Running against population aging

Delay in conducting a broad pension reform of social security reduces scope for promoting a gradual transition system.

Solange Monteiro

SOCIAL SECURITY IMBALANCE is one of most serious problems threatening Brazilian public finances and growth. Brazil’s population is rapidly aging and we have not been able to reform the social security, which already spends the same as richer countries such as Japan and Germany. In 2015, expenditure on pensions amounted to R$683 billion, or 11.6% of GDP. Of this total, the pension is 7.4% of GDP. In other economies with similar demographic and development profiles like Brazil, such as Chile and Mexico, this spending takes up a much smaller share of around 2%.

Keeping the current retirement rules, it is estimated that by 2060, when elderly Brazilian population is expected to more than triple, social security spending will be at 18% of GDP. The population aging and bad economic conditions of the country highlight that the failure of promoting a comprehensive reform of the social security model increasingly reduces the possibility of a smooth transition to a financially sustainable model. “We have wasted a lot of time and if we have the need to carry out a stronger fiscal adjustment, this transition will have to be even shorter,” says Marcelo Abi-Ramia Caetano,
coordinator of social security studies at Institute of Applied Economic Research (IPEA).

The concern is that if on one hand the economy’s recession adds urgency to the social security reform; on the other also it carries risks of resulting in limited reforms, which in the future can compromise the social security sustainability. This was one of the top alerts in the seminar “Pension Reform: An opportunity for Brazil”, sponsored by the FGV Graduate School of Economic (EPGE), FGV Law School, and the Brazilian Institute of Economic (IBRE) in April, in Rio de Janeiro. At the event, Joaquim Falcão, Dean of FGV Law School, argued for analyzing the social security problem as a structural problem separate of the current dire economic situation, highlighting the difficulty of reaching a consensus on “reconciling the government’s cash flow with social security benefits, among the various social groups, the current generation to future generations, and political interests of Congress and the Executive.” Manoel de Castro Pires, Secretary of Economic Policy of the Ministry of Finance, recognizes the challenge to educate society about the importance of a technically complex and inevitably unpopular issue. “Yet, we need to find a narrative that reflects correctly the serious economic dimension of the social security issue,” he says.

Economic costs
For Afonso Arinos de Melo Franco, EPGE, the starting point for a comprehensive reform is to look into the current social security regime of transferring working population’s income (consumption capacity) to retired and assess its costs in terms of fiscal and economic growth. “The current social security regime affects savings and

Brazil's population is aging rapidly
Projected population in millions

<table>
<thead>
<tr>
<th>Year</th>
<th>0 to 14 years</th>
<th>15 to 65 years</th>
<th>more than 65*</th>
<th>elders-to-adults ratio (%)</th>
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</thead>
<tbody>
<tr>
<td>2015</td>
<td>47.4</td>
<td>140.9</td>
<td>16.1</td>
<td>11.5</td>
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<tr>
<td>2020</td>
<td>44.3</td>
<td>147.8</td>
<td>20.0</td>
<td>13.5</td>
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<tr>
<td>2030</td>
<td>39.3</td>
<td>153.9</td>
<td>30.0</td>
<td>19.5</td>
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<tr>
<td>2040</td>
<td>35.4</td>
<td>152.6</td>
<td>40.1</td>
<td>26.3</td>
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<tr>
<td>2050</td>
<td>31.8</td>
<td>143.2</td>
<td>51.3</td>
<td>35.8</td>
</tr>
<tr>
<td>2060</td>
<td>28.3</td>
<td>131.4</td>
<td>58.4</td>
<td>44.4</td>
</tr>
</tbody>
</table>

Change in %
2015 to 2060
-40.3%   -6.7%    262.7%   286.1%

Source: IBGE.
* According to IBGE, life expectancy of a 65 year old person will increase from 18 year in 2015 to 21 years in 2060.
“The current social security regime affects savings and investment, [and consequently growth],” he says.

The impact on growth results, among others, from the low retirement age in the General Social Security System (RGPS): on average, 58 years, against average 64 years in 34 countries in The Organisation for Economic Co-operation and Development (OECD). Franco points out that the current regime encourages the early retirement of productive people and increases consumption. “As a result, it reduces aggregate savings of the economy and investment in physical capital,” he says.

Luis Eduardo Afonso, School of Economics, Business and Accounting of the University of São Paulo (FEAUSP), highlights the lack of progressivity of the current social security regime: the average lower age retirees in Brazil are individuals with higher pensions and contributed only for working time. “The regime allows the better educated individuals that spent more time in the formal labor market—therefore, higher income—to retire before the others,” he says. He adds that, compared to other countries, Brazil has a high social security benefit-to-contribution ratio, which implies “a relatively high benefit for

Projections indicate that Brazil's social security benefits would reach 12% of GDP by 2050, adding public employees' pensions benefits would total 16% of GDP more than Italy spends in social security.

(% of GDP)
GDP growing at 2%

Source: IBGE.
a long time period,” as life expectancy has risen. Government statistics agency (IBGE) projects that the life expectancy of 60 year-old Brazilians will increase from 22 years in 2015 to 25 years in 2060.

