Brazil

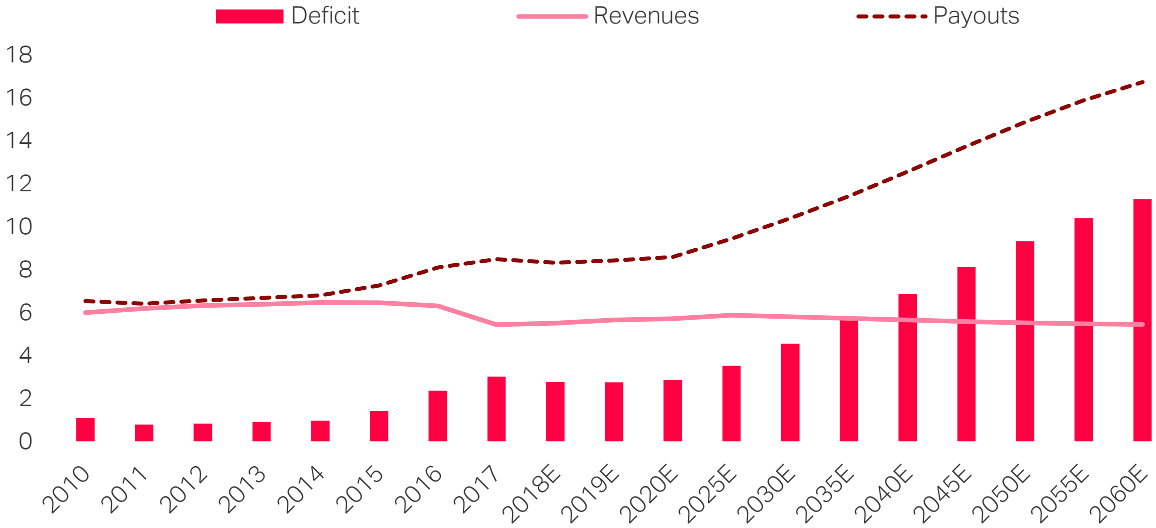
WHY PENSION REFORM CAN PASS IN 2019

Elizabeth Johnson

- **The outgoing Temer administration has successfully communicated the need to reform the pension system**
- **Incoming Economy Minister Paulo Guedes has appointed members to his team who have experience negotiating tough legislation with the Congress**
- **Reform pressure will come increasingly from governors, many of whom will be taking office in 2019 with coffers empty and amid little hope of improvement**
- **The fly in the ointment is President-elect Jair Bolsonaro himself, who continues to send signals he is not in favour of a robust reform**

Pension deficit, payouts and revenues (in a scenario without reform)

% of GDP



Source: Planning Ministry.

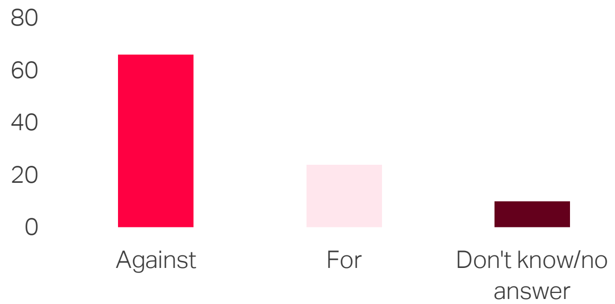
Four reasons why pension reform will likely pass next year

Brazil will have a historic opportunity to pass pension reform in 2019. Despite the shortcomings of the outgoing administration, unpopular President Temer will be leaving Brazil on a much sounder economic footing than was the case in May 2016 when he took office. At that time, Temer started what turned out to be a successful – albeit incomplete – reform cycle. The administration not only passed key fiscal reforms, such as the federal spending cap late that year, but also made invaluable contributions to the business environment in Brazil through the labour reform and in helping the country's state-controlled companies to regain credibility. Moreover, he will be handing the government over to President-elect Jair Bolsonaro with inflation firmly under control and record-low interest rates. Although the economic recovery has been far slower than expected, GDP next year is likely to grow at its highest level since 2011. And despite the administration's failure to pass pension reform, the Temer government has played an indispensable role in setting the stage for the next government to begin getting Brazil's fiscal house in order. Below we highlight four reasons for our optimism that the Bolsonaro administration will be able to pass pension reform in 2019.

