

OECD Policy Memo

Pension Reform in Brazil

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In a nutshell....

Brazil's pension system is an outlier compared to pension systems in OECD countries. All public pension schemes in OECD countries include a minimum retirement age. The Brazilian system pays high replacement rates - pensions relative to working age incomes - and it does so at a much lower age. While life expectancy in Brazil is a little below the OECD average, this gap does not justify a much lower retirement age. As it stands, **the pension system is financially unsustainable.** An in-depth reform is necessary and inevitable.

Pension spending (excluding BPC-LOAS and the separate public sector regime) rose from 4.6% of GDP in 1995 to 8.2% in 2016, despite the fact that the population is still relatively young. It is estimated that under the current rules, pension spending could reach almost 17% of GDP by 2060 (20% of GDP including the public sector regime). The combined annual shortfall of the pension schemes is close to 4.5% of GDP, contributing substantially to the general government budget deficit.

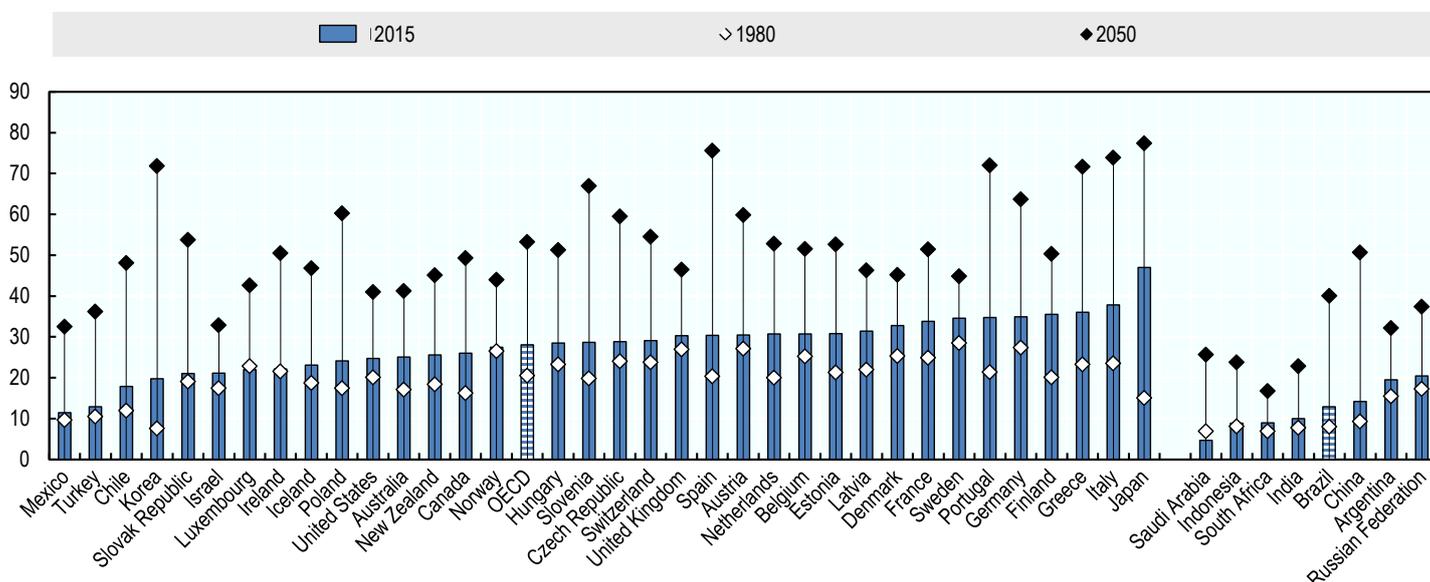
Brazil will be ageing fast. In 2015, the old-age dependency ratio was half the OECD average; by 2050, however, Brazil will be rapidly closing in on the OECD average and by 2075 it will be older than the average OECD country based on this indicator (Figure 1). The population aged 65 and above will more than triple within the next four decades, increasing from about 7.6% of the population in 2010 to 38% by 2050.

Pensions are an important pillar of social protection...

Pensions have undoubtedly played a significant role in the quest against old-age poverty in Brazil, and they have been very successful in reducing it well below the population-wide average (OECD, 2015a). At present, all pension recipients – and this includes almost all people aged 65 and above – receive at least the minimum wage, which is more than 5 times as much as the poverty line of BRL 170 (equivalent to USD 55).

