Report No. 19641-BR

Brazil
Critical Issues in Social Security
(In Two Volumes) Volume I: Summary Report

June 19, 2000

Brazil Country Management Unit
Latin America and the Caribbean Region

Document of the World Bank

CURRENCY AND EXCHANGE RATES (R$/US$)

Currency Unit - Real (R$)
December 1995: R$0.97
December 1996: R$1.04
December 1997: R$1.12
December 1998: R$1.21
December 1999: R$1.84
April 2000: R$1.76

WEIGHTS AND MEASURES

The Metric System is used throughout the report.

FISCAL YEAR

January 1 to December 31

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ABBREVIATIONS AND ACRONYMS

BNDES	National Development Bank *(Banco Nacional de Desenvolvimento Econômico e Social)*
CLT	Consolidated Labor Code *(Consolidação de Lei do Trabalho)*
DATAPREV	Parastatal agency providing data support to the Ministry of Social Security *(Empresa de Processamento de Dados da Previdência Social)*
DB	Defined Benefit Pension Plan, where pensions are based on a formula based on years of service and earnings
DC	Defined Contribution Pension Plan, where pensions depend on contributions and investment earnings
DEPEM	Department for Pension Regimes of States and Municipalities in the Federal Ministry of Social Security *(Departamento do Regimes de Previdência dos Estados e Municípios)*
EET	Regime that Exempts pension contributions from taxation and Exempts investment income, but Taxes pension benefits.
FAPI	Long-term Investment Plan administered by Mutual Fund Companies (*Fundo de Aposentadoria Programada Individual)I*
FGTS	Severance Fund *(Fundo de Garantia por Tempo de Serviço)*
FGV	Getulio Vargas Foundation *(Fundação Getulio Vargas)*
GDP	Gross Domestic Product *(Produto Bruto Interno)*
IBGE	Brazilian Institute of Geography and Statistics *(Fundação Instituto Brasileiro de Geografia e Estatística)*
IMF	International Monetary Fund *(Fundo Monetario Internacional)*
INSS	National Social Security Agency *(Instituto Nacional de Seguridade Social)*
IPD	Implicit Pension Debt
IPEA	Institute of Applied Economic Research *(Instituto de Pesquisa Econômica Aplicada)*
MPAS	Ministry of Social Security and Social Assistance *(Ministerio da Previdência Social e Assistência Social*
NDC	Notional Defined Contribution Pensions (*Contas Escritural*)
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-As-You-Go
PGBL	Pension Plan administered by Open Pension Funds and assets managed by Mutual Funds *(Plano Gerador de Beneficio Livre)*
PME	Monthly Employment Survey *(Pesquisa Mensal de Emprego)*
PNAD	National Household Survey *(Pesquisa Nacional por Amostra dos Domicílios)*
PPV/LSMS	Living Standards Measurement Study *(Pesquisa das Padrões da Vida)*
PROST	Pension Reform Options Simulation Toolkit

RGPS	General Regime for Social Security *(Regime Geral da Previdência Social)*
RJU	Pension Regime for Government Workers *(Regime Jurídico Único)*
RPC	Regime for Complementary Pensions *(Regime de Previdência Complementar)*
SEAP	Secretariat for State Administration, Federal Government of Brazil *(Secretariat de Estado da Administração e do Patrimônio)*
SEAP-P	Secretariat for Social Security – Government of the State of Parana *(Secretaria Especial para Assuntos de Previdência)*.
SPC	Secretariat for Complementary Pensions *(Secretaria de Previdência Complementar)*
SUSEP	Regulatory Agency for Open Funds *(Superintendência de Seguros Privada)*

ACKNOWLEDGMENTS

This report consists of two volumes. Volume I contains a detailed summary of the report's findings and their policy implications, written for a general audience interested in the main messages of the report. Volume II is the Policy Report which is directed at policy makers and specialists, and contains discussions of the most important policy recommendations for each of the components of the Brazilian social security system.

The report was prepared by a World Bank team consisting of **Indermit S. Gill** (Task Manager, LCSHD), **Truman G. Packard** (Social Protection Specialist, LCSHD), **Juan Yermo** (Consultant, LCSFP, now with the OECD), **Anita M. Schwarz** (Senior Human Resources Economist, HDNSP) and **Dimitri Vittas** (Lead Economist, DECRG). The report was produced under the supervision of **Gobind T. Nankani** (Director, Brazil Country Management Unit – LCC5C), **Suman Bery** (Lead Economist, LCC5C), and **Eliana Cardoso** (Lead Specialist – Economic Policy, LCSPR). **Robert Holzmann** (Director, Social Protection, HDNSP) provided guidance and advice to the team throughout the process. The peer reviewers were **Louise Fox** (Lead Specialist – Pensions, HDNSP), **P.S. Srinivas** (Financial Economist, LCSFP), and **Mariluz Cortes** (Principal Operations Officer, LCSFP), and the outside reviewers were **Olivia S. Mitchell** (Professor, Wharton School – University of Pennsylvania) and **Francisco E. B. Oliveira** (IPEA – Rio de Janeiro).

This task was carried out in close collaboration with the Federal Government of Brazil, especially with officials of the Ministry of Social Security (MPAS) under the leadership of Minister **Waldeck Ornelas**. The report team is thankful to many persons in MPAS who patiently provided guidance and encouragement, especially **Vinicius C. Pinheiro** (Secretary of Social Security), **Marcelo Viana Estevão** (former Secretary for Social Security), **Paulo Kliass** (Secretary for Complementary Social Security), and **Marcelo Caetano.** The report team is also grateful to officials of the Government of the State of Parana for their help in understanding the complexities of state pension systems. We would especially like to thank Governor **Jaime Lerner**, **Renato Follador Junior** (Special Secretary for State Pensions), **Miguel Salomão** (Secretary for Planning), **Alcyone Saliba** (Secretary of Education), and **Claudia Busnardo**.

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1. Brazil's social security system faces problems of unsustainable fiscal deficits, inequities and actuarial imbalances, unnecessarily high efficiency costs, and lack of diversification due to low coverage of funded schemes. To illustrate the need for changes, this section examines the state of the system before the effect of reforms carried out during the last few years.

Components and main problems

2. Brazil's social security and pensions system consists of three parts, with proposals to establish what may be regarded as a fourth:

- **The national social security system (RGPS),** administered by the Federal Government's Institute for National Social Security (INSS), to which about half of the labor force of 60 million contribute, and beneficiaries number 19 million.
- **The pension regime for government workers** (RJU), administered by the Federal Government, and all state and many municipal governments for their workers; contributors and beneficiaries each number about 3 million.
- **Funded pension plans to supplement RGPS pensions** (SCP): Privately managed, intended to supplement RGPS benefits; contributors number 3 million and beneficiaries 1.5 million, but the industry is dominated by pension funds of public enterprises.
- **Funded plans to guarantee RJU benefits or to supplement them** are being proposed, and state governments are especially keen on setting up these funds for their employees. Some states such as Bahia and Parana have already taken steps to do so.

This report examines the critical issues for reform in each of these four components, examining both the inter-linkages and balance between them (mainly in Volume I) as well as suggesting component-specific remedies (mainly in Volume II).

*The principles of the Brazilian reform are **greater equity** through elimination of abuse and uniform treatment, **greater efficiency** through creation of individual accounts, and economic stability through **fiscal and actuarial balance.***

3. In terminology popularized by the World Bank, Brazil's system of old age support has a large mandatory publicly-managed pay-as-you-go ***first pillar*** consisting of the RGPS and the RJU, and a relatively small (but growing) voluntary privately-managed funded ***third pillar*** consisting of the SCP. Brazil does not have a ***second pillar***, viz., a mandatory funded component, which most countries in Latin America now do. Countries with a large third pillar, such as the USA, also do not have mandatory nationwide funded schemes. But after the reforms in many Latin American countries during the 1990s, Brazil is alone among its neighbors in having a large first pillar, no second pillar, and a relatively insignificant third pillar.