1. There is near-consensus that pension reform is necessary

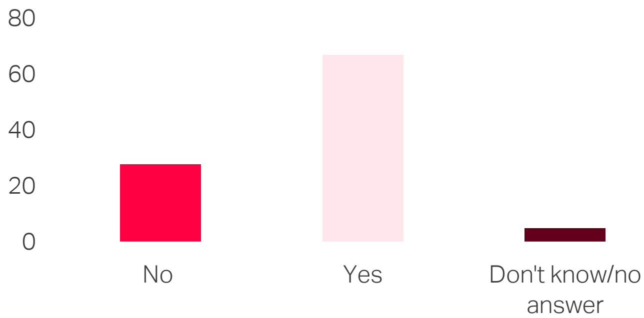
Over the past two years, the Temer administration succeeded in making the country's fiscal situation part of the public debate. Starting in the first half of 2017, it worked hard to communicate the need for pension reform and to expose the inequality of the current system. Despite campaigns by special-interest groups opposing the reform, the government worked tirelessly to explain the need for the reform to the population, which finally appears resigned to the fact that the current retirement system is unsustainable. As illustrated in Charts 1-2 below, there has been a shift in the population's understanding of the reform. Whereas a poll conducted from 31 March to 1 April 2017 showed that 66% of those asked were against pension reform, a survey carried out late last month showed that 67% believe that reform is necessary. Although the questions asked in the polls were slightly different, there has been a marked change in the attitude of Brazilians towards the reform since the Temer government began debating the issue back in 2017.

Chart 1: 2017 Poll: Are you for or against pension reform?
% / Poll dates: 31 Mar-1 Apr 2017



Source: Datapoder360.

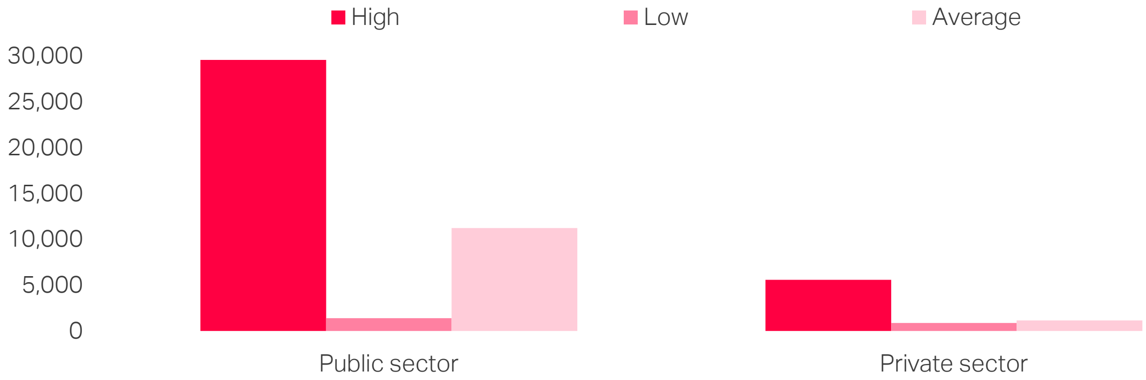
Chart 2: Nov 2018: Is pension reform necessary?
% / Poll dates: 21-23 Nov



Source: XP/Ipespe.

