of the merits, costs and benefits of each waiver should be part of the debate over the Pension reform in Congress. However, it is worth noting that even if all 0.6% of GDP in Pension contribution waivers had been reversed, the Pension system would still have recorded a deficit of 1.9% of GDP (and Social Security a deficit of 3.7% of GDP) in 2016.

The Pension system’s imbalances stem from rising expenditures, not a lack of revenue. Given the country’s current demographic scenario, Brazil’s Pension expenditures are high – close to those of countries like Japan, where the elderly share of the population is three times larger. A reversal of waivers would not change the fact that without reform, the combination of an aging population and generous benefit-granting rules will put Brazil on an unsustainable path of rising expenditures.

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1 Each year the executive branch drafts and executes three budgets: the fiscal budget, the investment budget for the state-owned companies and the Social Security budget.

2 According to the IRS, Social Security contribution waivers amounted to BRL 54 billion (0.9% of GDP) in 2016. Of this total, BRL 14.5 billion (0.3% of GDP) stemmed from payroll tax cuts introduced in 2011 and do not reduce Pension revenue. This waiver is reimbursed to the Pension system by the National Treasury and therefore accounted for as a federal government cost.
4. Is the de-earmarking of federal revenues (DRU) the cause of the imbalances in the Pension system and Social Security?

No. The DRU is a tool that allows for flexibility in public-sector budgeting and is not applied to Pension revenues. Earmarking non-Pension Social Security revenues to Pension expenditures is simply a way of masking the Pension system’s deficits.

The Brazilian tax system includes taxes and the so-called contributions. Contributions, unlike taxes, have specific purposes and their proceeds cannot be used freely by the government. About 60% of the federal government’s revenues come from social contributions, which in Brazil are constitutionally assigned to financing Pensions (as in the case of Pension contributions from payroll) or Social Security as a whole (as in the case of PIS/COFINS). The DRU is a similar constitutional mechanism that “de-earmarks” 30% of the federal revenues from social contributions. The DRU eases budgeting rigidity by allowing the government to use some of these contribution proceeds for other purposes, such as investment, education costs or public sector wages.

Importantly, the DRU does not apply to Pension revenues from private sector workers or public employees. This implies that the RGPS and RPPS Pension deficits have exactly the same values, regardless of the application of the DRU.

Using non-Pension social contribution revenues (such as PIS/COFINS) to cover Pension expenses is a way to mask the Pension deficit. In addition, the artificial accounting of these revenues in the Pension system results reduces the availability of these resources for other budget priorities, including health and education, and does not solve the Pension system’s main problem: the upward trend in Pension expenditures.

Finally, it is worth noting that, even if the DRU was annulled, the Pension balance would not turn positive. The DRU reduced Social Security revenue by 1.4% of GDP in 2016. Even if we add back this “lost” revenue, the Pension system would still have run a deficit of 2.9% of GDP in the period. In this case, however, the federal government would still have to cover all the remaining expenses, which would lead to greater difficulties in budget management, in turn prompting higher taxes or exacerbating spending cuts and delays.

5. Is the rural Pension system the only system running a deficit?

No. The urban Pension system will likely also end 2016 with an annual deficit of 0.8% of GDP, compared with a deficit of 1.7% of GDP in the rural segment. Historically, the urban Pension system’s balances have been negative, aside from some transitory, minor surpluses between 2009 and 2015. Brazil’s aging population – the main driver of the current Pension reform effort – will affect the spending and deficit s of both the urban and rural Pension systems.

6. Is it possible to improve the Pension result without reforms?

No. The problem affecting the Pension system is structural in nature, not an accounting issue. Reform is essential because of the upward trend of Pension spending, which are immune from deficit accounting methodologies. The projected aging of the Brazilian population, in the context of the country’s generous benefit-granting rules by international standards, imposes the need for reform to guarantee the payment of benefits and the solvency of the Brazilian government over time. Without reform, this adjustment would have to be accomplished through measures that would have a strongly negative impact on the population, such as significant tax increases or a sharp rise in inflation. If the current rules are maintained and the economy is balanced, the Pension deficit will worsen by an average of 0.30% of GDP per year as Pension expenditures increase as a function of the aging population, while revenues are unlikely to rise above GDP given that the wage bill – the most relevant economic variable for Pension revenues – is unlikely to grow above productivity in the coming years.
7. Would the poorest suffer the most from an increase in the retirement age?