4. The reliance of the majority of Brazilians on a single source of formal old age support, viz., the federal government, leaves them vulnerable to all the risks associated with holding an undiversified portfolio. Over-reliance on government in Brazil results in pressure to maintain public pensions at high levels, leading to spiraling public financing requirements, exacerbating labor market distortions and diverting resources from social services such as education. In 1999, for the first time, government expenditures on social security on 21 million retirees exceeded its education spending on 48 million students. In a country as youthful as Brazil—with five times as many people below 20 years of age as there are above 60—these changes signal a worsening misallocation of public resources. Social security has jeopardized current growth by contributing to Brazil's large public debt; it now threatens prosperity for many years to come by diverting resources from investments in the future.

In 1999, for the first time, Brazil—a relatively youthful country—spent more public resources on its 21 million retirees than the 48 million students enrolled in its pre-schools, schools, colleges, and universities

Unsustainable fiscal imbalances

5. The most obvious indicator of the affordability of the social security system are fiscal balances. By this measure, Brazil cannot afford the social security system it has. The accounting deficits (receipts minus expenditures) in the RGPS and Federal RJU were about R$9.5 billion and R$22 billion in 1999. Simulations conducted for this report show that without reforms, RGPS and ***Federal Executive Branch*** RJU deficits will increase to R$20 billion and R$23 billion respectively in 2005, and to about R$40 billion each by 2010. RJU numbers need to be adjusted upwards by one-thirds to account for the relatively generous judicial, legislative, and military pensions, for which simulations were not carried out (see Volume II for details). Comprehensive information on fiscal imbalances in state and municipal RJUs is also not available, but Ministry of Social Security data suggest a similar magnitude for subnational RJUs combined. ***Using simulations for the Federal Executive RJU and these rules of thumb for extrapolation***, the numbers clearly show that while the RGPS eventually would have become the larger burden, the RJU remains the more serious problem on fiscal grounds for the next 15-20 years unless deep reforms are carried out for the federal and subnational RJU (See **Figure 1**).

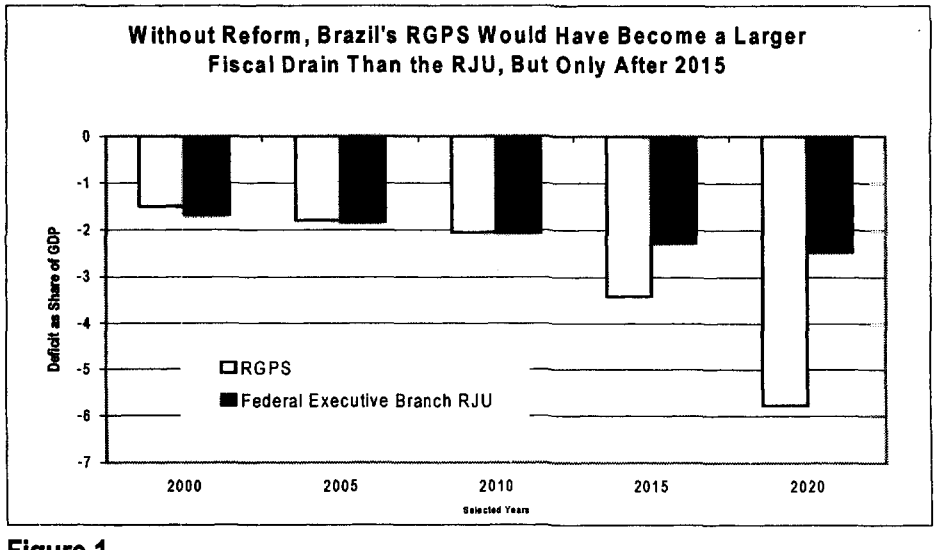

Figure 1

Gaping inequities

6. In a country with high levels of income inequality, even a fiscally burdensome social security system may be worthy of subsidization if it serves the poor well, or if it is redistributive in its aggregate effect. But a large part Brazil's public pensions is currently structured to subsidize the relatively well-off more than the poor. Statistics indicate that less than 1% of social security spending reaches the poorest 10% of Brazilians, while about 50% is cornered by the wealthiest 10%. Through its generosity, the system also implicitly transfers wealth from future generations to current workers/retirees. **Figure 2** also shows that the Federal Government pays about R$17,500 annually as a ***per retiree subsidy*** for pensions of government workers, after imputing contribution-as-employer by the government at twice the rate for employees (as in the RGPS). The annual subsidy for RJUs nationwide is about R$8,000 per beneficiary, compared with less than R$1,000 for the RGPS. These numbers reflect differences in benefit levels, eligibility rules and system dependency ratios. If left unchecked, the gap between annual Federal government subsidies to the typical RGPS and RJU participant will grow from R$16,000 to R$80,000 between 2000 and 2020. Salary, pension, and job security levels in Brazil's federal government are often higher than for similar workers in the private sector. While the average benefit in the RGPS is less than two minimum salaries (or R$ 250 per month), the average benefit for retirees from the federal judiciary is more than forty times the minimum salary (or about R$6,500). Reduction of differences between the RJU and RGPS will be a big step towards greater equity and better redistribution in Brazil's social security. Cutting RGPS benefits (e.g., through the new benefit formula) without also reforming RJU pensions will exacerbate income inequality even if it helps to contain the overall fiscal burden.

Without reform, the gap between annual Federal government subsidies to the typical RGPS and RJU participant grows from R$16,000 in 2000 to R$80,000 by 2020

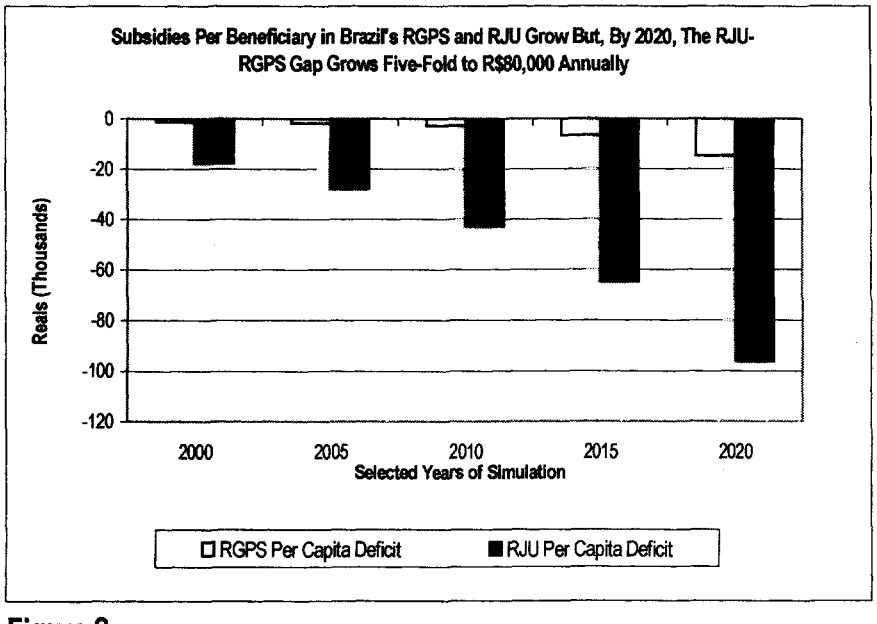

Figure 2

Unnecessarily high efficiency costs

7. In the case of the RGPS, these generous benefits have had to be financed by rates of payroll taxes that—despite being among the highest in the world—have proved to be inadequate. RJU benefits have largely been financed from ***general tax revenues***, as the regime is only now taking on the contributory features of a PAYG system. Brazil raises taxes of about 33% of its GDP, among the highest rates in the world, and still has to borrow to meet its public expenditure needs. The IMF estimates that direct expenditures for public pensions and the cost of servicing the debt incurred on its behalf are almost 10% of GDP. Along with administrative weaknesses in the social security system and flawed enforcement of labor laws, onerous levels of taxation are believed to be a principal cause of the high and growing informality of employment in Brazil. **Figure 3** shows a steady decline of the share of formal employment in the six largest metropolitan areas in Brazil over the last two decades. Some observers argue that the labor-related distortions due to high INSS ***payroll taxes*** make RGPS reform more urgent than RJU reform. This report reasons that tax-related distortions arising because of RJU financing needs—which are currently three times as large as those of the RGPS—may be as or more serious. When fiscal, equity, and efficiency concerns are all considered, reform of the RJU will remain the higher priority for some years to come.