Pension reform also permeated the electoral debate in 2018, where there was a near-consensus about the need for the reform from all core candidates. Even the Workers' Party (PT) platform, which initially rejected the need for the pension reform, ultimately changed its tune; and the party's candidate, Fernando Haddad, admitted the necessity of addressing the ballooning deficit. This is a significant departure from the 2014 election, when pension reform was not discussed. Although Bolsonaro did not make a firm proposal for pension reform during the campaign and refused to attend any runoff round debates, he never denied the need for such reform, which remains one of his economic team's top priorities. Furthermore, all of the candidates – including Haddad – discussed the need to even the playing field for public and private sector workers, because of the huge inequities between the two systems. Bolsonaro has also signalled he could potentially tackle the politically unpopular goal of reducing privileges for civil servants, who receive the most generous pensions in the country. While the average private sector pension is just BRL1,226/month, the average public sector pension is BRL11,272/month (see Chart 3 below).

Chart 3: Average pensions for public vs private sector workers
BRL/month



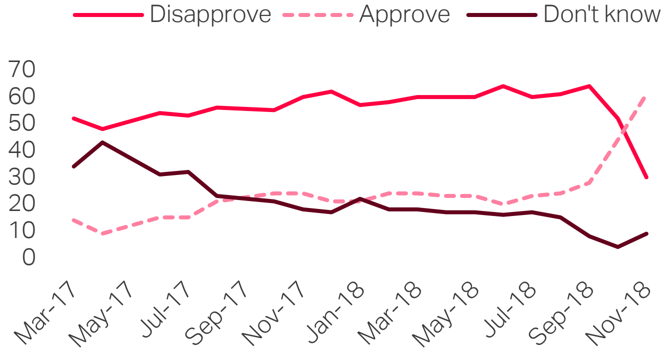
Sources: INSS, Planning Ministry.

2. Bolsonaro has the popular support that Temer lacked – for now

Unlike Temer, who took office after former President Dilma Rousseff had been impeached, Bolsonaro was elected with just over 55% of valid votes (or roughly 39% of the total vote count). By contrast, Temer will be leaving office with the lowest approval rating (5%) of any Brazilian President. Although Bolsonaro remains a controversial figure, he has seen his approval rating improve since he was elected, according to the most recent Estadão-Ipsos poll, which was conducted in early November (see Chart 3 below). Likewise, the CNI/Ibope poll released this Thursday (13 December) showed that 75% of those polled believe that Bolsonaro and his team are on the right path, while just 14% said he is on the wrong path.

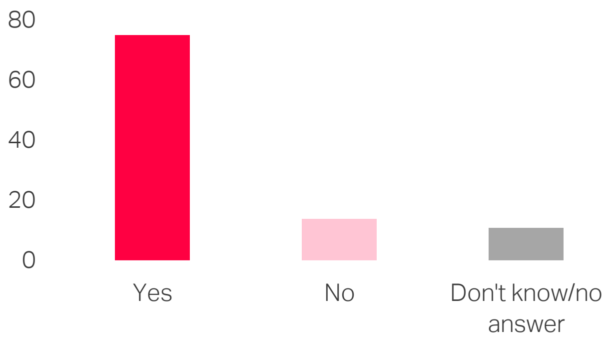
Although this is positive news now, Bolsonaro's longer-term approval hinges on economic improvements, which, in turn, depend on the passage of unpopular reforms. In one sign of the challenges that still lie ahead, the top four problems cited by those surveyed in the CNI/Ibope poll were healthcare (46%), unemployment (45%), corruption (40%) and public security/violence (38%), while a mere 3% cited the social security deficit as a big problem. Not surprisingly, healthcare, job creation and fighting corruption also led the list of top government priorities in 2019 for those polled, while just 5% polled said that pension reform should be a priority next year. Should the ongoing scandal around suspect financial transactions involving Bolsonaro's family and the former chauffeur of Bolsonaro's son Flávio continue to gain traction, as it has this week, the new President's honeymoon period could be cut short next year, as early optimism about his government fades among the population.

