Brazil

MAIA TAKES THE LEAD ON PENSION REFORM

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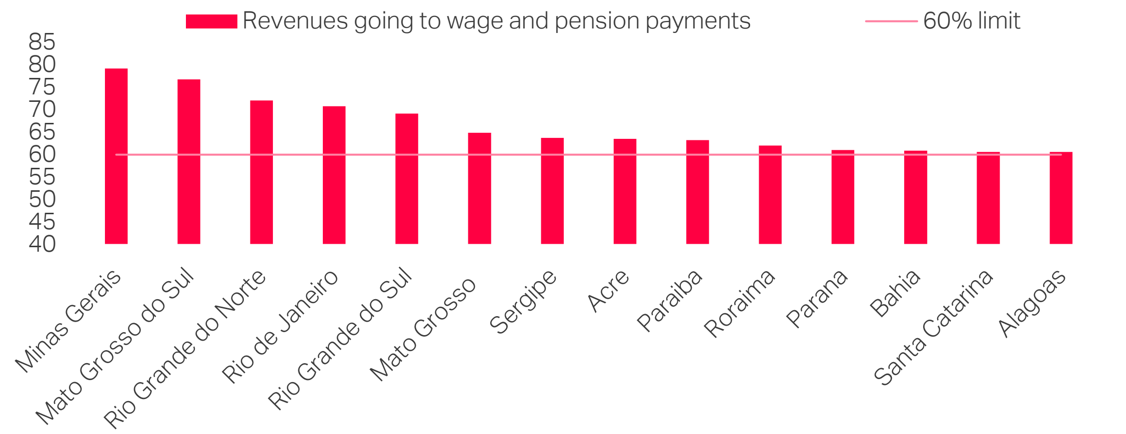
- **Support from a growing number of governors of cash-strapped states will help the government approve pension reform**
- **Lower House Speaker Maia is the key political supporter of the reform, but he will seek to show his independence from the administration**
- **For his part, Economy Minister Guedes has shown his willingness to offer financial assistance to states in exchange for their support for reform**
- **Because of the extension of his hospital stay, Bolsonaro has still not signalled whether he will push for a more ambitious reform**

Wage and pension payments as percentage of total revenues in fiscally troubled states

% of total revenues



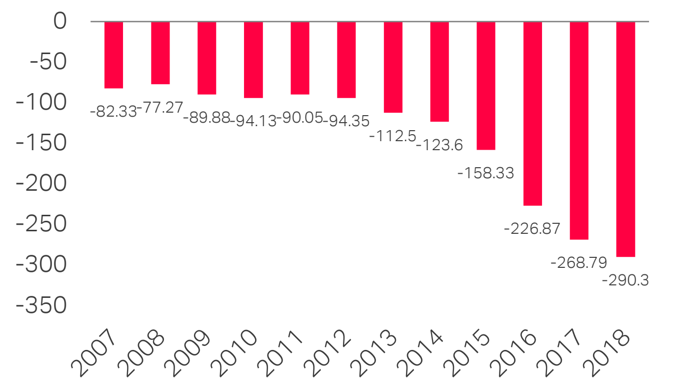
Source: Brazilian Treasury.

Pension reform isn't only about the federal government

Investors are focused on the approval of pension reform because it will put federal government spending on a more sustainable path. The unsustainable nature of Brazil's federal pension system has been broadly debated in recent years. Since the federal spending cap was passed in 2016, thereby limiting public spending to the rate of inflation, the growth in pension spending has increasingly become a topic of public debate and investor focus. In 2018, the consolidated federal pension deficit increased 8% yoy to BRL290.3bn, contributing to the country's fifth consecutive federal primary fiscal deficit last year (see Charts 1-2 below), further highlighting this problem.