The structure of and administrative weaknesses in both the unreformed RGPS and RJU imply large tax-related distortions and labor market inefficiency

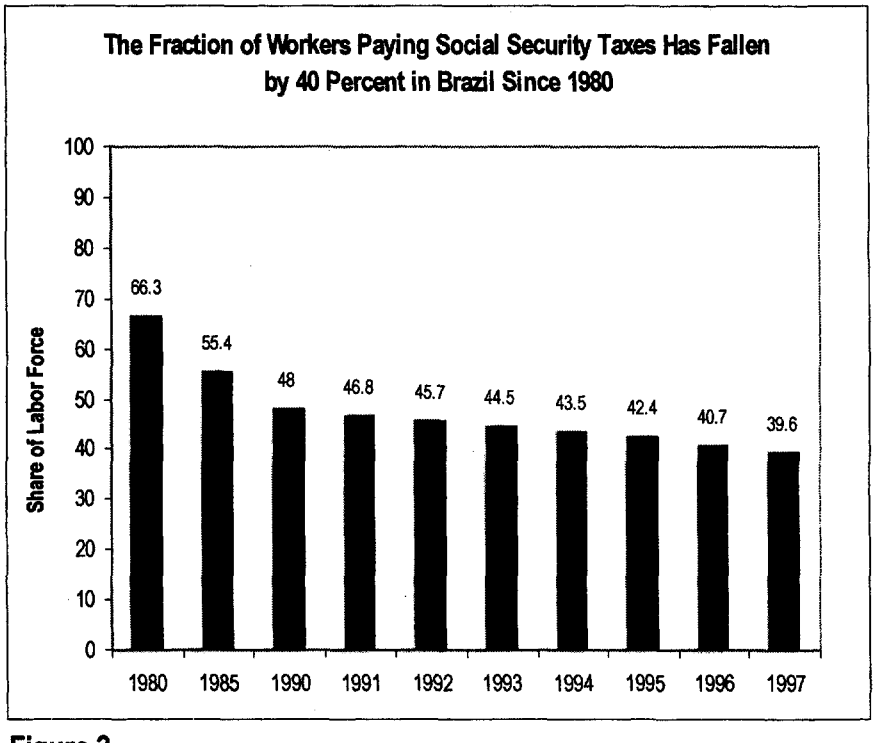

Figure 3

Low coverage of funded schemes

8. While funded company pension plans manage about R$100 billion worth of assets, coverage of funded pension plans remains low at about 5% of the workforce (see **Figure 4**). The low coverage of this third pillar of old age security is somewhat surprising for a country with one of the most sophisticated capital markets in the developing world. Given this institutional strength, the likely reasons for this are an unfavorable tax treatment for retirement accounts, an inadequate regulatory/supervisory structure that does not inspire investor confidence, and the generosity of unfunded first pillar pensions. Almost all OECD countries have an "EET" model, where pension contributions and investment returns are exempt for taxation, and only pension benefits are taxed. Brazil in contrast has what can be described as "eet" system, with limits on such exemptions but also considerable uncertainty of treatment. Reducing the tax burden and promised benefits in first pillar pension systems are the other instruments for faster growth of pension funds in Brazil. In 1980, pension fund assets as a fraction of GDP in both Brazil and Chile were 1% of GDP; today, while this ratio is about 10% in Brazil, it is more than 40% in Chile, where wide-ranging social security reforms addressed these weaknesses.

Given Brazil's robust capital markets, the likely reasons for low coverage of funded pension schemes are uncertain tax treatment, inadequate supervision, and the generosity of the two unfunded schemes – the Regime Geral and the Regime Juridico Unico

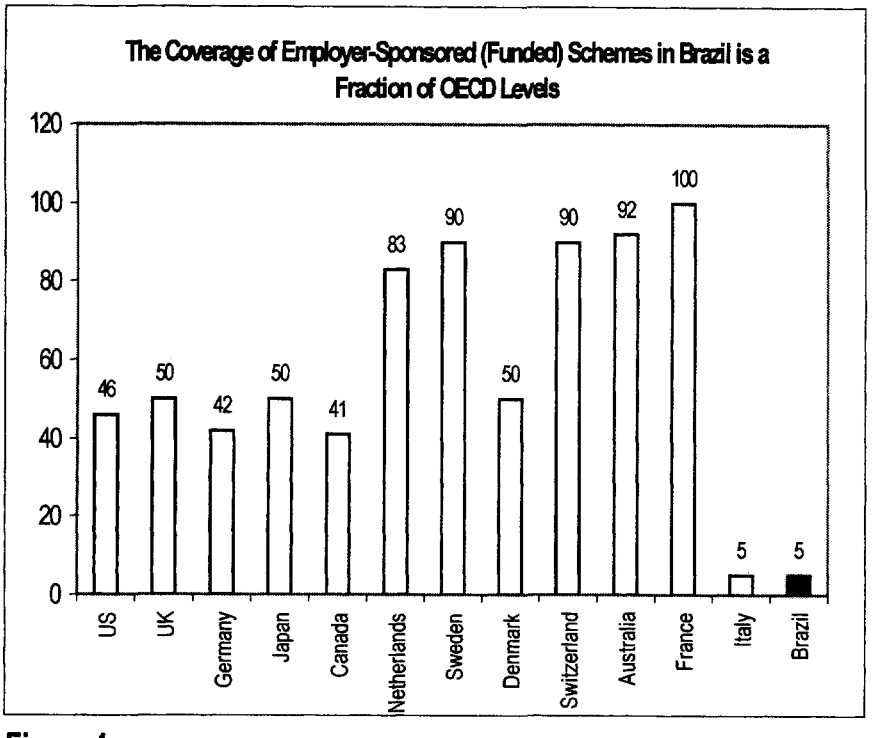

Figure 4

9. Setting up employer-sponsored pension funds for government workers will increase the coverage of funded schemes, but under current conditions these funds are not sustainable (more on this below).

II. THE GOALS OF REFORM

10. The Brazilian government's reform efforts aim to reduce fiscal deficits, lower actuarial imbalances, increase equity and redistribution, reduce collateral inefficiencies, and facilitate growth of funded pension schemes.

Reducing fiscal imbalances

11. Fiscal balance is the main and immediate goal of the Brazilian reform. In the RGPS, this is mainly sought by ending reduced pensions (*aposentadoria proporcional*) and introducing a new formula for calculating pension benefits (called *fator previdenciario* in this report), a change finalized recently and whose effects are yet to bear fruit. Simulations of the effect of the first measure—the elimination of reduced pensions—showed gains until 2010 over what would have occurred without this reform, as people wait longer to get unreduced benefits and the reference wage is lowered. But without further reform, the changes could, under some assumptions, even have actually ***worsened*** fiscal imbalances over the medium to long term, as those who would have retired with reduced benefits (70-99% of reference salaries) would begin to retire with unreduced (100%) benefits. The main achievement of the first round of reform was—by removing the benefit formula from the Constitution—to make deeper reform easier. The government has used this space to introduce the new formula which can result in measurable fiscal gains (**see Figure 5**). While not guaranteeing to return the RGPS to balance (except under optimistic assumptions regarding how individuals postpone retirement in response to incentives to work longer built into the *fator previdenciario*), these measures will result in measurable short-, medium- and long-term fiscal gains if implemented rigorously. But without a legal ***minimum retirement age***, these gains cannot be regarded as certain.