Chart 4: Approval rating of Jair Bolsonaro
%



Source: Estadão-Ipsos

Chart 5: Is Bolsonaro on the right path?
% / Poll dates: 29 Nov - 2 Dec



Source: CNI/Ibope.

3. Guedes has put together a team with strong political skills

While the market had always expected incoming Economy Minister Paulo Guedes to put together a solid economic team, there have been genuine concerns about the ability of that team to negotiate reforms with the Congress. Similarly, Bolsonaro's strategy of appointing members to his cabinet based on negotiations with political caucuses rather than with party leaders has given cause for concern, as we highlighted in our 2 December note (Guedes wades into the fray). Such concern has been partly allayed by recent discussions with the Party of the Republic (PR), the Democrat Party (DEM) and the Brazilian Social Democrat Party (PSDB), among others. But perhaps more important, Guedes' final appointments to his team has shown that he increasingly understands the importance of having staff who have not just strong technical but also political skills.

Arguably, the best example is the appointment this week of outgoing Rio Grande do Norte Congressman Rogério Marinho of the market-friendly PSDB party as Social Security Secretary. Prior to taking office as a federal Congressman in 2007, Marinho was Economic Development Secretary of his state. But he was also rapporteur for the Temer administration's labour reform and worked tirelessly to get the reform approved. Marinho has said that his goal is to have the reform passed in the first half of the year, which is when Bolsonaro should still be in the throes of his political honeymoon.

Marinho will be working closely with Leonardo Rolim, who is currently Executive Secretary of the Social Security Ministry. Prior to joining the ministry, Rolim worked as a Lower House budget analyst and as an adviser to the Senate Economic Policy Committee. Like Marinho, he combines political experience and technical skills. Other members of Guedes' team who have solid political experience and ties to the Temer administration include Marcelo Guaranys, who will have the No. 2 post at the Economy Ministry, and Waldery Rodrigues Júnior (see Table 1 below).

Table 1: Key nominees for the new Economy Ministry and related posts

Post	Nominee	Details
Confirmed		
Economy Minister	Paulo Guedes	Bolsonaro's University of Chicago-trained economic guru is in charge of the new super-Economy Ministry, which merges the current Finance, Planning and Trade Ministries.
Executive Secretary	Marcelo Guaranys	Currently in charge of infrastructure at the Chief-of-Staff's office, he has held top positions in government, including as head of civil aviation regulator ANAC; he will assume the No. 2 post at the Economy Ministry.
Secretary General of Finance	Waldery Rodrigues	The economist and engineer has extensive experience in government and has been at the Finance Ministry since 2016; previously he worked in the Senate.
Adjunct Secretary of Finance	Esteves Colnago	Temer's current Planning Minister has previously worked in the Finance Ministry, the Treasury and the Banco Central, which will aid the new economic team.
Debureaucratization Secretary	Paulo Uebel	The former São Paulo Planning Secretary under João Dória shares Guedes' liberal economic views and has an MBA from Columbia University.
Productivity Secretary	Carlos da Costa	The former BNDES director has an MA in economics from UCLA and has worked in both the public and private sectors.
Trade Secretary	Marcos Troyjo	The former diplomat is a professor at Columbia University and the founder of the Centre for Business Diplomacy as well as an expert on globalization.
Secretary of Privatizations	Salim Mattar	The founder and chairman of one of Latin America's biggest car rental firms, Localiza, will be in charge of privatizations.
Secretary of Social Security	Rogério Marinho	The outgoing Rio Grande do Norte congressman belongs to the market-friendly PSDB party, is a trained economist with solid legislative experience and was the rapporteur of the Temer government's labour reform.
Undersecretary of Social Security	Leonardo Rolim	The former Policy Secretary at the Social Security Ministery has deep technical knowledge of the pension system and experience negotiating with the Congress.
Tax Secretary	Marcos Cintra	The business school professor is a specialist in the Brazilian tax system and has a PhD in economics from Harvard University.
Treasury Secretary	Mansueto Almeida	Temer's current Treasury Secretary is well liked by the market and his agreement to stay in the same post in the new government is positive.
BNDES President	Joaquim Levy	The respected University of Chicago-trained economist had a short-lived stint as Dilma's Finance Minister in 2015 before he moved to the World Bank; his past experience will be helpful in opening the "black box" of past BNDES loans.