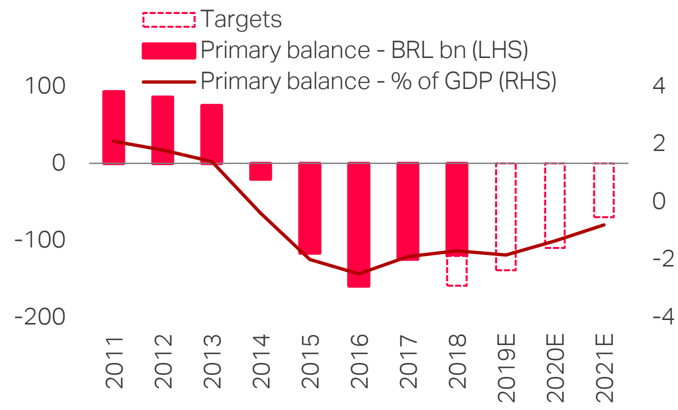
Chart 1: Consolidated federal pension deficit

BRL bn



Source: Social Security Secretariat.

Chart 2: Federal primary balance and targets in 2019 budget



Sources: Finance and Planning Ministries.

A growing number of states are already in fiscal crisis. While the federal government's fiscal situation is far from comfortable, many Brazilian states have already reached tipping point. The fall in tax revenues because of the recent recession resulted in a loss of BRL278 bn in revenues between 2015 and 2017, according to economist Raul Velloso. Meanwhile, consolidated debt levels of Brazilian states jumped to BRL746.4 bn in August 2018 from BRL353.2 bn in 2009, the Senate's Independent Fiscal Institution reports. Although irresponsible borrowing during the Dilma era is in part to blame for the ballooning debt levels, rising pension spending on state government employees is also a significant factor.

In the past month, for example, four states declared "financial calamity," because they are unable to pay the wages of civil servants in a timely fashion, service their debts or pay suppliers. Although declaring "financial calamity" gives state government's more budgetary flexibility, it does little to solve their longer-term fiscal problems, which can be resolved only through political negotiations and the approval of structural reform.

Fortunately, many newly elected or re-elected governors are eager to quickly find solutions to their state's fiscal problems. For example, all four of the states that declared financial calamity this year – Goiás, Roraima, Rio Grande do Norte and Mato Grosso – have first-term governors who took office with little or no money in the bank to cover basic expenses. Unless they manage to get their state's finances on track, they are unlikely to be able to fulfil campaign promises, much less meet their financial obligations, reducing their chances of being re-elected in 2022.

Table 1: Fiscal and political indicators of states in "financial calamity"

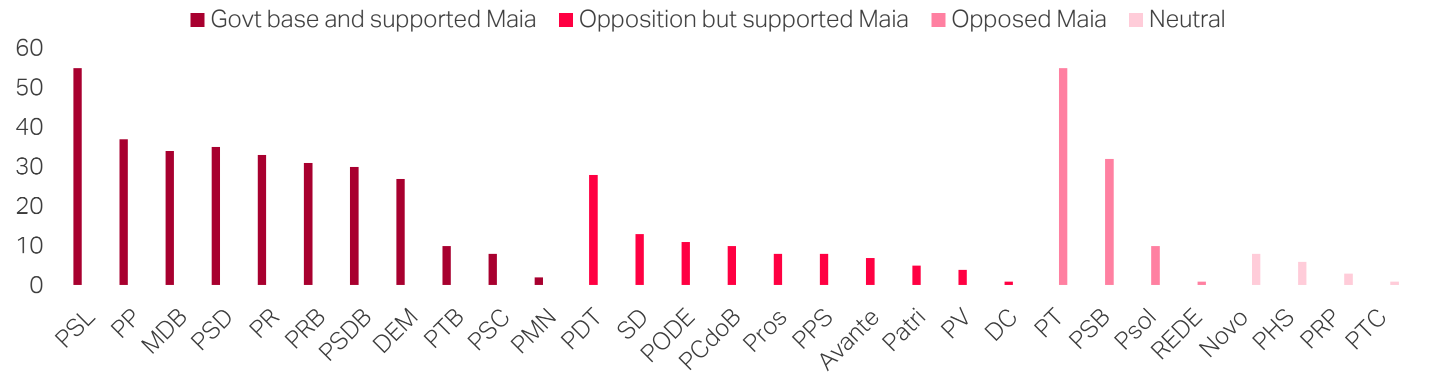
State	Governor/party	No. of federal Congressmen	Debt/revenue ratio	Payroll/pension as % of spending	Payroll/pension as % of revenue
Goiás	Ronaldo Caiado (DEM)	17	0.92	52	58.4
Roraima	Antonio Denarium (PSL)	8	0.415	54	62.0
Rio Grande do Norte	Fátima Bezerra (PT)	8	0.132	74	72.1
Mato Grosso	Mauro Mendes (DEM)	8	0.441	58	64.9
Rio de Janeiro	Wilson Witzel (PSC)	45	2.70	56	70.8
Minas Gerais	Romeu Zema (Novo)	53	1.86	60	79.2
Rio Grande do Sul	Eduardo Leite (PSDB)	31	2.19	57	69.1