The goals of Brazil's reform efforts are—in order of urgency—to reduce fiscal deficits, lower actuarial imbalances, increase equity and redistribution, reduce collateral inefficiencies, and facilitate growth of funded pensions.

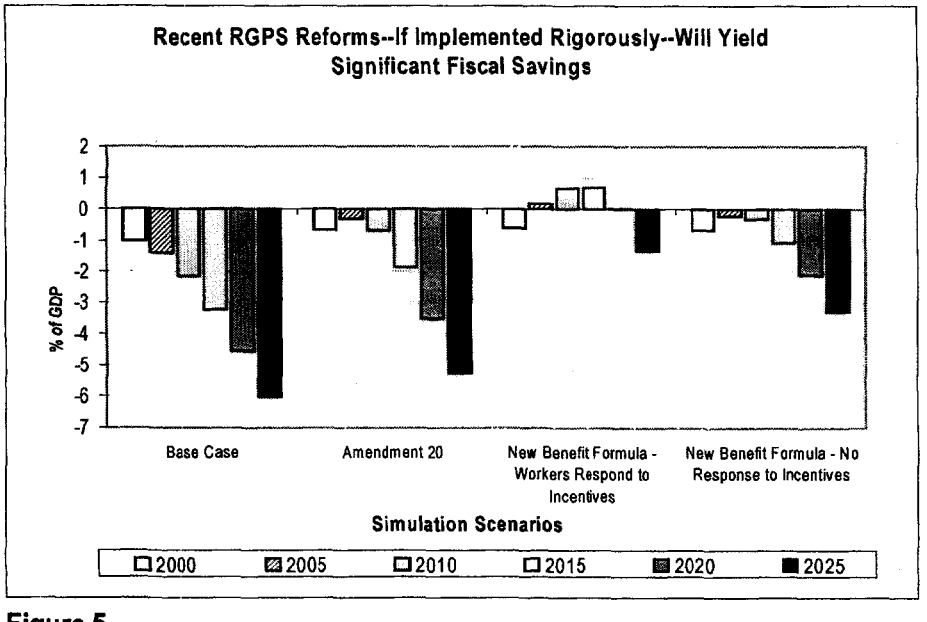

Figure 5

12. In the RJU, the main reforms simulated are the introduction of a minimum age of 53/48 years for men/women at which retirement benefits commence and the elimination of reduced pensions. A contribution rate hike for federal workers and retirees approved by the legislature in early 1999 was struck down later by the Supreme Court. The Federal Government now is trying to amend the rules in order to introduce contributions by federal retirees (most state governments already levy such contributions, but are vulnerable to legal challenges if the Supreme Court ruling stands). The Hauly Amendment to this bill also seeks to extinguish the RJU altogether by mandating that all new hires belong to the RGPS.

13. Simulations indicate that even if the increased contribution rates had been approved, the effect of these changes would have been to slow down, but not eliminate, the growth of fiscal deficits in the Federal RJU. Without the reforms, for example, the deficit reaches 2.3% of GDP—from the current 1.5%—in 2015; if implemented, the reforms would have pushed this date to 2020. Including subnational RJUs as well would likely double these figures. **Figure 6** shows the relatively modest gains if the government manages to introduce an 11% contribution rate for retirees in 2000. Simulations also show that the retirement ages proposed by the government (53 and 48 years for men and women respectively, rising gradually to 60 and 55 years) have little immediate effects on system balances ***at the current statutory replacement ratios of 100%***. The effects of the Hauly amendment were not simulated, but its main effects are predictable: given the relative youth of current government workers and retirees, the beneficial effects of the Hauly amendment will not be felt for at least another generation, though subnational governments will start to experience a loss of revenue right away (because the new workers and their employers would have to contribute to the INSS).

While the federal government pays an annual subsidy of 1000 reais for each private sector retiree in the Regime Geral, the subsidy is 17,500 reais—or three times the per capita income of Brazil—for every person retiring under the Federal Regime Juridico Unico

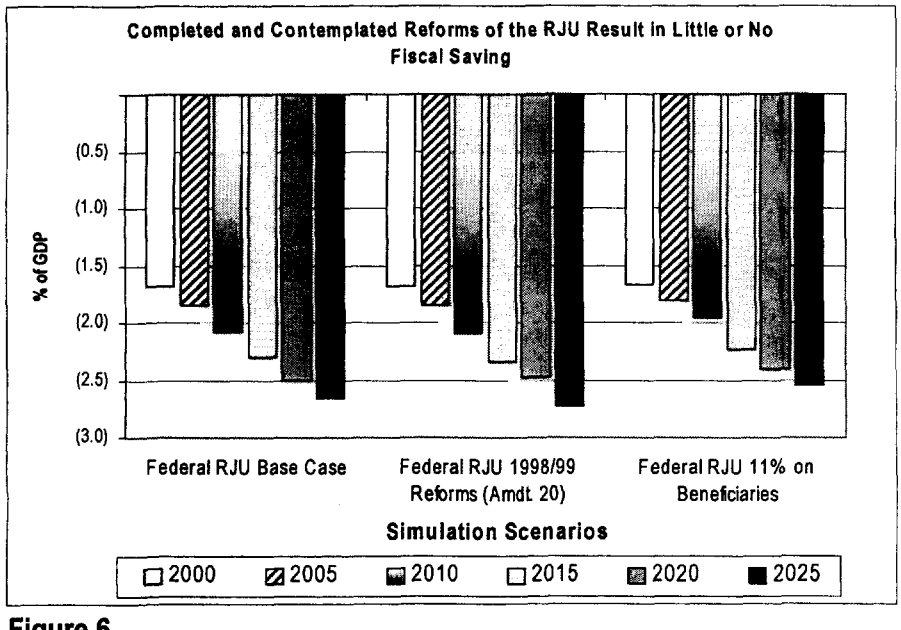

Figure 6

Lowering actuarial imbalances

14. Fiscal and actuarial balance are often treated as identical by commentators on social security reform in Brazil. In fact, it is unlikely that fiscal and actuarial balances ever coincide. Fiscal balance in a PAYG system occurs when **total** contribution revenues match total pension benefits being paid; actuarial balance relates an **individual's** expected benefits to the same individual's past contributions. Elements affecting fiscal balance include the number of contributors and pensioners, and contribution and benefit rates. What does not enter into the fiscal balance is the relationship between benefits collected by any one pensioner and what he/she paid as contributions in the past: the contributions paid in the past were revenue then and entered previous years' fiscal balance, while benefits collected today are expenditures out of today's fiscal accounts.

High replacement rates in the RJU and no minimum retirement age in the RGPS result in significantly higher rates of return in Brazil as compared with those in the US social security system

15. **Figure 7** shows the effects of the reforms for the principal programs in the RGPS and Federal RJU for male workers (the results for women are similar). Note that these numbers are computed using an implied contribution by government at twice the rate of RJU participant contributions, to make them comparable to RGPS rates of return. Rates of return in both the RGPS and RJU length of service programs fall, but by a smaller fraction for the RGPS. But in general, compared with the rather modest fiscal gains for the RJU, these numbers reflect the relatively deeper reforms for ***new entrants*** as compared with RJU incumbents. RGPS reforms affect both incumbents and newcomers, but rates of return fall by less for both relative to those in the RJU. However, RGPS reforms are relatively certain (with reforms validated as legal by the judiciary), while the reforms simulated for the RJU are still speculative in nature.