Sources: Local press reports.

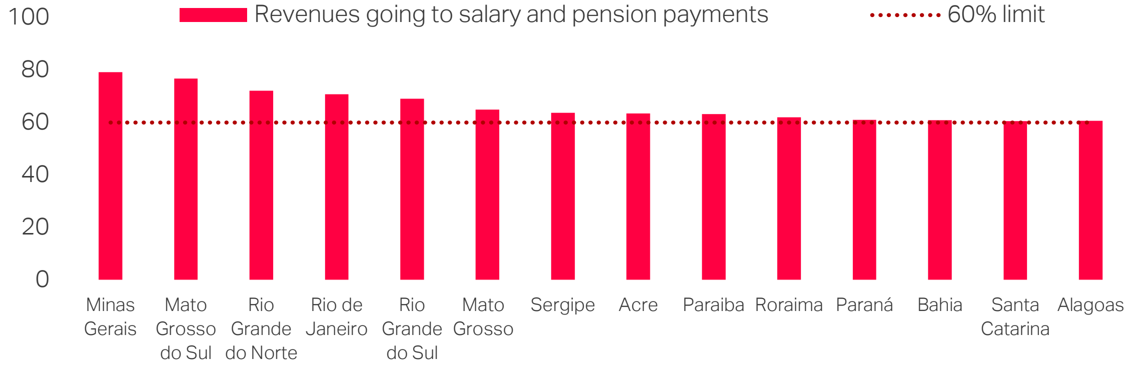
4. State governments need pension reform even more than the federal government

Although the federal government will soon have its day of reckoning if pension reform is not passed, that day has already come for many Brazilian states. According to a recent study by the Brazilian Treasury, states saw their pension deficits rise by a combined total of 26% between 2015 and 2017. As a result of the rapid increase in pension spending, 16 of 27 Brazilian states saw spending on salaries and pensions exceed the legal limit of 60% of total revenues, while five of those states spent more than 75% of their revenues.

São Paulo daily *O Estado de S. Paulo* recently reported that 11 governors could leave office on 31 December with no funds available for the governors who will be taking office next year. Although this would be a violation of the Fiscal Responsibility Law, the outgoing governors have often stacked local courts with their allies, which means that they may not be held accountable, even though they should be. The situation for states is worse than that of the federal government because all their pensions are paid to civil servants, who are the most privileged class of public employee – not only do they retire with 100% of their final salary; their pensions are indexed to the wages of the employee who is currently performing their previous function.

Chart 6: Fiscal situation of worst-ranked states

% of net current revenues



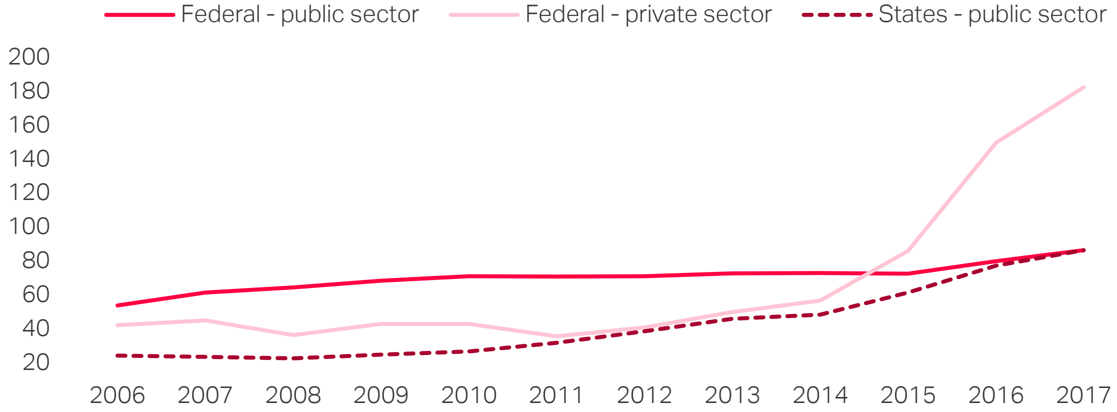
Source: Brazilian Treasury.