Source: Treasury

Speaker of the Lower House Rodrigo Maia sees governors as important allies in the battle to pass pension reform. Following the ease with which he won re-election, gaining votes from parties across the political spectrum (see Chart 3 below), Speaker of the Lower House Rodrigo Maia has taken ownership of pension reform. Maia has a clear understanding of the fiscal outlook for the federal government without the reform. But he is also keenly aware of the fiscal troubles that many states, including his own state, Rio de Janeiro, are currently facing. Maia's willingness to take the lead as the political advocate of the pension reform is good news for Economy Minister Paulo Guedes, especially since the Lower House leader of Bolsonaro's Social Liberal Party (PSL), Goiás Congressman Vitor Hugo, received a very lukewarm response from other members of the government's allied base in his first attempt to discuss pension reform last week. Maia has wasted no time in his efforts to try to increase support for the reform and has made it clear that he will seek to rally state governors in an effort to make them the foot soldiers in his battle for the pension reform.

Chart 3: Parties that supported and opposed Maia's re-election

No. of seats



Source: Local media.

But Maia is also seeking to remain independent from the administration and to give the Lower House a stronger voice in the legislative processes. While Guedes continues to hash out the final details of the reform proposal and wait for Bolsonaro's release from the hospital, Maia is seeking to show members of the lower legislature that he will give them an active voice in shaping the reform. For example, the Economy Minister had indicated his plans to piggyback the new pension reform proposal on the Temer version in order to speed up approval of the reform, but Maia has put the kibosh on those plans. In several interviews since being re-elected Speaker, he has said that a new constitutional amendment will have to be submitted and that it will need to clear all the hurdles required of such an important piece of legislation. Maia justified this decision by arguing that rushing legislative approval could mean facing legal challenges from the country's highest court (STF) down the road. Thus, the reform will need to be approved by the Constitution and Justice Committee (CCJ) as well as by a special committee that will have to be created specifically to analyse pension reform.

Noting that members of the Congress typically spend more time in Brasilia during the first month of the legislative session, Maia estimated that it will be possible for the document to clear the CCJ roughly three weeks after the proposal is formally presented to the Lower House. Because the PSL is the largest party in the Congressional bloc that supported Maia's re-election bid, the party is likely to be given control of the CCJ, which is important for the process of legislative approval. Still, the upcoming Carnival holiday (4-6 March) will likely delay the work of the CCJ. Maia added that an additional 11 sessions of the special committee will be necessary, which means up to three weeks. Only after these two hurdles have been cleared will the bill be presented to the 513-member lower legislature, where it needs to be approved by a three-fifths majority in two full floor votes. Maia estimates that realistically, the reform could be sent for a full floor vote in the second half of May and approved by June.

Maia has also indicated that pension reform is his top priority and that he will work closely with Guedes. With one eye focused on his own political future, Maia has made it abundantly clear that he plans to play a fundamental role in gaining votes for the proposal. He has given interviews on several major television networks and newspapers, stressing the importance of the reform for the future of the country. Maia has been a key ally for Guedes, and the Speaker's meetings with governors dovetails with work by members of the economic team in Brasilia, who are also seeking to convince state leaders to lobby their representatives in Brasilia in favour of the reform.

