Brazilian Pension Reform
The Groundwork for Sustainable Growth

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Key takeaways

- The pension reform approval in Brazil is a very positive development. Approval of the pension reform follows a significant deterioration in macroeconomic conditions in the country, particularly since 2014. Paradoxically, this has served to increase the sense of urgency regarding the necessity to approve important structural reforms.

- The famous quote, “Don’t let a good crisis go to waste,” would seem apt in the context of the pension reform approval. We believe that the approval of the pension reform helps lay the groundwork for sustainable growth in Brazil for the future, though more needs to be done with respect to additional reforms in the coming years.

Why is the pension reform necessary?

One of Brazil’s key structural problems in the past few decades have been the deterioration of public finances, driven in large part by the continuous growth in primary expenditures – particularly mandatory expenditures. In fact, only about 9% of primary expenditures are discretionary, i.e. possible to reduce or eliminate.

Furthermore, social security accounts for more than half of the mandatory expenditures, as can be seen below (henvis til figure nr). Survivor’s pensions – which refers to the pension provided to the legal spouse or partner of the deceased contributor – and retirement benefits represent c.83% of total expenditures in the social security system. In general, both the retirement age and retirement benefits have been very beneficial for Brazilians. Under the previous law, retirement was determined by a formula combining both age and contributions, allowing many people to retire in their low-to-mid 50s. According to the OECD, the average retirement age of Brazilian men and women has been the lowest among OECD countries.
With a Brazilian population that is expected to age rapidly in future years – as can be seen below in figure 2 – the pressure on public finances under the existing rules would be immense. The current administration has predicted that without the pension reform (as well as other reforms), the mandatory expenditures would exceed 100 percent of the budget by 2022, and thus prevent investment in other areas of the economy. For these reasons, approval of the pension reform was essential.

**Why was it approved now?**
There has been talk of significant changes to the pension reform for the past two decades. The reasons for the pension reform being approved this time are manifold. President Bolsonaro won the election on the back of promises to rectify the economy. However, despite the strong increase in the representation of Bolsonaro’s party, the PSL, in Congress, Bolsonaro is the president with the lowest representation in the lower house since Brazil’s re-democratization. As a result, additional support was needed from other center-right-leaning parties. This transpired as a result of Bolsonaro’s solid approval rating amongst the public and a large turnover of members of the Congress and Senate following the election. In essence, new political support has been instrumental in paving the way for pension reform in Brazil.

**Highlights of the reform**
The reform proposal initially had a target saving BRL1.2 trillion (c. USD 288 bn). However, given the complexity of the reform and fragmented nature of the Brazilian political system, this was eventually watered down through various negotiations and the two rounds of votes in both the lower house and Senate.

The key highlight of the reform was an increase in the minimum retirement age to 62 for women and 65 for men – following a transition period – from the aforementioned level of the mid-50s. Other highlights include same social security rules for new private sector employees and civil servants, lower pension benefits, and lower entry-level salaries for civil servants. At a high level, the pension reform will result in BRL800 bn (c. USD 200 bn) of savings over a 10-year period – equivalent to c.10% of Brazil’s GDP in 2018.

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What happens next?

Approval of the pension reform should not be seen as a silver bullet for Brazil. However, it has been a necessary condition for fiscal consolidation. The government aims to present other structural reforms to further improve public finances and boost Brazil’s productivity and competitiveness. Tax reform and privatization of certain state-owned assets are top of the agenda. Brazil is notorious for its complicated tax system, as exemplified by its top ranked position on the World Bank’s list of the countries in which it takes the most time to file taxes.

As a direct consequence of Brazil’s overly complex tax system, tax litigations are abnormally high. In one analysis, which took a sample of 24 publicly listed companies, tax litigations reached BRL405 bn (c. USD100 bn) at the end of 2018, equivalent to 25% of these companies’ market cap and 124% of their EBITDA. Moreover, the system is so complex that court rulings often overrule the tax authorities’ litigation claims. A simpler and more transparent tax system would potentially boost Brazilian companies’ productivity by reducing the uncertainty and economic burden associated with filing taxes, with the result that the government will attempt to overhaul this system in the coming months.

The government has put forth an ambitious market-friendly, reform-focused agenda. It will most likely not succeed with all its initiatives. However, on a continent that is experiencing political turmoil and civil unrest, Brazil currently stands alone in its bold attempt to drive structural reforms. Approval of the pension reform is
clearly a significant step in the right direction for the long-term sustainability of the Brazilian economy.

**How are we positioned?**  
In CWW EM, we have gradually increased our exposure to Brazilian equities over the course of 2019, partly driven by the increased confidence in the reform agenda as well as declining interest rates and a gradual pickup in the economy. Our focus remain on identifying pockets of structural growth. In particular, we are excited about the digitalization of the Brazilian society, and we are invested in leading e-commerce, software and fintech companies. Also, we have exposure to companies with strong business models which are benefitting from the aging population in Brazil. We are invested in companies that are generally less sensitive to the overall economic environment. These companies should continue to grow even in a more challenging macro environment, though positive developments on the economic and reform front will provide additional direct and indirect tailwinds.

For more information about our investments in EM, please see cworldwide.com.