Although the pension reform would not be an overnight cure for the fiscal woes of Brazilian states, it would help bring some much-needed relief to their budgets in the medium term. This is why we expect more fiscal pressure next year on the governors of debt-ridden states, which the Bolsonaro team can use as a bargaining chip to ease short-term debt issues for the states.

In the meantime, however, federal legislators continue to add to fiscal erosion in a warning sign for what could happen in a worse-case scenario. Last week, the Lower House approved a bill to relax the Fiscal Responsibility Law for municipalities and to remove sanctions on mayors who allow payroll and social security spending to go past the current limit of 60% of current net revenues. While the rule is valid only in certain conditions – notably, if the municipality has a fall of 10% or more in fiscal revenues for factors beyond its control such as a drop in federal transfers or oil & gas royalties – economist Ana Carla Abrão, the former Finance Secretary of Goiás, has called it "the greatest attack I've seen on fiscal responsibility in this country". The bill now awaits Temer's signature (or veto). While the new economic team therefore has a window of using the growing fiscal pressure for positive ends, if it fails in its attempt, the consequences will be dire.

Chart 7: Pension deficits of state and federal governments

BRL bn (adjusted for inflation)



Source: Raul Velloso.

Conclusion

Pension reform in 2019 is our base case. Besides the reasons cited above, we make this judgment based on the fact that Paulo Guedes and key members of the Bolsonaro team understand that the window to pass this reform will not remain open forever. That is why it is essential that the government come up with a pension reform strategy early next year, so that once the Senate and Lower House leaders have been elected in February, it can begin moving ahead with the reform. As we highlighted earlier, the weak opposition and the shift to the right of the Brazilian electorate will help the administration pass this reform.

Ironically, the biggest hurdle today may be Bolsonaro himself, who is divided about a robust pension reform. In recent weeks, the President-elect and his son, Eduardo – the leader of Bolsonaro's PSL party in the Lower House – have made statements indicating that they are still not convinced that a robust pension reform is needed. Two weeks ago, Bolsonaro asserted that the latest Temer pension reform bill – which has already been watered down to about half of its original fiscal savings – was "a bit aggressive for the worker". He also said, "We can't save the country by killing the elderly". Similarly, Eduardo told US investors that the government would do its best to pass pension reform but "perhaps it wouldn't succeed".

To add to the potential headwinds ahead, the President-elect also signalled that he is now thinking about passing pension reform only in stages – first, by passing legislation for a minimum retirement age and next by implementing a defined-contributions scheme à la Chile. We believe that the primary focus should be on passing the minimum retirement age, especially because there is no consensus about the efficacy of Chilean system and the costs of transitioning to a defined-contribution scheme. Including this in the debate could serve as a distraction, potentially pushing the debate into 2020, which is a municipal election year. The big problem with dividing the pension reform initiative, though, is that many unpopular elements of the reform could easily be "delayed" by legislators to the second phase of the programme on the grounds that it is a work in progress. This could lead to a much more diluted pension reform being passed next year than the market would like to see.