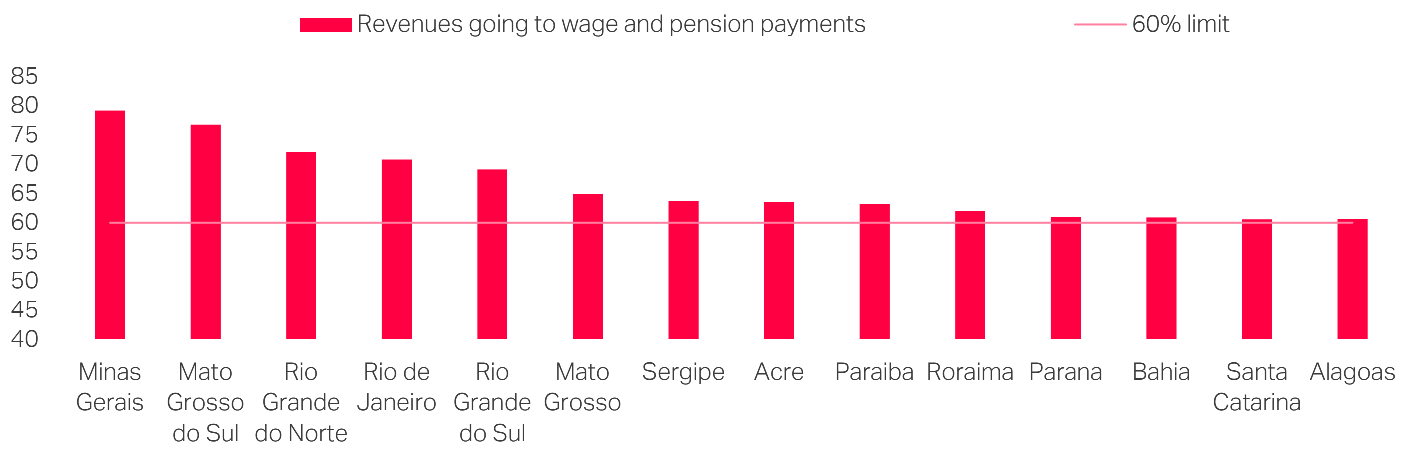
Quid pro quo for cash-strapped states

Maia is already seeking to bring cash-strapped governors on board to support reform. In the ten days since his re-election, Maia has sought to broaden the pension reform debate to include state and municipal governments, rather than just the federal government. Building on his own support from parties across the political spectrum, he has already started to meet with state governors. Last week, Maia met with Camilo Santana, the Workers' Party (PT) governor from Ceará state as well as São Paulo Governor João Doria, who is the leader of the Governor's Forum, a group which supports pension reform. This week, he is scheduled to meet with Wellington Dias, the PT Governor of Piauí, and Pernambuco Governor Paulo Câmara of the Brazilian Socialist Party (PSB). Maia is hoping to convince them – along with their respective representatives in the legislature – of the importance of pension reform for their own states.

Now that the election is over, governors are more willing to support the reform, especially if it gives them some breathing room to invest in health, education, public security and infrastructure. Indeed, without the reform, governors would have to continue spending a growing share of tax revenues on wage and pension payments, leaving very little for investment. Tight budgets have resulted in hospital closure and rising crime in the worst cases and are in part responsible for the wave of outsider politicians elected in gubernatorial races last October.

Although Temer had tried to convince governors to support the reform and to lobby their representatives to approve it, this strategy failed for him because of his low popularity which most governors saw as a political liability. While many governors undoubtedly would have liked to see pension reform passed, they were afraid of supporting it ahead of the 2018 election. With the new term started, they now see a window to support the reform – and in doing so they may be able to reap some of its benefits ahead of the 2022 election.

Chart 4: Wage and pension payments as percentage of total revenues in fiscally troubled states

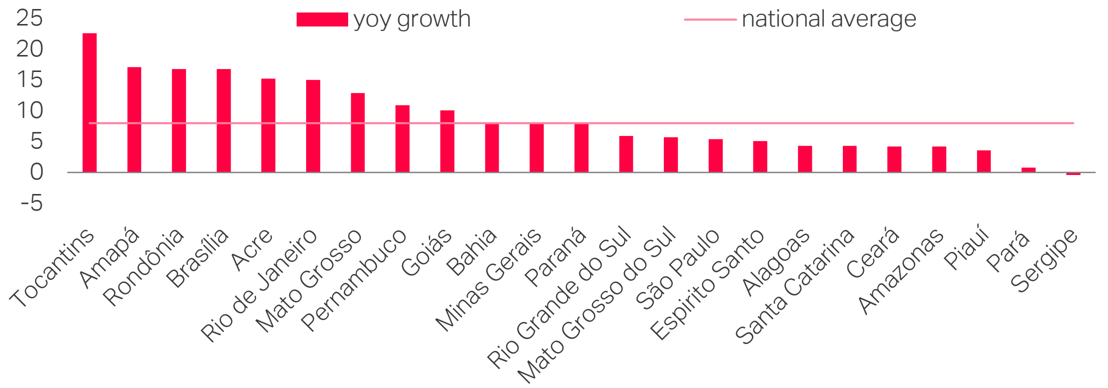


Source: Brazilian Treasury.

