Brazil

PENSION REFORM TAKES SHAPE

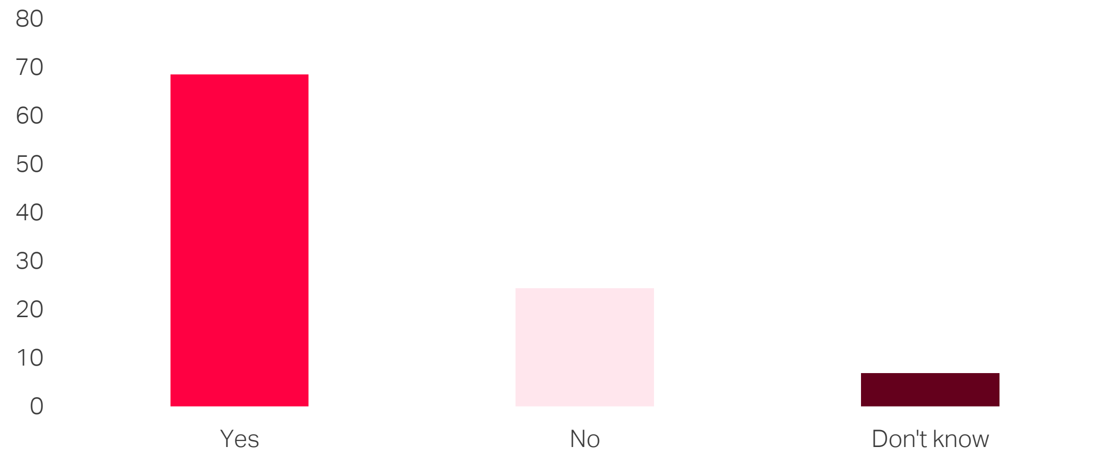
Brazil team

- **Growing popular support for reforming the pension system will aid approval of the reform**
- **Economy Minister Guedes appears to be winning the battle for a more ambitious pension reform, but Bolsonaro will have the final word**
- **Another good sign for reform is growing support for the re-election of Lower House Speaker Maia, but the Senate presidency remains a risk**
- **A further risk is posed by Bolsonaro's top political coordinators, who do not support a robust reform**

Support for pension reform is surprisingly strong. President Jair Bolsonaro and his economic team received some positive news this week with the release of an opinion poll conducted last month by Paraná Pesquisas about pension reform. No fewer than 68.6% of those surveyed in the poll said they believe that the new administration should move ahead with pension reform. The poll numbers confirm that despite the unpopularity of the pension overhaul, the widespread debate about pension reform conducted over the past two years has slowly convinced public opinion of the unsustainability of the current pension system. This bodes well for the new administration, which is already benefiting from surprisingly strong approval ratings, as we highlighted last month (see our 16 December 2018 note Sun and clouds in 2019).

Chart 1: Should Bolsonaro reform the pension system?

% / Poll dates: 12-15 December

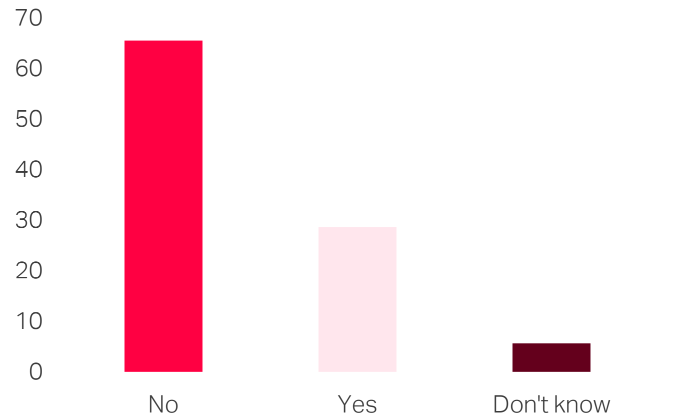


Source: Paraná Pesquisas.

The population increasingly understands the inequity of the current system. In addition to the growing understanding of the need for pension reform, the poll highlights that people are increasingly aware of the inequality of the current pension system, which has created a privileged class of civil servants. This message was repeated consistently during the Temer administration and reiterated last week by Bolsonaro's economic guru Paulo Guedes in his first official speech as Economy Minister. Guedes called the Brazilian pension system a "factory of inequality", a description that most local pension experts would agree with. In an encouraging sign that the message has begun to filter through to the general population, 65.6% of respondents in last month's poll said that public-sector workers should not continue to receive full salaries after retirement (see Chart 2 below). Indeed, significantly higher pensions are paid to public-sector workers compared with those in the private sector, as Chart 3 below shows.