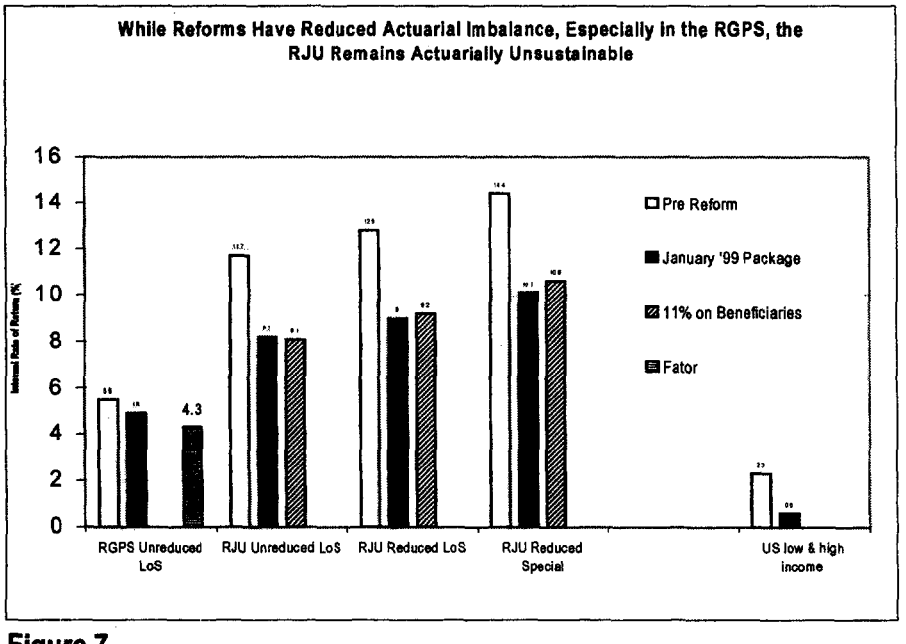

Figure 7

16. The comparison of post-reform rates of return in Brazil with rates of return in the US social security system (see Figure 7 again) reveals how much more needs to be done to bring the Brazilian first pillar systems to actuarial balance, especially in case of the RJU. Statutory replacement rates are graduated between 29% and 62% in the US, depending on the income-level, considerably lower than the uniform 100% rate in Brazil. Higher income-earners in the US may even face ***negative*** rates of return: their replacement rate is less than one-third that of their Brazilian counterparts. In Brazil, high replacement rates with no minimum retirement age translate into large actuarial imbalances, even though contribution rates rise with wages and are generally much higher than in the US.

For fiscal, equity, efficiency, and capital market - related reasons, the reform of the RJU should precede any further changes in the rules determining RGPS benefits

Increasing equity and redistribution

17. The third goal of social security reform in Brazil is to improve equity. One measure of inequity is the difference in the rate of return in different programs. Within the RGPS, for example, annual rates of return in the Old Age Program are 15-20%, higher than the generous RJU Special Length of Service program. But the average benefit in the Old Age Program is low, and the majority of beneficiaries may indeed qualify for means-tested social assistance. Discrepancies in rates of return between Old Age and Length of Service are perhaps a better indicator of inappropriate classification than of system inequity: the profile of Old Age Program beneficiaries provides a strong case for considering it a part of social assistance, which for transparency reasons could be funded out of general revenues rather than contribution-based social security. But there may be political economy reasons for retaining this administrative arrangement if it is believed that this increases the chances that these social assistance expenditures will continue to be funded (more on this below).

18. With reforms in the RGPS proceeding at a considerably faster pace than for the RJU, the gap between RGPS and RJU subsidies has grown over the period 1999-2000. It is noteworthy, though, that the most pro-poor component of the RGPS pensions—the Old Age Program—has been protected from cuts. Restricting reform to the Length of Service program in the RGPS—which is primarily urban and male—and protecting Old Age Program pensioners—predominantly rural and female—from cuts has helped to minimize adverse effects on the poor. Passage of the Hauly Amendment will ensure greater equity in the long term, but one of the most effective ways to both reduce inequity and improve the redistribution in Brazil's public spending over the next 5-15 years is to immediately bring about more fiscal and actuarial balance in the RJU.

Reducing collateral inefficiency

19. There are two major inefficiencies in the Brazilian labor market, both of which can be traced at least in part to weaknesses in the social security system. First, because of the relative generosity of government pensions, there is little or no mobility from the public to the private sector. Second, the high payroll tax rates levied to finance RGPS benefits (that, together with *ad hoc* taxes levied to fund social security benefits, add up to about 33% of the cost of labor), and the high general tax rates needed to meet the pension deficits for government and private sector workers significantly raise the cost of doing business in Brazil's regulated sector.

Social security taxes are high in Brazil, and are exceeded only by a few European countries such as Portugal

20. Unlike many countries undergoing fiscal adjustment, government workers in Brazil are generally overcompensated relative to workers with similar attributes (such as age, education and experience) in the private sector. For example, a recent study found that:

- a male worker with a high school diploma in the federal judiciary in Brasilia gets 50% higher pay, had 80% more job security, and could expect 75% higher pensions compared to his private sector counterpart.
- a female civil servant with 12 or more years of education working in the state administration in Rio de Janeiro would get the same salary, had 70% more job security, and could expect 40% higher pensions.
- a secondary school teacher in Sao Paulo's public schools gets 15% lower pay but has 50% more job security and can expect 50% higher pensions than a similar worker in the private sector.

Large public-private differences in compensation leave no motivation for government workers to pursue possibly more productive private sector careers (this is especially true for low wage workers), and also create unintended incentives to join government service just before retiring to get higher pensions (this is especially true for high wage workers).

21. High payroll levies and weak links between contributions and benefits inherent in a PAYG system—made even weaker by lax administration—result in high labor costs in Brazil's regulated sector, and deepen the divide between formal and informal employment. **Figure 8** illustrates that social security taxes are high in Brazil, and are exceeded only by a few European countries in the industrialized world. With reforms taking root in countries such as Argentina and Mexico, Brazil's high tax rates result in lower wages and employment in an increasingly competitive global economy.

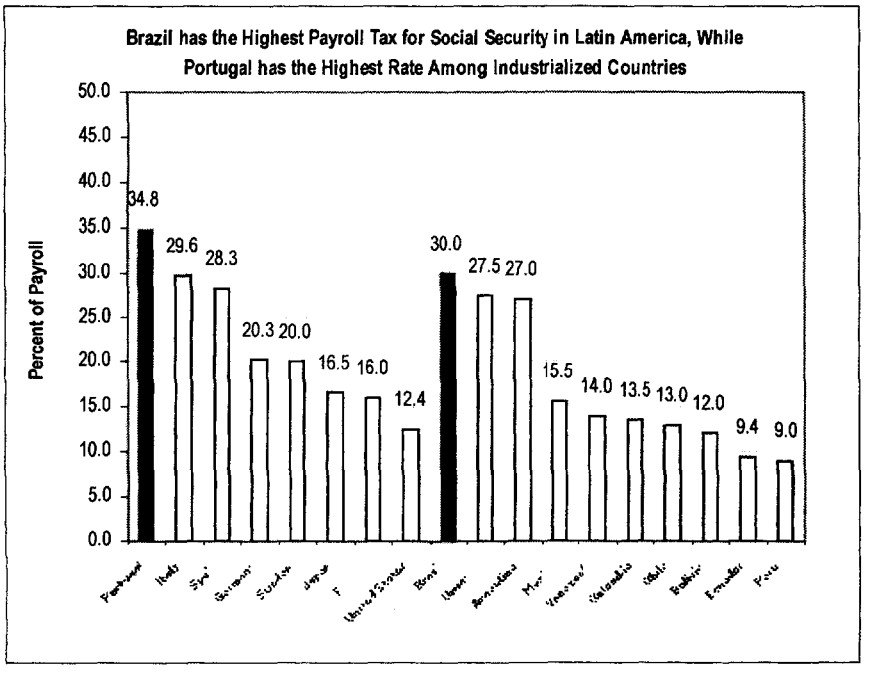

Figure 8

Pension funds for government employees should ideally not be set up before RJU rules are changed, and tax incentives for private pension funds are unlikely given fiscal constraints facing government today

Facilitating expansion of funded schemes

22. The limited macroeconomic and fiscal elbow room due to the nature and timing of Brazil's stabilization has precluded the setting up of a multi-pillar system with a mandatory funded scheme. But the consensus in Brazil is gradually moving towards greater reliance on funded schemes for old age support. This is in line with the experience of other countries. The government has taken steps to encourage voluntary funded schemes, including a set of well-designed rules for both private and government pension funds, and also plans to consolidate and strengthen supervision. But it is unlikely that it can find the fiscal space for tax incentives for individual and employer-sponsored retirement plans until deeper first-pillar reforms are completed.