Pension costs for states continue to balloon. The amount that states are spending on pensions increased by an average of 14% year on year in 2017 to nearly BRL93.9bn. The largest increases were in Paraná (94%), Maranhão (46%), Mato Grosso do Sul (46%), Acre (42%) and Bahia (27%). Although data are not yet available for all of 2018, the average increase in the 12-month period ending in August 2018 was 8%, while real revenues increased by just 3%, according to the government's Institute of Applied Economic Research (IPEA) (see Chart 5). States including Minas Gerais, Goiás, Rio de Janeiro and Rio Grande do Sul have even faced difficulties in paying wages of active workers on time. For example, newly elected Minas Gerais Governor Romeu Zema announced last week that the 2018 mandatory Christmas bonus for state workers would be paid in 11 monthly instalments this year. Earlier this month, the Finance Secretaries of seven Brazilian states requested that the country's highest court (STF) give them permission to reduce the number of hours that civil servants work as a way to cut payroll. A ruling on this issue is scheduled for 27 February.

Chart 5: Growth in pension spending (Sept 2017 to Aug 2018)*

% change yoy

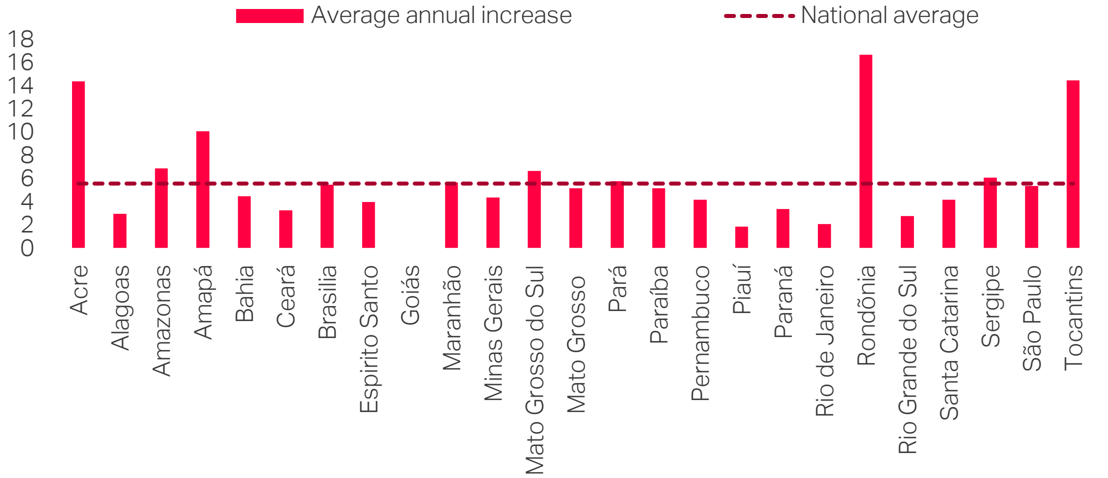


Source: IPEA.

*All states included except for Roraima, Paraíba, Rio Grande do Norte and Maranhão.

The increase in pension spending is in part the result of demographic trends, but it is also because of an increase in the number of state civil servants filing for retirement benefits. In Brazil, many civil servants often continue to work after having fulfilled the requirements for retirement, but because they are concerned that a future reform would roll back their benefits, are opting to retire. As Chart 6 below indicates, the number of retired public employees in Brazilian states increased by an average annual rate of 5.6% between 2014 and 2017. This rapid rate of increase highlights that even the states not currently in financial trouble are on the path to fiscal insolvency.