Chart 2: Should public workers continue to receive full salaries after retirement?

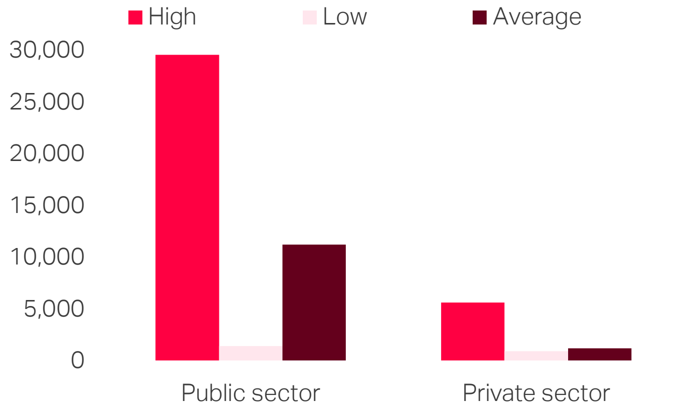
% / Poll dates: 12-15 December



Source: Paraná Pesquisas.

Chart 3: Average pensions for public- vs private-sector workers

BRL/month



Sources: Folha de S. Paulo, INSS.

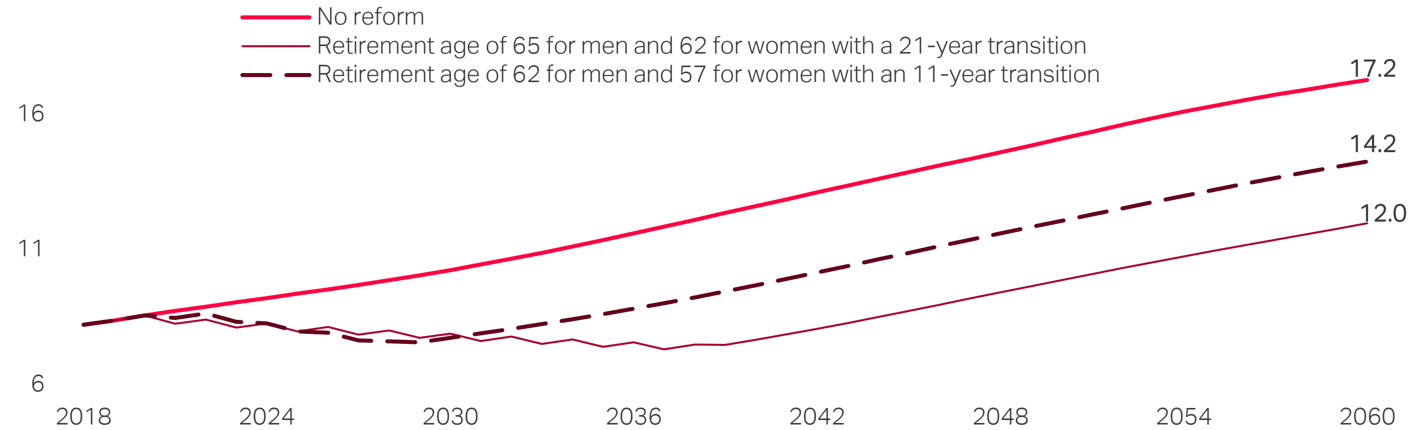
Despite mixed signals from Bolsonaro himself, Guedes' push for a broad pension reform appears to be gaining the upper hand. Although the new government's pension reform proposal has not yet been released, Economy Minister Guedes has indicated that the goal is to pass a robust reform that will put Brazil on a sustainable fiscal path for the next two decades, rather than one that would need to be revisited by the next government. This is a positive sign after President Bolsonaro indicated that he might propose a less ambitious reform last week. Bolsonaro's missteps were compounded last Friday by his erroneously announcing a hike in the IOF financial transaction tax as well as a reduction of the income tax rate to 25% from 27.5% – both statements which later had to be redacted by the Social Security Secretary Marcos Cintra and which generated massive confusion and a scathing round of criticism by local media. Following the incident, Bolsonaro reiterated this Monday his willingness to leave economic matters to Guedes. The extent to which the President is able to follow this policy will be fundamental to monitor, because it could dictate the success or failure of the economic reform agenda this year.