However, this generates a drag on public resources which might be used to the benefit of other groups of the population, for instance to fight high child poverty. Moreover, demographic developments will add substantially to pressures on public finances, as pension benefits disbursed exceed incoming contributions, with the difference being covered from the national budget.

Figure 1. Old-age dependency ratio will more than triple in Brazil by 2050
Number of people older than 65 years per 100 people of working-age (20-64), 1980-2050

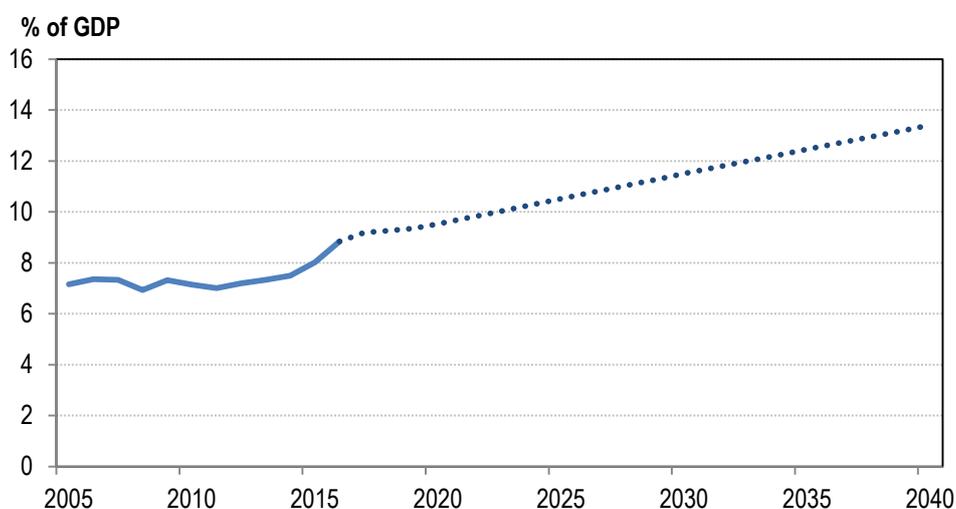


Source: United Nations World Population Prospects: The 2015 Revision.

... but pension expenditures are high and will become unsustainable

Already, Brazil's pension and social assistance system costs over 10% of GDP, of which 8.2% for old-age pensions, despite its young population. In the longer term, estimates suggest that population ageing will imply higher and higher pension spending if the current parameters of the system remain unchanged. Pension spending would increase by almost 3% of GDP by 2030, and by almost 5% by 2040 (Figure 2). This excludes the separate pension system for civil servants, which currently costs around 2.2% of GDP.

Figure 2. Population ageing will raise spending pressures without a reform
Expected spending on pension benefits¹



1. Social security benefits include urban, rural and social assistance pensions, but exclude pensions for civil servants. The “baseline scenario” assumes real GDP growth of -0.3% in 2017, 1.5% in 2018, and 2.5% over 2019-2040, with average inflation of 4.5%. The number of social security beneficiaries is assumed to grow on average by 3.1%, in line with elderly population growth (age 55+). Minimum pensions are assumed to be indexed to the minimum wage, which is projected according to the current indexation rule based on past consumer prices plus past GDP growth.

Source: OECD Pensions at a glance, IMF Fiscal Monitor, United Nations World Population Statistics, Ministerio da Previdencia, OECD calculations.