At the seminar, experts pointed out that the mix of social security, assistance and income redistribution objectives of the current social security system, as well as the accumulation of a number of exceptions, results in a high level of payroll taxes with negative effects for the labor market, encouraging informal labor or arrangements that reduce payroll taxes. Bernard Appy, director of the Tax Citizenship Centre, indicates that low-income workers are not encouraged to pay social security taxes “because the value of social assistance benefits is the same social security benefits floor,” while professionals with higher income “avoid paying social security taxes through loopholes.” The difference between the alternative ways to pay social security taxes is significant. While the basic social security taxes range from 28% to 31%—employers pay 20% on the total wages and employees pay between 8% to 11% on the contribution salary—an individual can pay 11% of minimum wage or 5% of earnings as an individual micro-entrepreneur, guaranteeing the same rights, except for the possibility to retire by working time. In addition to reducing tax collection, Appy notes that the search for less expensive working arrangement from the taxation point of view can result in less efficient businesses, harming economy’s productivity.

The experts also advocated the need to eliminate the subsidies resulting from different retirement age or social security tax rules for gender and rural workers—which, they say, are no longer consistent with the labor market reality in the country. Paulo Tafner, IPEA researcher, points out that the actuarial deficit of women’s retirement is almost 40% higher than male’s, with an upward trend. “Women retire five years earlier, live eight years longer, and today their participation in the labor market is growing at a faster rate than the male,” he says. Tafner points a global tendency to equalize the retirement age of men and women. “Countries like Germany, Spain, Netherlands, Portugal, South Korea, Mexico and Peru have set the same age for both men and women at 65 years.” The same applies to in rural worker’s retirement. Despite the great development of agribusiness in the country, with more skilled workers, rural workers contribute relatively little for their pensions—only 2% of total social security revenue in 2015. “If we changed the rural sector’s social security taxes closer to the urban sector, we would have more tax collections and provide more legal certainty

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in granting social security benefits to rural workers,” says Pires.

Another issue contributing to the social security imbalance is the indexation of pension benefits to the minimum wage. “The minimum wage indexes more than 60% of welfare benefits and 40% of spending. Letting benefits grow much more than the economy in a context where the population is aging rapidly is not sustainable,” Tafner says. He estimates that, all else constant, every 1% real increase in the minimum wage implies 0.44% more in welfare spending. “And despite this impact, the effect of this policy on poverty reduction is very limited,” he adds.

Consensus and communication

In view of all distortions numbered, experts at the seminar see that the reform agenda needed to make social security financially sustainable cannot be limited to a partial fix. Experts view as critical elements of a broad social security reform: delinking benefits from the minimum wage, gradually eliminate retirement for working time, increase the retirement age, make the same the eligibility for retirement benefits between men and women and urban and rural workers, separate non-contributory social assistance benefits from contributory social security benefits, and set stricter rules for granting non-contributory social assistance benefits, which in Brazil represent more than double the spending recorded in the world average. Kaizô Beltrão, EPG, estimated the impact of these changes on social security financial balance: it would reduce social security spending by 8 percentage points of GDP by 2030, stabilizing spending at the 2010 level.

Afonso, FEAUSP, sees as critical the combination of the various reform measures; if they are badly orchestrated, they can generate imbalances. He believes the ideal would be to establish an automatic adjustment mechanism that adjusts benefits and contributions according to demographic and economic variables within the defined rules. “Thus there would be no need to renegotiate the rules, something painful to be done through Congress.”

On the side of tax collection, Afonso also advocates the elimination of different rules for gender and rural workers. Appy supports separating contributory social security benefits from non-contributory social assistance benefits, which should have its own funding. “Reducing the payroll taxes on low-income workers generates gains, including from the political point of view,” he adds.
Pires, Ministry of Finance, believes a successful social security reform could have significant impacts in the short term as it would “diminish the perception of fiscal risk and signal budget flexibility, reducing long-term interest rate [and stimulating the economy].” In the long term, Pires points out the reform would reduce the incentives for early retirement, raise savings and increased productivity. He points out that, with the increase in the number of retirees compared to the working population, Brazil will require a 28.6% labor productivity over 2016–2050 to maintain social security sustainable.

Seminar participants agreed that the challenge for a broad reform of social security is not technical, but political consensus, for which is essential to raise society’s awareness of the costs of their choices. “We need to dispel popular myths that if the economy grows the social security deficit will disappear as it is impossible to stimulate the economy with the current structure of public spending, and a paternalistic view of the government as benefactor. Things have their price and someone has to pay for it,” says José Cechin, CEO of Fenasaúde and former Minister of Social Security. Rubens Penha Cysne, director of EPGE, underlined the initiative of the seminar as the creation of a permanent forum for debating Social Security reform, contributing to the dissemination of ideas and consensus building.

“Today people hold the common view that retirement pension will replace income, but no country in the world does this,” says Afonso. He argues that social security reform debate should be accompanied by financial education and savings incentives for private supplementary pensions. “If we do not this, we can fuel a backlash against social security reform in the future due to dissatisfaction about the fall in benefits,” says Caetano, IPEA, warning about the Brazilian historical record of reforms in search of social security sustainability followed by reversal of reforms, involving long judicial processes by claimants.