The minimum retirement age and transition period proposals will be key to monitor. More ambitious proposals advocate a minimum retirement age of 65 for both men and women, whereas the Temer proposal stipulated a minimum retirement age of 65 for men and 62 for women. Similarly, the more exacting proposals see a 10-year transition period to the new retirement age for older workers, while under the final Temer proposal it would have taken more than 20 years for all workers to be subject to the minimum retirement age. As highlighted below, the long-term savings for the reform hinge on these factors. And while we do not expect the wholesale approval by the legislature of any proposal presented by the government, if the initial reform is not sufficiently ambitious, it could ultimately be watered down to the extent that it would have a very limited impact on fiscal accounts. As a case in point, the original Temer pension reform proposal first launched in December 2016 was expected to generate fiscal savings over the first decade of BRL670-800 billion, but the current bill has been whittled down to about half of the estimated fiscal savings. Furthermore, because the Temer government failed to pass the reform, which led to two more years of fiscal erosion, the Bolsonaro administration must enact a more ambitious reform simply to achieve the same fiscal results.

These details have the potential to make or break the reform. In 2017, total spending for private-sector pensions reached 8.4% of GDP and nearly 12% if federal public-sector pensions are included. If the pension system remains on its current, unsustainable trajectory, we estimate that total pension spending for private-sector workers alone will rise to 17.2% of GDP by 2060. Should the final proposal from the Temer administration that is currently in the Lower House be approved – which changes the minimum retirement age to 65 for men and 62 for women respectively, with a 21-year transition period – total pension spending could rise much more gradually to 12% of GDP by 2060. But in a scenario with a minimum retirement age of 62 for men and 57 for women and an 11-year transition period, which Bolsonaro hinted he could support, total pension spending could rise to 14.2% of GDP by 2060, making this third option a less optimal reform than the Temer plan (see Chart 4 below).

Chart 4: Pension spending for private-sector workers as a percentage of GDP

% of GDP



Sources: IBGE, Finance Ministry, TS Lombard estimates.

The administration also indicated this week that it will seek to pass the reform in one fell swoop. Aside from Bolsonaro's mixed signals, other seemingly positive elements include the announcement that the administration plans to attempt to pass a single reform, rather than to subdivide the reform into several bills that would be passed separately, as Guedes suggested he was in favour of last year. We believe that this will make a stronger reform easier to pass. Similarly, the administration has also announced that it plans to push ahead with the inclusion of a Chilean-style capitalization element to the reform that would change Brazil's defined-benefits pension scheme to a defined-contributions scheme. However, Guedes added that this is likely to apply only to middle- and upper-income Brazilians. By excluding lower-income Brazilians from this part of the pension reform, we believe it would be easier to pass. At the same time, however, local pension experts are strongly divided on the inclusion of this element, with some arguing that it complicates a pension reform unnecessarily and that a transition period from Brazil's current system to the new system would be very costly for the government.

In tandem with this, Bolsonaro has promised an audit of current pension recipients to reduce fraud. While the reform is being finalized, the new government is hoping to boost short-term savings through an in-depth analysis of current pension recipients. According to Social Security and Labour Secretary Rogério Marinho, there are indications of irregularities in an estimated 2 million pensions. These include disability pensions for people who have recovered from an accident or illness and are able to work. The audit will also analyze rural pensions to confirm that recipients did work at their declared jobs.

The measure will also aim to strengthen the regulatory framework for the National Social Security Institute (INSS) to conduct these audits and will also offer bonuses to INSS workers to conduct the investigations. Marinho cited a study by the National Audit Court (TCU) that indicated that there are irregularities in as many as 30% of pensions. Because the audit could go into effect immediately, it could result in savings of BRL9 billion in the first year alone. That would be equivalent of roughly 4% of the total pension deficit for private-sector workers projected for 2019. Economy Minister Guedes said this week that the move could result in BRL17-20 billion/year in fiscal savings and could be signed by Bolsonaro as a presidential decree this week; however, it would still need to be passed by the Congress in H1/19 to be enshrined in legislation.

The government has also indicated that it could change the rules for benefits granted to the dependants of prison inmates. As part of his tough-on-crime stance, Bolsonaro has attacked the pension benefits granted to the families of those incarcerated in jail, arguing that it creates incentives for crime. Currently, the pensions paid to such families are slightly higher than the minimum wage, which has enraged Bolsonaro and his supporters. Under the proposal, which is still being finalized, the terms of these pension payments would be altered to make it more difficult for dependents to claim benefits. Although the savings would be marginal (roughly BRL600 million/year), the proposed changes to these benefits would please Bolsonaro's base.