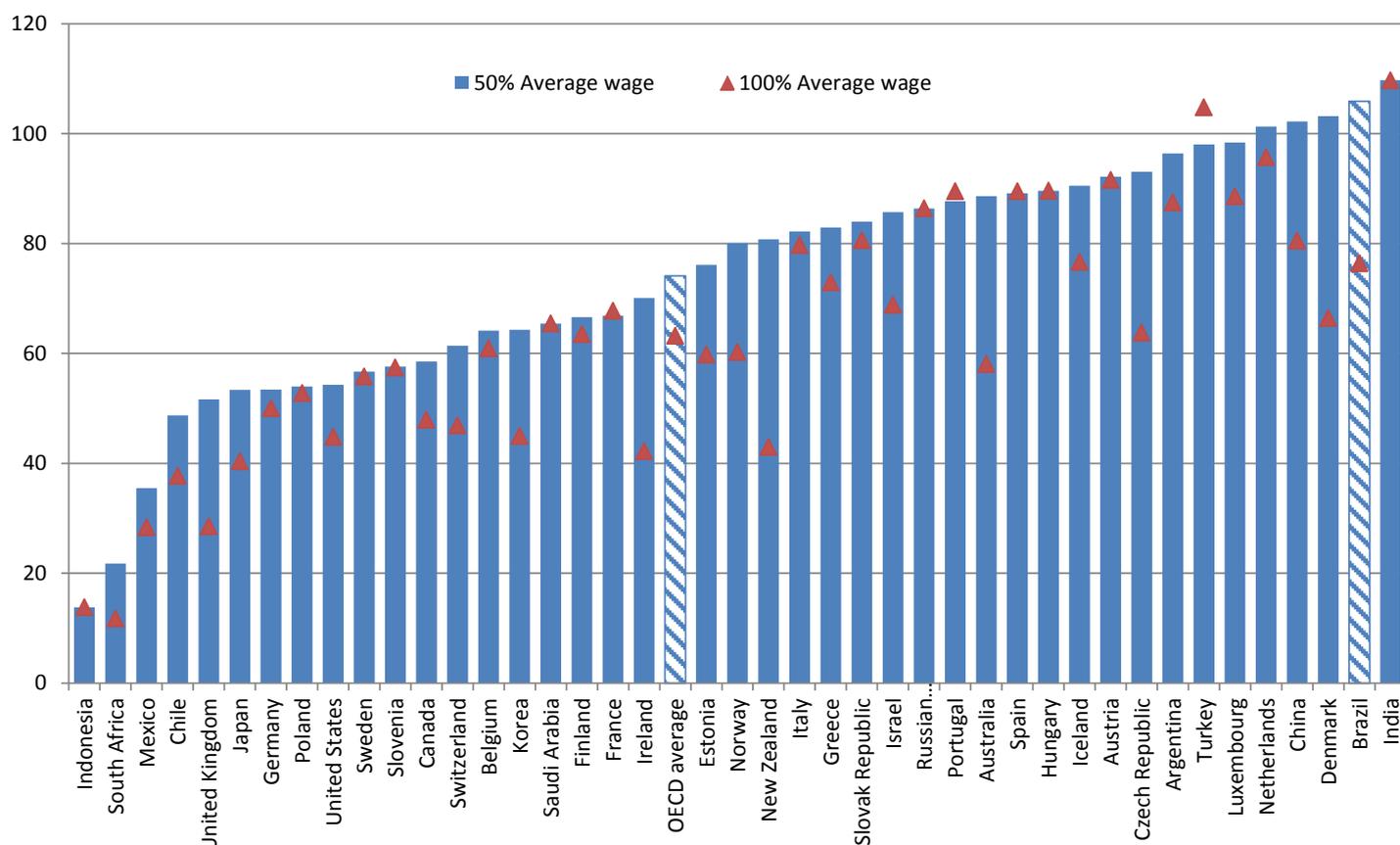
There are many areas in which reforms are needed

Several policy measures could contribute to containing pension and social assistance expenditures. Raising Brazil’s low average retirement ages of 56 years for men and 53 years for women (as a minimum number of years of contribution to the system provides eligibility to pensions irrespective of age) as part of a comprehensive pension reform appears urgent, by introducing a binding minimum retirement age. Many OECD countries are now gradually moving their normal retirement ages beyond 65 years for men and women (OECD 2015b). In the future, the retirement age could be linked to rising life expectancy so as to make adjustment automatic and thereby avoid using up political capital in a routine reform process.

Brazil also stands out for its high pension benefits relative to working-age incomes, in particular for low-wage earners (Figure 3). For the reference case of an average-wage worker entering the labour market at age 20 with a full career, a full pension is obtained at the age of 65.5 years on average in the OECD, paying 53% of pre-retirement earnings in net terms. In Brazil, a man (woman) would get a full pension paying 70% (53%) of pre-retirement earnings, at age 55 (50). Under the current reform proposal, a man would have to contribute until age 65 as in the OECD, and would then get a pension paying 96% of pre-retirement earnings. This is still much higher than in any OECD country.