23. The Federal government has also facilitated the setting up of complementary pension funds for government workers. While risky, this is promising from a political economy point of view: it allows government to offer its employees a "new deal" consisting of lower but more dependable pensions rather than confronting them with the bad news that their benefits will be reduced, and it ensures that privatization proceeds are used to pay down the governments' debt. To make this lasting solution, however, the government must do two difficult tasks ***before*** pension plans are created. The first is to take the RJU benefit formula out of the Constitution, introduce a minimum retirement age for current workers, lower replacement rates, and increase the reference period. Under current RJU rules, even large infusions

of cash (e.g., from privatization) are quickly dissipated: simulations for Parana's RJU show that even if a year's revenues of the state government (about R$5 billion) were parked in a pension fund and earned a high rate of return, the funds are used up in five years (see **Figure 9**). The second is to remedy weaknesses in the regulatory and supervisory system.

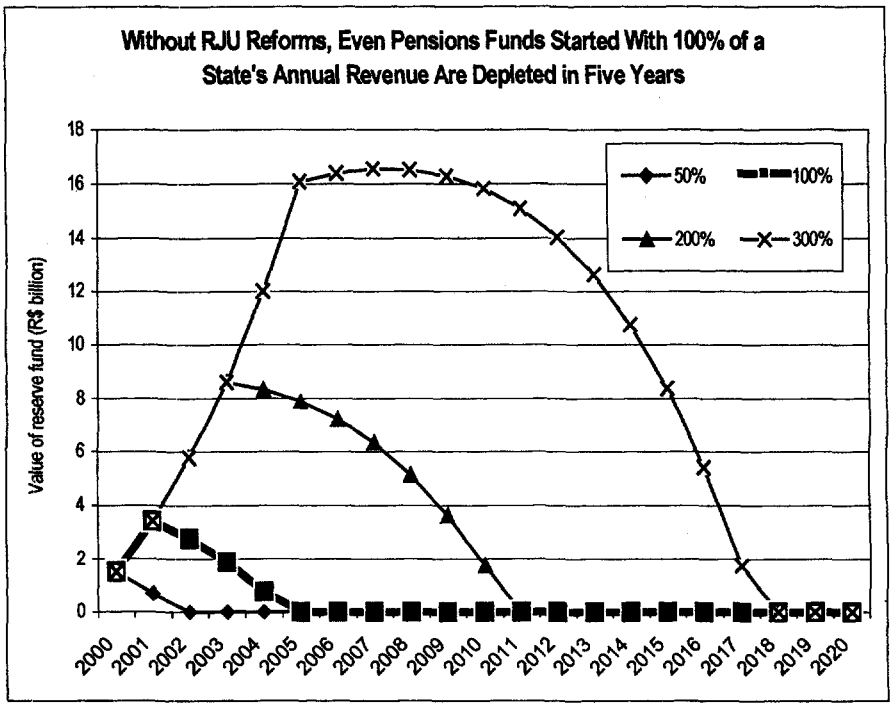

Figure 9

For most states, even putting one year's total revenues into a pension fund cannot finance state pension expenditures for more than five years

III. THE POLICY INEVITABILITIES

24. To attain the goals stated above, Brazil has little choice but to reduce subsidies for government pensions by lowering replacement rates, lengthen the reference period for calculating pensions in the RJU, institute a minimum retirement age in the RGPS; have greater funding of pension liabilities and, eventually, reduce payroll tax rates. While exacerbating public-private inequity, recent RGPS reforms are an important step towards improving fiscal balance and efficiency. The fiscal burden of public pensions and growing gap between RGPS and RJU pensions should be publicized using a strategic communications campaign to generate support for continued reform among those who stand to gain the most from it—the youth, private sector and the poor.

*The key to effective reform of social security is widening the debate to include potential winners from these changes – especially the **private sector**, the **young**, and the **poor***

Subsidies for government pensions have to be reduced

25. All the findings of this report indicate that there is no recourse other than to quickly reduce the subsidy for pensions of government workers that is projected to double in magnitude by 2005, even after a generous government-as-employer contribution of 20% of payroll is imputed:

- Fiscal reasons – RJU fiscal deficits are more than twice those in the RGPS, and this would not have changed for another ten years in the absence of reforms. With the latest reform of the RGPS benefit formula, ***RJU deficits will remain greater than RGPS deficits.***
- Equity reasons – On a per beneficiary basis, the federal government "subsidy" to the RGPS is less than 5% of the subsidy to RJU retirees. Without reform, this rises to 15% by 2025, ***but the absolute gap in the subsidy grows five-fold to R$80,000 and, with the latest RGPS reforms, this gap will rise considerably.***
- Efficiency reasons – While the high payroll tax that finances RGPS benefits distort the labor market, ***high general taxes required to fund the larger RJU deficits may be as distortionary as the INSS levy.***
- Saving-related reasons – Though the saving and capital market development rationale for pension reform is unproven, conditions in Brazil indicate that ***better fiscal and actuarial balance in first-pillar pensions—especially the RJU—will allow the fiscal headroom for fostering sustainable growth of the third, funded pillar.***

Replacement rates have to be lowered

26. The simulations conducted in this report, while not providing failsafe quantitative projections, provide reliable measures of ***relative effectiveness*** of policy measures. The results show that replacement rates in the RJU have to be lowered for making any sizeable gains on the fiscal, actuarial, and equity fronts:

- Raising contributions – Increasing contribution rates is not sufficient even for actuarial balance at rates of replacement nearing 100%; ***for fiscal balance, contribution rates of greater than 50% are required which***

are neither politically feasible nor economically desirable. Estimates show that ***only marginal improvements in equity would have resulted in the Federal RJU from the higher/graduated contribution rates of 11-25% struck down as unconstitutional in 1999.***

- Reducing evasion – Reducing evasion is difficult at current high contribution rates, but simulations show that even ***eliminating*** evasion does not restore actuarial balance; at the high replacement rates and easy eligibility conditions, increasing coverage would have worsened fiscal balance. ***The fator previdenciario addresses this shortcoming.***
- Increasing time of contribution – The elimination of reduced pensions was shown to help in the short term, but—at the high replacement rates existing at the time—this measures may have actually ***worsened*** the fiscal balance in the RGPS over the medium to long term. ***The fator previdenciario addresses this shortcoming effectively***.
- Instituting a minimum age of retirement – Our simulations indicate that ***the fiscal gain to having the proposed retirement age of 60/55 years for men/women is modest but measurable in the short-term.*** But while this measure will help in improving actuarial balance considerably and delay retirement, there appears to be no political appetite for instituting this eligibility condition for the RGPS.