Legislative touchpoints ahead to watch

In another boost to reform hopes, market-friendly Lower House Speaker Rodrigo Maia stands a good chance of winning re-election in the upcoming 1 February election for top legislative leaders. Having proved his legislative credentials over the past two-and-a-half years as Speaker, Maia – who belongs to the centre-right Democrats party (DEM) – has always had an edge over other candidates heading into this important election. But his chances of gaining re-election were further aided last week when, in a surprise announcement, Bolsonaro's Social Liberal Party (PSL) agreed to support him. The PSL will be the second-largest party in the Lower House in the new Congress, with 52 congressmen, making its endorsement an important one. Previously, Bolsonaro's son, Eduardo, who is the PSL Lower House leader, had confirmed that the party was keen to support another candidate, adding to fears that the PSL could be excluded from top committee posts if its chosen candidate lost and Maia won.

In exchange for PSL support, Maia has promised to give the party the presidency of the Lower House Constitution and Justice Committee, which is crucial for passing constitutional amendments and establishing legislative governability. In addition, Maia has agreed to give the PSL the presidency of the Finance and Tax Committee as well. Thus far, 12 political parties totalling 262 Congressmen (or 51% of the Lower House) have already announced their backing for Maia's candidacy, which appears to put him above the threshold of victory. Besides the PSL and Maia's DEM parties, they include the Social Democratic Party (PSD), the Party of the Republic (PR) and the market-friendly Brazilian Social Democratic Party (PSDB).

Still, Maia's re-election is not a foregone conclusion, which means last-minute candidates are key to monitor. While the winds are strongly blowing in the Speaker's favour, the legislative vote is likely to be a secret one in which individual congressmen could easily disregard their party's preferred candidate in favour of someone else if they choose. Despite a case filed against the secret vote, Supreme Court Chief Justice Dias Toffoli on Wednesday rejected a motion to make the vote an open one, which adds to the outside risk that a dark horse candidate could yet unexpectedly emerge as victor. Moreover, other big parties that were once in Maia's camp were not only disconcerted but downright dismayed by the Speaker's alliance with the PSL, as it has turned him into the government candidate for the post rather than a candidate who will uphold the Lower House's independence.

Such parties include the leftist Workers' Party (PT) of former President Lula, the largest party in the Lower House, which supported Maia in his previous election to Lower House head but is now leaning towards not backing him this time around. They also include the Progressive Party (PP) and the Democratic Movement Party (MDB) of former President Michel Temer, the third- and fourth-largest parties, respectively. If the PT, PP, MDB and other opposition parties can all rally behind another candidate such as Deputy Speaker Fábio Ramalho (MDB) or the PP's Arthur Lira, Maia could find himself with a tougher race ahead than he expected and see the election go to a runoff round. To add to the simmering underlying tensions, the PP and MDB have been unhappy with Bolsonaro's refusal to cede key posts to their parties in exchange for their support, not to mention the strong anti-corruption drive that is backed by Justice Minister Sérgio Moro. These issues could spill over into the legislative leadership elections if the new government makes missteps, meaning that Maia's triumph is not guaranteed, although he is the favourite to win.

The reform scenario looks less optimistic in the Senate, where Senator (and former Senate President) Renan Calheiros is the frontrunner for the Senate presidency. Supreme Court Justice Toffoli's decision this week to reject an open vote in the legislative leadership elections has had important and negative implications for the Senate race too, as it favours the election of scandal-hit Senator Renan Calheiros (MDB). If the vote were an open one, many Senators could find themselves embarrassed to vote for Calheiros as he is being investigated on multiple corruption charges. In a secret vote, however, this is unlikely to be the case. Another factor favouring his candidacy is that the Senate presidency is traditionally awarded to the upper legislature's largest party, which is the MDB. According to his allies, Calheiros could have as many as 52 votes sewn up or 64% of the vote. But, once again, a secret vote makes the final vote count unpredictable. Calheiros' MDB colleague Senator Simone Tebet is another contender for the post, as is incoming PSL Senator Major Olímpio and PSDB Senator Tasso Jereissati. However, the odds of the latter two candidates being elected are long at the moment, as the PSL has only 5% of the seats in the Senate and Jereissati – despite his market-friendly status – does not have the support of other key PSDB senators.

Although Calheiros has tried in recent weeks to show that he is aligned with Economy Minister Guedes' reform agenda – even going so far as to have dinner with Guedes after the elections and going on to praise him (see our 2 December 2018 note Guedes wades into the fray) – he is likely to be unreliable if he succeeds in winning the Senate presidency. During his successful Senate re-election campaign last year, Calheiros campaigned as a strong ally of former President Lula. He also appears likely to advocate a more watered-down version of pension reform when the bill reaches the upper legislature. Furthermore, if his track record is any indication, he has the potential to reject market-friendly reform initiatives outright, as he did in

2015 when he was Senate President under the Dilma government – a move that heightened Dilma's problem of maintaining governability in Brasilia and contributed to her downfall.