No. An increase in the retirement age would affect the higher-income segment more significantly than lower-income Brazilians. Higher-income workers generally fulfill their minimum contribution period sooner, due to their higher qualifications and employment stability. Along with their early achievement of retirement age, this group’s high average income increases pension payments, putting strong upward pressure on Pension expenditures. Lower-income workers, on the other hand, despite entering the labor market earlier, are subject to a higher degree of informality and usually retire based on age alone – i.e., at the age of 65 for men and the age of 60 for women – under the current rules. In fact, the average benefit granted is higher for pensions qualified for by contribution time than those qualified for by retirement age, which tend to hover around the minimum wage pension-payment floor. Thus, the adoption of minimum ages more strongly affects those taking early retirement based on their contribution period, who receive higher average benefits and are concentrated in the richest portion of the population.

8. Is the minimum age of 65 inadequate?

No. Under the proposed reform, the minimum age of 65 would only be fully effective after the end of the transition period – in 2033 for men and in 2038 for women. Until then, life expectancy in Brazil will continue to grow, generating ever stronger pressure on Pension expenditures: life expectancy was 63 years in 1980, has reached 76 years in 2016 and is projected to rise to 80 years by 2040. There are only 12 countries besides Brazil that have not established a minimum retirement age, with Ecuador, Saudi Arabia and Serbia being the most notable examples.

9. Shouldn’t spending cuts be allocated to interest expenses and not Social Security, given that interest expenses represent the largest federal expenditure?

No. Interest expenses are a consequence and not the cause of the country’s fiscal problems. An interest rate is a price that depends on a country’s savings rate and risk of insolvency, and is not merely a governmental decision. Local and international historical experience shows that artificial price control mechanisms do not generate the results sought for by society, at least not in a sustainable manner. The structural reduction of interest expenses stems, therefore, from an increase in the savings rate and a reduction in the country’s insolvency risk. To this end, the structural fiscal adjustment that could be effected by the spending cap and Pension system reform is essential, as they will allow for a reversal of a trend that has persisted at least 20 years of federal primary spending growing faster than the economy. Given Brazil’s aging population, if the country’s generous benefit granting and adjustment rules are maintained, Pension spending – already the largest federal primary spending item (40% of the total and 8.2% of GDP) – will continue to grow annually. These reforms will help make Brazil’s public spending and public debt trajectories sustainable, reducing the country’s risk of insolvency. With lower public spending, and with households saving for longer periods according to the new retirement rules, the savings rate of the economy would also increase. In turn, a higher savings rate and increased fiscal sustainability would lead to structural declines in interest rates and interest expenses.

10. Does the spending cap (PEC 241/55) impose a tougher-than-necessary Pension reform?

No. The need for Pension reform was not created by the imposition of the spending cap. Given the aging of the Brazilian population, in a Pension scheme with generous benefit-granting rules, spending levels will have to grow continuously over time. There will be no guarantee that Pension commitments will be honored, and any eventual adjustment mechanisms would likely have an even more negative impact on the population. Without
reform, the government will not be able to meet its spending cap and the public debt trajectory will become unsustainable. Without the prospect of debt stabilization in the medium term, economic growth will be lower and real interest rates will be higher. Eventually, the adjustment would have to happen by means of a sharp increase in inflation or steep cuts in benefits and acquired rights, measures which would exacerbate any economic downturn, as has occurred in Greece. Another example of a compensatory measure would be an increase of at least 4 pp of GDP in the tax burden to finance the growing Pension deficit, which would decrease household income and greatly hinder the economic recovery.

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