Brazil’s Pension System in International Perspective

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Outline

- International comparisons
- Need for reform
- What to do?
- Some specific suggestions
- Macroeconomic implications
International comparisons
Gross replacement rates
Net replacement rates
Retirement age (men)
Retirement age (women)
Contribution rates
Pension Spending in International Context, 2011

- Brazil: 9% of GDP
- Advanced Economies: 8% of GDP
- Emerging Economies: 4% of GDP

Source: IMF Fiscal Board Paper FO/DIS/11/252; Brazilian Ministry of Finance
Need for reform
System has bad incentives

- High gross & net replacement rates
- Extremely low retirement age
- Very high contribution rate, exacerbated by additional payroll levies
- Leads to dysfunctional labor market:
  - High informality
  - Low labor force participation
- Must prepare for future demographics
Problems

- Cross subsidies to old-age pensioners
  - Uses 40 percent of resources, but . . .
  - . . . raises much less in terms of contributions

- Payroll tax structure
  - No cap on employer contributions
  - Multiple add-ons (FGTS, etc.)
Problems (cont’d)

- Benefit structure
  - Length of service eligibility
  - Replacement rates (problems with fator)
  - Survivor & disability benefits
  - Tie to minimum wage
What to do?
OECD recommendations

- Work longer
  - Also work more years—start earlier
  - Increases contributions & decreases benefits
- Focus on vulnerable workers
  - For instance, flat benefit
- Shift focus to individual, funded retirement accounts
  - Encourage workers to save on their own
OECD recommendations (cont’d)

- **Work longer**
  - Many countries increasing retirement ages, but not as fast as might be indicated by increasing longevity

- **Focus on vulnerable (esp. poor) workers**
  - Canada, Netherlands & New Zealand are examples
  - Cuts tie between contributions & benefits, incentive for informality
OECD recommendations (cont’d)

- Increase incentives for private saving
  - New Zealand again, United Kingdom, Germany are examples
  - Little incentive to save if public pension system provides high replacement rates
Relevance for Brazil

- Raise retirement age
  - Length of service eligibility still obtains, with low average retirement age
  - *Fator* rewards delayed retirement, but replacement rates still high at low ages

- Focus on vulnerable
  - Old-age pensions (and social assistance pensions) protect vulnerable, but . . .
  - . . . only through huge cross-subsidies distorting the system
Relevance for Brazil (cont’d)

- Encourage workers to save on their own
  - Infrastructure exists, but with high replacement and contribution rates, incentive is not there
  - Private saving works best when the public system is less generous and costly
Relevance for Brazil (cont’d)

- No magic bullets available from international experience
  - Where reforms have been successful, key factors have been discipline & willingness to make hard decisions (and perhaps some luck)
  - Issues in Brazilian system have been well known for a long time, but reforms have been difficult/impossible for both political and legal reasons
Some specific suggestions
Medium-term reform options

- Imperative to bring current system into balance before any fundamental reform
  - Needed reforms have been understood for decades
    - Discussed by local commentators and recommended by IFI TA
  - Most important question: How can political and legal hurdles to reform be overcome?
Medium-term reforms (cont’d)

- Restructure benefit system generally
  - Move from length-of-service to age criterion
  - Rationalize current old-age pension system
    - Should either be self-financing or have explicit budget transfers to cover contribution shortfall
    - Use consistent benefit formula for all worker; subsidies should be explicit and financed
    - Consider generosity of minimum benefits in concert with other antipoverty programs (e.g., *bolsa escola*)
- Needs to be transparent
Medium-term reforms (cont’d)

- Reduce and restructure contribution rates
  - Impose equal cap on employer contributions
  - Eliminate payroll levies for which benefits are unrelated to contributions
    - Possibly shift to consumption tax in line with current trend to “fiscal devaluation”
  - Gradually reduce contribution rates in tandem with replacement rates
    - More emphasis on complementary system
Medium-term reforms (cont’d)

- Restructure factor to reduce replacement rates to balance with reduced contribution rates
- Reduce generosity of survivor & disability benefits, which drain resources
- Close RPPS to new entrants
  - Make employer contributions explicit during phaseout
  - Make compensation transparent
Medium-term reforms (cont’d)

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Longer-term reform options

- Once system is in balance, more fundamental reforms can be considered, building on international experience

- Alternatives
  - Fully privatized (Chile)
  - Basic pension augmented by private saving (Australia, New Zealand, UK)
  - Automatic calibration of pay-as-you-go scheme (Sweden NDCs, Germany)
Macroeconomic implications
Increasing retirement age

- Larger labor force strongly supports growth (including through an incentive to increase investment)
- Public savings increase.
- Given the shorter expected retirement period, private savings decrease, however.
Macroeconomic Effects (cont’d)

- Reducing Generosity of Benefits (including through lower replacement rates)
  - A gradual reduction in benefit generosity encourages higher private savings, which in turn benefits investment.
  - There is also an incentive to work longer (so as to build up savings).
  - Public savings increase.
Macroeconomic Effects (cont’d)

- More emphasis on a complementary system, with both lower contribution and replacement rates
  - Lower contribution rates lead to higher labor supply (and less informality) => Investment rises
  - Private savings increase as benefits will be lower.
  - Public savings increase in the long run, although there is a transition fiscal cost.