In addition to the legislative leadership elections, another key issue to monitor will be signs from Bolsonaro's top political coordinators on pension reform. Thus far, however, the signals have been half-hearted on this front, in stark contrast with the rhetoric from the President's economic team. As we have previously written (see our 2 November 2018 note Mixed messages from the Bolsonaro team), Bolsonaro's Chief-of-Staff Onyx Lorenzoni and incoming PSL Senator (and current Congressman) Major Olìmpio were fierce critics of Temer's pension reform and teamed up with the PT to vote against it in a Lower House committee. Unfortunately, there has been little sign to date that their stance has changed. In an interview this Monday, Major Olímpio confirmed that he is in favour of a more gradual reform and once again argued that state military police and prison guards should be subject to less rigorous rules than the general population. He also said he remains in favour of a longer transition period to the minimum retirement age than the one provided for in the current Temer pension reform bill.

In another negative sign, Government Secretary General Carlos Alberto de Santos Cruz – who alongside Chief-of-Staff Onyx is one of Bolsonaro's top two political liaisons – told local press on Tuesday that he believes the military should be excluded from pension reform. The same view was expressed by Bolsonaro's Defence Minister, General Fernando Azevedo e Silva, in a recent interview. On a positive note, Vice President Hamilton Mourão, a retired general himself, has offered to negotiate a pension reform that is acceptable to the military, which could help to include them in the overhaul of the pension system, but the already open dissent from the other generals on Bolsonaro's core team indicates that the debate will be a heated one.

As we have previously highlighted, how Bolsonaro ultimately decides to treat the military and related personnel in his pension reform bill will be crucial to monitor for how robust or watered down the fiscal savings will ultimately be. This is because other lobby groups will fight tooth and nail for similar exclusions if the military receives special treatment, whereas if the reform is consistent for both public and private employees, it will be easier to adopt the moral high ground as well as to sell it to the general population.

Although such statements do not, of course, automatically doom the President's pension reform to one that will lead to significantly reduced fiscal savings, they do indicate that to date, the government's top political lieutenants have not yet been convinced of the importance of a robust fiscal reform. Signs on this front are therefore key to monitor. Should the rhetoric of the military top brass and Bolsonaro's top legislative liaisons change, it would be positive for investors; but if they continue to make statements along the same lines over the next four to eight weeks it would be negative for market hopes of a robust pension reform.

Conclusion

Bolsonaro has been given a golden opportunity to pass pension reform. Despite early missteps and his clear lack of understanding of economic policy, Bolsonaro remains on solid footing to pass pension reform this year if he can seize the opportunity. As we highlighted in our 13 December 2018 note Why pension reform can pass in 2019, the Temer administration has done the groundwork for the reform. Similarly, many Brazilian states are already facing significant pension-related crises, which will boost support for the reform owing largely to their growing fiscal problems. Only six governors started the year without fiscal problems, which means that the remaining 21 states face significant economic troubles.

The new administration is unlikely to face its own fiscal crisis in 2019. Despite uncertainty about whether the mega pre-salt auction can take place this year, Guedes and his team should comfortably meet the 2019 primary deficit target of BRL139 billion (-1.8% of GDP) in the 2019 budget. For 2019, the government should even be able to post a lower-than-expected primary deficit, especially if the BNDES state-run development bank increases repayments to the Treasury, GDP growth meets the current market estimate of 2.5% and other planned privatizations and IPOs take place. According to average market estimates, the government is likely to post a BRL100 billion primary deficit this year, even without extraordinary revenues from the pre-salt mega-auction. While this would be a far cry from Bolsonaro's campaign promise of getting rid of the primary deficit in one year's time, it would nonetheless keep Brazil's short-term fiscal situation from deteriorating further. And if the government were to succeed in holding the mega pre-salt auction this year, then it could end 2019 with a much better primary balance. That scenario would also mean that the administration would have much more breathing room to tackle its two other key fiscal challenges of the year: meeting the federal spending cap and the golden rule.

Without pension reform, however, fiscal accounts will continue to deteriorate. Although we continue to expect pension reform to pass, the Bolsonaro government cannot drop the ball. While initial signs indicate that the new administration is keenly aware of the need to push the reform through as quickly as possible, it remains unclear whether Bolsonaro himself understands the gravity of the situation. Unless he fully supports a robust reform, there is a risk that the Congress will water down the administration's proposal beyond recognition.