The indexation mechanism for minimum pension benefits contributes substantially to the high level of pension benefits in Brazil: according to the constitution, the minimum pension cannot be lower than the minimum wage. Currently, the minimum benefit is thus equal to the minimum wage, and two-thirds of pensioners receive this benefit level. This has led to real increases in the minimum pension of almost 90% over the last 10 years. Given the strong political pressures for further minimum wage increases, keeping the minimum benefit indexed to the minimum wage is likely to result in rapid real pension increases.

Figure 3. Net replacement rate for full-career worker having entered the labour market in 2014



Source: Pensions at a Glance (2015)

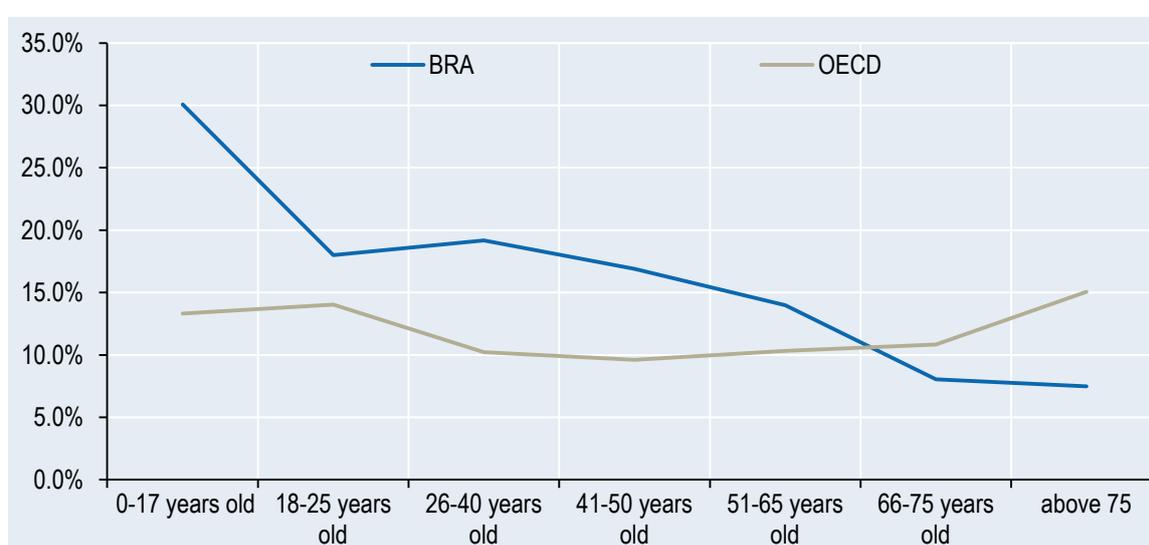
Those who contribute during part of their working life need only 15 years of contribution at age 65 for men or 60 years for women to receive the minimum pension, which is equivalent to the minimum wage of those working today. This is a high benefit level for a very short contribution period, even though about one third of workers do not contribute to old-age pension (OECD/IDB/The World Bank, 2014). On average in the OECD, 26 years are needed to get a minimum pension. In France and Switzerland, contributors are eligible for a prorated amount from even 1 year of contribution, but must contribute for much longer than 15 years to get the full minimum pension. Aligning Brazil's pension rules with those practiced in OECD countries would imply a minimum pension much lower than the minimum wage, with eligibility to some prorated pensions for shorter periods. Aligning the pension system for civil servants with that of private employees would be another source of potential savings.

A pension reform can be part of the effort towards social progress

A pension reform that brings Brazil closer to OECD practice would not compromise the commitment to reduce income inequality. In fact, better targeting of social benefits could accelerate Brazil's social progress. First, less rapid real increases of transfers whose recipients are situated at the 56th percentile of the income distribution, which is where the minimum wage stands, will hardly increase inequality and will not affect poverty.

A shift in social expenditures could also lead to a better balance of social protection across age groups. Part of the savings from a pension reform could be used to increase social transfers with a strong inequality-reducing impact, like the conditional cash transfer programme Bolsa Familia which currently costs less than 1% of GDP. Such a focus on more efficient redistribution instruments would benefit children, whose poverty rates are currently much higher than those of the elderly (Figure 4).

Figure 4. Poverty by age group



Source: OECD Income Distribution Database (IDD).