There is no recourse for Brazil but to lower the high, uniform replacement rates—experience suggests that rates higher than 40-70% cannot be sustained

International experience suggests rules for sustainability and equity: replacement rates of 30-40% for high wage earners (with voluntary pensions as a supplement if desired) and 60-70% for low wage earners (with social assistance to supplement as needed). It is necessary to remove the benefit formula for RJU pensions from the Constitution, as done for the RGPS in 1998. For those already retired, it is reasonable—in the absence of a minimum retirement age—to expect the same rate of contribution as for those still working, otherwise the effective replacement rate is higher than 100%, providing a harmful incentive to quit working and contributing early. ***And the rule for benefit indexation can then be changed from salary levels to price indices.***

The reference period has to be lengthened uniformly

27. Increasing the reference period from the current last month for the RJU and last three years for the RGPS will yield fiscal, equity, and efficiency benefits, ***but especially if done uniformly for both regimes***.

- Fiscal gains – Since most workers earn the highest salary at the end of their careers, an end-loaded replacement formula (last 36 months in the RGPS and last month in the RJU) implied a higher pension expenditures than would result if the entire working history is taken into account in calculating pension levels. The recent change in the RGPS benefit formula to increase the reference period to almost the full working life will increase labor market efficiency. It also raises INSS revenues because workers lose if they underreport earnings, as is the current practice.
- Equity gains – Age-earnings profile of educated (i.e., wealthier) workers are higher and ***steeper***: while a 60 year old educated man earns three

times the salary of a similarly schooled 25 year old man, this ratio is only 1.5 for less educated workers. Extending the reference period to the working life would remove pro-rich biases in the formulas of both RGPS and RJU, but—because RGPS pensions are capped at R$1255 per month and RJU pensions are not—especially for government pensions.

- Efficiency – Labor market efficiency will improve most if the increases in the reference period are uniform for both the RGPS and RJU.

The recent changes in the RGPS benefit formula accomplish this objective for private sector social security. For the greatest fiscal, equity, and efficiency gains, it is necessary to remove the RJU benefit formula from the Constitution, lower the replacement rate for current workers, change the rule of indexation from nominal salary to inflation, and increase the reference period so ***that the rules are the same in both the RJU and the RGPS***.

For fiscal, efficiency, and labor market reasons, Brazil should eventually lower contribution rates for funding its mandatory social security programs to about 15-20%

A minimum retirement age has to be instituted

28. A minimum age at which benefits commence has to be introduced for RGPS retirees. While the fiscal gains from this measure may be modest in the short term as the retirement age is phased in, this step is critical for labor market efficiency reasons, viz., signaling that pensions are for old age support and not as an additional source of income while individuals are or should be working. Simulations show, however, that the retirement age must be at least 60 years to be effective. Work-life differences and labor force participation differences between men and women may provide some rationale for having ***shorter length of contribution*** requirements for women, but life expectancy statistics suggest that the ***retirement age*** should be the same for men and women.

Funded pensions have to grow in importance

29. For both fiscal and ***risk diversification*** reasons, the coverage and size of the funded pension system must grow in Brazil. Over-reliance on first-pillar pensions has resulted in political pressures culminating in adverse fiscal, equity, and efficiency outcomes. Sustainable growth in funded schemes has three major prerequisites: balanced and clear legislation, a skilled supervisory body, and actuarially balanced first pillar pensions, especially for government workers.

Taxes to finance first pillar have to be lowered eventually

30. Though tax rates cannot be lowered until pension benefits are lowered, it is important for planners to not ***assume*** that combined employer-employee rates of 30-35% of the salary bill are reasonable. This appears to be the case today: the maximum allowed ratio of pension deficit to net revenues of 12% at all levels of government is based on this arithmetic. International experience suggests that sharp increases in evasion occur at rates around 15% of payroll. Brazil's own experience suggests that rates higher than 15% are not politically feasible for government workers. The long term goal should be employee contributions of 7-10%, with at most matching employer contribution rates.

IV. OTHER POLICY CHOICES

31. While the last section discussed reforms that Brazil will in all probability have to make, this section suggests some changes that will help but may not be strictly necessary. These are to make the PAYG components of social security minimalistic, to integrate the RJU and RGPS, to rely on either mandatory or voluntary funding, and to separate contributory from noncontributory social security.

First-pillar pensions could be kept minimal

32. Having a well-run ***minimalist*** PAYG pension pillar that aims to provide a floor below which living standards do not fall for the elderly and the disabled has many attractive features, especially that it minimizes the distortions associated with defined benefit schemes such as the RGPS or RJU. Three changes are required for the Brazilian first pillar to be regarded as well-run and minimalistic: tightened administration of the INSS, lower benefits, and a graduated replacement structure that pays a higher fraction of reference wages to those with lower incomes. Such a scheme provides a societal safeguard against poverty of the elderly by being inherently ***redistributive***, protects governments from moral hazard by being ***frugal,*** and shields individuals from myopia by requiring ***mandatory*** contributions towards old age security. The size of the first pillar is fundamentally a societal decision—Brazil may choose to have a more generous one and pay a higher price in fiscal and efficiency terms. But there is no justification for having one that is weakly administered and highly unequal.

*While both theory and practice suggest that Brazilians should rely on more than one pillar of old age security, experience does not clearly indicate that a **mandatory** funded pillar is necessary*

RJU and RGPS pensions can be integrated

33. Equity and efficiency-related problems facing Brazil's social security would perhaps be best addressed by merging a reformed RJU with the RGPS, essentially reverting to the pre-1988 situation. The Hauly Amendment proposes to do just this over the long term. A majority of countries maintain separate systems for government workers, so Brazil would not be an exception if it continued with the current two-part first-pillar system. But almost 40% of countries surveyed recently—such as Argentina and the US—have begun merging these components. The US Federal Employees' Retirement Scheme was introduced in 1986, and today many federal government workers rely on the national social security system for the basic pension, to which the federal government contributes on their behalf just as would a private employer. Their pensions are augmented by closed pension plans, which the federal government oversees as would any private firm with an employer-sponsored pension scheme. Employees in many states in the US and Argentina also belong to the national social security system, as is the case for smaller municipalities in Brazil. With good design and strong supervision of employer-sponsored pension plans, this design offers the most occupational flexibility.

Third-pillar growth may make second-pillar unnecessary

34. With its high rate of informality and early average retirement age, Brazil can benefit from the labor market advantages of having a funded pension scheme. These include stronger links between contributions and benefits that reduce the motivation to evade, reductions in the pure tax component that lower the cost of labor, increased mobility because pension rights are portable, and reduced incentives to retire early. But not too much should be expected from the creation of a funded system. In Chile, where a funded system has been in operation for almost two decades, informal sector employment has remained at about 50%. Brazil's own experience with the FGTS—also a funded payroll-tax-financed scheme—again provides cause for caution. The causes of informality in Brazil may lie also with the manner in which labor legislation is enforced, with people with unsigned contracts receiving similar protection under the law as that afforded to those with formal labor contracts. In light of this, there are few labor-market-related reasons for government to ***mandate*** a funded component. Keeping the first pillar small and having a well-regulated voluntary pillar may well be sufficient for Brazil, just as it has been for the US.

Not too much should be expected—in terms of reduced informality—from increased funding of pensions, especially given the high tax rates on economic activity and the manner in which Brazil's labor laws are enforced

Assistance to elderly poor could be better targeted

35. Approximately 6 million persons, or 33% of the pension and survivor benefit recipients under the *Regime Geral,* are rural men/women who have little proof of service, but can prove that they are at least 60/55 years old. The average level of these benefits is R$137, just one real more than the legally specified minimum monthly salary until mid-2000, and sum up to about R$8 billion annually, i.e., roughly the size of the RGPS deficit in 1998. By all accounts, a large share of this sum goes to the elderly poor; by one account, these transfers are between 10-15% of the GDP of the poorest northeastern states such as Maranhão and Piauí.