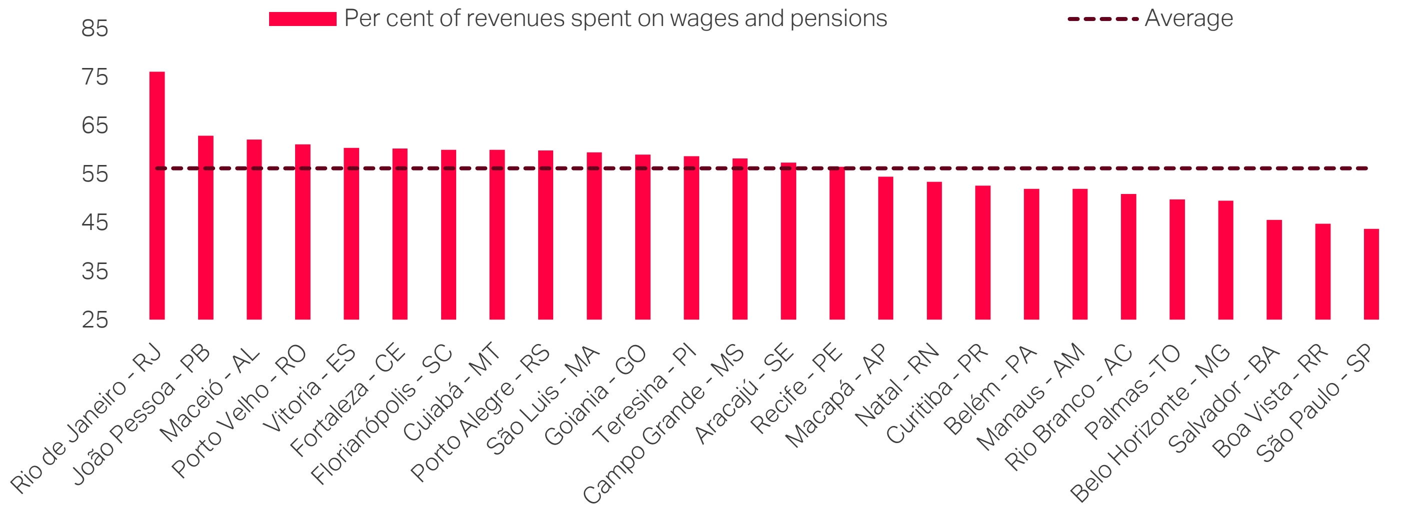
Chart 6: Annual increase in the number of retired state civil servants (2014-17)



Source: IPEA.

Meanwhile, many municipal governments are facing significant fiscal constraints too. As highlighted in Chart 7 below, state capitals are spending an average of 56% of their budgets on salaries and pension, which leaves limited resources for additional spending.

Chart 7: Municipal government revenues spent on pensions and wages
% of total revenues



Source: Treasury.

Passing legislation in local city councils has proved to be challenging for municipal governments, as highlighted by the bitter struggle at the end of 2018 in the São Paulo Municipal government to raise government workers' pension contributions to 14% from 11%. The reform proposal also included the creation of a pension system for new workers with a ceiling of BRL5,600/month, which is in line with the maximum payment for private-sector workers. Although the reform did pass, municipal government workers were on strike all last week to protest the changes.

Further financial aid to state and municipal governments will be offered in exchange for support. According to recent press reports, the Bolsonaro administration is willing to make some short-term concessions to states in exchange for their support for pension reform. These include a possible increase in federal government transfers of compensation from the 1996 Kandir Law, which eliminated the ICMS state tax on exports of commodities and semi-finished products. The administration has also reportedly offered to support legislation on debt securitization for states as well as the extension of the deadline for the payment of damages to the winners of lawsuits against state and local governments from 2024 to 2028.

The revenues from the planned mega pre-salt auction are also expected to be included in any negotiations between the administration and the states. The distribution of an estimated BRL100 bn or more in revenues from the planned sale next year of up to 70% of the rights to develop pre-salt acreage from blocks ceded to Petrobras, which failed to gain approval from the Senate last year, will feature in the discussions between governors and the administration. As we highlighted in November, Economy Minister Guedes and former Senate President Eunício de Oliveira were at loggerheads over the distribution of the revenues that could be raised by the sale of these assets. Then Finance Minister Eduardo Guardia had opposed a deal that would have transferred these revenues to the states, arguing that transferring the money to the states without requiring governors to move ahead with fiscal adjustment would be putting good money after bad.