Moreover, it is not only the President-elect and his family that sound sceptical about this reform but Bolsonaro's top political coordinators too. Incoming Chief-of-Staff Onyx Lorenzoni has long been a fierce foe of Temer's pension reform bill, as has key Bolsonaro ally, PSL Congressman (and incoming Senator) Major Olímpio, as we have previously highlighted. And while Lorenzoni has been weakened lately by accusations that he received illicit electoral donations from JBS – which means that he may not last in his post – it has not helped matters that Bolsonaro's other key political coordinator – incoming Government Secretary General Carlos Alberto dos Santos Cruz – also has little legislative experience. Santos Cruz is famed for being a tough, no-nonsense, hardline military man with a celebrated record, but while his appointment sends a clear message to Brasilia that the Bolsonaro team plans to change "business-as-usual" politicking in the capital, it does not inspire confidence that he will be able to aggregate legislative votes when the Congressional horse-trading comes down to the wire. Last but not least, ongoing party infighting and squabbling among Bolsonaro's own PSL party has heightened the sense of mixed messages issuing from the President-elect's own core base. In the meantime, the new 2019 Congress itself appears less convinced of the need to having a high minimum retirement age than the outgoing Congress, as we highlighted earlier this week. Without a strong, unified message, though, more chaos could ensue.

Looking ahead, these issues are not insurmountable, especially if Bolsonaro can be convinced by his economic guru, incoming Economy Minister Paulo Guedes, that a more fiscally robust pension reform is needed. But it also pushes up the odds that it will be a watered-down reform that will be passed, rather than an optimal reform. As we have previously written, one leading indicator to watch will be how the military and related personnel are treated in the pension reform proposal that Guedes is planning to release in January. If they are given overly generous terms, then it would be a bad sign, as other special interest groups would feel emboldened to press for more privileges too. Another key event in Q1/19 to monitor is the all-important election of the Lower House Speaker and Senate President in February next year. If market-friendly leaders who are allies of Bolsonaro win the election, the case for pension reform would be strengthened; but if the reverse should occur, then the odds would fall.

Failure to pass the reform will mean the return of inflation and another wasted opportunity. The Bolsonaro administration will have a historic opportunity to pass this reform in orderly fashion without having to resort to drastic measures, such as those seen in Greece. But neither the slightly improved fiscal outlook as 2018 comes to a close nor the market's patience will last for ever. As we have previously written, the new economic team will have not one but three big fiscal challenges next year: pension reform, growing pressure from the legislature to lift the federal spending cap and the likely suspension of the "golden rule" (which broadly states that new federal debt cannot be issued to pay for expenditures other than investments). Alongside these challenges, however, there is still the possibility of a fiscal windfall of an estimated BRL100+ billion from a planned, pre-salt mega-auction next year – assuming that regulatory agencies give the tender the green light and the legislature agrees to it as well Although the Senate's failure to pass the bill this quarter was a big blow to the incoming administration, as there is a chance it will not be held in 2019, the flip side is that it could give Guedes more ammunition next year to woo legislators over pension reform. Should the Bolsonaro government fail to seize its moment, Brazil will be back on the path to high inflation and meagre growth. Similarly, if it fails in its mission to improve the economy, it will be punished by the electorate, potentially paving the way for the Workers' Party of former President Lula to catapult back to the presidency.

Bolsonaro needs to be extremely focused in H1/19. Although Bolsonaro has a big window of opportunity to move ahead with reform given his popular mandate, he still must prioritize pension reform above all other issues during the first six months in office in order to push it through. Furthermore, his economic team must be extremely focused too. Because crises will undoubtedly appear – a case in point is ongoing global volatility, not to mention the simmering scandal around unexplained financial transactions to Bolsonaro's wife from his son's former chauffeur – his legislative efforts cannot be diluted, or the headwinds will grow. Recent discussions about tax reform and the independence of Banco Central might be important long term but they are not the top priority for the market and can be addressed down the road. Bolsonaro needs to learn from the mistakes of the Temer administration as well as those of Argentina's Mauricio Macri – who delayed key reforms only to find his political strength depleted and his country back in the throes of another economic crisis.