Moreover, such a shift could achieve the objective of reducing income inequality at a lower cost, or allow further reductions in inequality. For example, microsimulations using household data suggest that during 2012 and 2013, Brazil could have achieved 63% more in inequality reduction as measured by the GINI coefficient than it actually experienced if benefits had been indexed to inflation rather than to the minimum wage and the resulting savings had been spent as conditional cash transfers to poor households with children (OECD, 2015a).

There is also scope to subject survivor pensions to means testing. In addition, given the evidence of abuse in this area (Gragnotati et al., 2011), eligibility for survivor pensions could be subjected to a minimum number of years of marriage or to additional contributions during working life in order to insure a surviving spouse, as practised in Sweden.

Beyond the pensions, there is scope for further improvements in the efficiency of social programmes. The in-work transfer programme Abono Salarial, which costs 0.3% of GDP, should be re-evaluated. The programme pays formal sector workers who earn monthly labour incomes between one and two times the minimum wage, corresponding to the 56th and the 83rd percentile of the income distribution, a social benefit equal to one monthly minimum wage at the end of the year. Limiting this benefit to individuals who earn the minimum wage - instead of the current range - would save 80% of the money now spent, for example.

The original reform proposal submitted to Congress in December 2016

- The original government proposal sets a minimum age of 65 to apply for retirement (irrespective of the length of the contribution period) and raises the minimum contribution time from 15 years to 25 years.
- There will be transition rules for those already close to retirement.
- For those receiving more than the minimum pension, the calculation of pension benefits is changed. With the new formula, about 10 more years of additional contributions would be required to get the same benefit. The minimum pension level will remain at the minimum wage.
- The new conditions will apply to civil servants. Some special regimes will be harmonised, but some including firefighters, the military and police officers will keep a separate scheme.
- Rules for women will gradually converge to those for men over 20 years.
- Survivors' pensions will be reduced and the minimum survivor pension can be lower than the minimum wage.
- The benefit amount of the non-contributory pension (BPC-LOAS) will no longer be fixed as the minimum wage and the eligibility age increased from 65 to 70 years-old.

The proposed constitutional reform contains important steps that would improve the financial situation of the system. In particular, it would do so by both lowering spending and raising receipts. Spending would be reduced through two main channels. First, pension benefits would be lower for the same contribution path. Secondly, the measures would create incentives to retire later. This implies that benefits would be paid for a shorter period, while contributions would be paid for a longer period, thereby lowering pension expenditure while boosting total pension contributions and tax revenues. The effective net savings for the general government budget will depend on the pace of implemented measures. Current propositions imply a transition of 15 years. While it is difficult to assess whether they would be sufficient to ensure financial sustainability, especially given that the link between the minimum pension and the minimum wage is preserved, **all the main proposed measures go in the right direction.**

The final reform package will depend on ongoing negotiations, but policy makers should avoid straying too far from the original proposal in order to significantly improve the financial situation of the system

A brief description of the current system

Qualifying conditions

There are two criteria for eligibility to a pension:

1) With 35 years (men) or 30 years (women) of contributions the individual can retire at any age.
or

2) With at least 15 years of contributions the retirement age is 65 for men and 60 for women (5 years earlier for rural employees)

Benefit for full-career workers

When starting the career at age 20, retirement is possible at age 55 for men and 50 for women, which is way below any OECD country. For men for example, 44 years of contribution are required to get a full pension on average in the OECD, with the lowest period being 39 years for Slovenia and 40 years for Luxembourg and Turkey. While those with expected pension benefits above the minimum pension face incentives to work more years in return for a higher pension, those expecting to receive minimum pension benefits have no incentives to contribute beyond the above conditions.

Social assistance programmes for old-age population

Pension-like assistance benefits are also available to those who do not qualify for a retirement benefit on the basis of the two conditions mentioned above. The BPC-LOAS was created to assist old-age people (65+ years old) or disabled people whose household income per capita is under one-quarter of the minimum wage (floor). They receive an amount equal to the minimum wage and their conditions are reviewed every two years. In 2016, 4.6 million people received BPC-LOAS, with less than half being older than 65 (the disabled represent the larger share). Another benefit, Previdencia Rural (Rural Pension) is for men aged 60 and women aged 55 or older, who have completed at least 180 months of work in rural areas. The benefit is equal to the minimum wage.

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