Negotiations with Petrobras are expected to be concluded this month. The offshore acreage in question was originally granted to state-run oil firm Petrobras by the Lula administration in 2010 as part of the so-called "transfer-of-rights" agreement, which gave the company the right to produce 5bn bbl of oil from the blocks. But because the recoverable volumes are believed to be much larger, the government plans to sell the rights to the additional oil in these fields to oil majors, which have shown strong interest in these areas. Petrobras President Roberto Castello Branco said last week that he expects the negotiations over the transfer of rights to be concluded by the end of this month, which would pave the way for the auction to take place at the end of the year. Newly elected Senate President Davi Alcolumbre is expected to play a key role in the negotiations with the Senate to approve legislation to allow the auction to go forward.

The opposition remains weak and divided. While Maia's ability to negotiate with party leaders from across the political spectrum is good news, the lack of a solid opposition will also help the government push through the reform. It was clear in the legislative leadership election that the divisions among the leftist parties persist. And after former President Lula was sentenced to nearly 13 years in prison for corruption and money laundering – his second sentence in the Operation *Lava Jato* ("Car Wash") investigation – it appears that the leadership void on the left will continue.

At the same time, Renan Calheiros could be forced to work with the government to help his son, Renan Filho, who is the Governor of Alagoas state. While this does not mean that Renan, who suffered a humiliating defeat in his bid for the Senate presidency earlier this month, will not be working behind the scenes to undermine the administration, he is likely to focus his ire on the government's anti-corruption agenda. The same holds true for veteran MDB Senator Jader Barbalho, who supported Renan's bid for the Senate presidency. Barbalho's son Helder is the newly elected governor of Pará state and he, too, is facing significant fiscal challenges.

The same is true for newly elected and re-elected PT governors in the northeast, who need both the pension reform and federal aid if they want to fulfil any of their campaign promises. The recently elected PT governor of Rio Grande do Norte state, Fátima Bezerra, has already made overtures to the Bolsonaro government in the hope of improving the state's bleak fiscal outlook.

Conclusion

Guedes and Maia are on the same page, which bodes well for the reform. Despite the lack of a clear message from President Bolsonaro himself, the good news is that the Speaker of the Lower House and the Senate President see pension reform as the top priority. Although the path ahead will be challenging, the strategy of turning the reform into a national issue, which involves state and municipal governments, will play an important role in getting it passed. Maia's political skills – and longer-term ambitions – make him the ideal partner for Guedes and the economic team to build support for the reform. And while Senate President Alcolumbre's lack of experience is a concern, he appears to have the support of veteran members of the Senate, who will help him navigate the rough waters of the upper legislature.

The economic team also appears to be willing to eliminate some elements of the reform to keep it focused. Guedes and the economic team began testing the waters last week when a draft version of the reform was "leaked" to the press. This gave the team an opportunity to gauge the reaction to some elements of the proposal. Since the document was released, the economic team has appeared willing to eliminate some elements of the draft proposal – such as coupling the pension reform with a mini-labour reform and the inclusion of a capitalization system. We believe this is positive and will help speed up the approval process.

Justice Minister Moro's anti-corruption legislation could prove another distraction. Moro's proposed overhaul of the justice system includes elements that have strong popular support – such as stiffening prison sentences for corrupt government officials. But there is a risk that if the administration expends its energy on trying to get two reforms approved, it will fail to pass either a meaningful pension reform or the ambitious public safety and anti-corruption package. So far, Maia and Alcolumbre have made it clear that the pension reform is the top priority, which bodes well for its approval. However, this process needs to be monitored.

While Maia and Guedes have expressed their support for an ambitious reform, Bolsonaro needs to be on board too. Now that the elections for the legislative leadership are over, the clock has started ticking for the Bolsonaro administration to present the final version of its pension reform proposal to the legislature. Although the administration had promised to present its proposal by 21 February, Bolsonaro's slower-than-expected recovery from surgery could delay the final proposal. The market is clearly anxious to see the final proposal, but we believe that the most important signal in coming days will come from Bolsonaro himself. If he expresses his willingness to use his political capital to push for an ambitious reform, his current popularity, combined with the rising understanding among the population about the need for the reform, will set the stage for its approval this year.