36. There are several good arguments to support replacing the contributory pensions received by rural households with targeted social assistance. The poverty impact and welfare benefits cited in Volume II would be attained, and perhaps increased if the current contributory old age pensions program were a social assistance program with a secure, more broadly-based source of revenue. As a social insurance system, the old age pension system fails on actuarial and fiscal grounds. And while it succeeds in redistributing income from urban to rural workers, the net impact on income distribution in rural areas is unclear—largely because the incidence of contributory social insurance and non-contributory social assistance cannot be analyzed separately. Additionally, retaining the old age benefit as contributory social assistance may provide workers with strong incentives to strategically abuse the RGPS. Recent reforms to the

RGPS length of service program tighten pension benefit-to-contribution linkages, and cut replacement rates. Current length of service contributors thus have an incentive to opt for benefits under the old age system, undermining the fiscal sustainability of the reforms. The lenient eligibility requirements for an old age pension extended to rural workers increase the potential for strategic abuse. Separating the social insurance system from the social assistance function might be beneficial even if both continue to be administered by the same agency, preventing cross-subsidies from one to the other, and allowing the government to target poverty relief at one group with fewer disincentives for the other.

The decision on whether or not to separate contributory from noncontributory pensions should be made keeping in mind the complicated ***political economy*** *of social assistance, not solely on the basis of fiscal or administrative considerations*

37. On the opposite side of the argument, separating the public pensions received by rural households from the mainstream social security regime may leave the program without a political constituency to defend it, and make public benefits for the rural elderly vulnerable to large budget cuts by future governments that are under pressure to reduce spending. Additionally, eliminating the contributory component of the old age pension benefit—however symbolic or nominal this may be—may trap poorer workers in a marginalized social program with no mechanism and hence incentive for eventually graduating into the general pension system.

38. In a country where it has been difficult to make government expenditures poverty-focussed, rural pensions are exceptional and should be protected from cuts during the reform of the RGPS. While this noncontributory segment is obviously being funded with general revenues from the Treasury instead of earmarked contributions collected by the INSS, it may not serve Brazil well to institutionally transfer this program to the Secretariat of Social Assistance. While this decision is perhaps best made by those who understand both the administrative implications of these options and the complicated political economy of welfare programs in Brazil, the recommendation of this report is to keep it bundled with a system that has widespread voter interest. Hence it should be left under the INSS, but the Ministry of Social Security should sponsor a thorough evaluation of the Old Age program to make it even better targeted to needy groups such as the rural poor, for whom currently there are few other welfare options.

V. SUMMARY AND CONCLUSIONS

39. Social security is the single most important fiscal issue facing the federal and subnational governments in Brazil today. The overall pension deficit was about R$40 billion in 1998, or more than 5% of GDP. When the interest payments on public debt accumulated on behalf of public pensions are included, this ratio doubles to 10% of GDP.

The criteria for evaluating reform measures

40. There are many compelling reasons for reform of social security in Brazil including equity, labor market efficiency, and savings and capital market development, but fiscal concerns are correctly viewed as paramount. Accordingly, in evaluating whether or not a proposed measure is consistent with the constraints and objectives of Brazilian social policy, this report suggests five criteria—**in order of importance**—for evaluating any reform strategy or measure:

1. Immediate fiscal payoff,
2. Long-term fiscal sustainability,
3. Equity considerations, especially RGPS versus RJU,
4. Efficiency considerations, especially labor market distortions, and
5. Savings and capital market development impact.

Despite facing formidable legislative, judicial, and other obstacles, the Government has actively pursued social security reforms since 1997 and has achieved considerable success

The progress made

41. The obstacles to reform are well-known and formidable, having legislative, judicial and executive dimensions. Despite these obstacles, the Federal Government has actively pursued reform since 1997. Even in the midst of the 1998 national elections—never an easy time for governments to renegotiate social contracts with voters—the Federal Government kept up the momentum for reform. Constitutional reforms were approved in November 1998 and other measures—notably increased contributions from RJU participants—were attempted in 1999. The main reforms are:

- **RGPS:** Modest short-term fiscal relief through increased eligibility requirements but significant medium-term and long-term fiscal gains due to new benefit formula that lowers replacement rates and lengthens reference period for calculating pensions; the introduction of the benefit formula also sends a clear signal that the government is serious about using the space cleared by earlier constitutional amendments.
- **RJU**: Relatively modest fiscal relief due to increased eligibility requirements, mainly a minimum length of public service and time in job

from which retirement takes place, and phased in age of retirement; main systemic change would be a clause invoking automatic employee contribution increases if the pension deficit exceeds 12% of net current revenues at any level of government.

- **SCP**: Major improvements can result if rules marking a shift to defined contribution plans with lower employer contributions are implemented, and entities other than enterprises (such as professional groups) are allowed to set up closed pension funds.

The challenges ahead

Sustainable reform of the complex Brazilian social security system under the constraints faced by the country may be best accomplished through a series of measures whose sequence is determined by tactics as much as strategy

42. The principal challenges are to reduce the generosity of both RGPS and RJU pensions while keeping a safety net element, reduce differences between RGPS and RJU pensions, and encourage sustainable growth of funded plans by paring down RGPS and RJU (unfunded) pensions and by strengthening regulation. The reform of a complicated social security system such as that of Brazil under the fiscal, administrative and political constraints that it faces must be viewed as a step-by-step process, with the sequencing determined both by strategic and tactical considerations. **Table 1** presents the steps that would be consistent and inconsistent with the long-term goals of a sustainable, effficient, and just social security in Brazil. Table 1 also summarizes these goals. The steps consistent with these goals would be:

- **Reduce RJU fiscal deficits**: The main reforms needed are reduction of statutory replacement ratios from current 100% for fiscal and equity reasons, and increasing the reference period from the last salary to the full working life; both require amending the Constitution, the urgency of which will be better appreciated through revelation of imbalances through actuarial audits of federal and state RJUs and open discussions (see **Table 2** for details). Having retirees contribute at the same rate as active workers helps on fiscal, equity and efficiency grounds, but should not be considered the primary measure for restoring balance.

- **Control growth of RGPS deficits and improve redistribution**: The first priority should be the administrative strengthening of the Ministry of Social Security, especially the INSS. The main design-related reform needed is a retirement age of at least 60 years; this would require a constitutional amendment). Fiscal and efficiency gains from the recent reform of the Length of Service program's benefit formula depend critically on the administrative capacity of government to prevent leakage to other programs, especially the Disability and Old Age programs. Other implementation-related steps involve maintaining the rural old age pensions program but refining its administration to lower fraud (see **Table 3** for details).

- **Increase pension fund coverage**: The main reforms needed are better supervision of employer-sponsored plans and friendlier tax treatment of individual retirement accounts (see **Table 4** for details); employer-sponsored

plans should be set up under similar rules as for in the private sector, but after current RJU rules are changed through negotiations with government employees, preceded by strategic communications to inform the electorate of the benefits from social security reform (see **Table 5** for details).

The unfairness of reduced RGPS pensions without similar reductions in the generosity of government pensions should now be widely publicized to generate support for deeper RJU reform

43. Reforms of the RJU should now take priority over further changes in the design of the RGPS. RJU reform will undoubtedly be politically challenging. To facilitate these reforms, the adverse equity effects of completed RGPS reforms without reductions in the generosity of RJU pensions should be widely publicized to generate grassroots support for comprehensive reform of the RJU. Pension funds for state pensions, or introducing a funded component in pensions of Federal government workers can be a ***facilitating factor*** for making RJU reform politically palatable, but—given that all pension systems are already in deficit even with high rates of contribution—do not constitute a feasible reform strategy on their own. There are few convincing reasons to liquidate taxpayer-financed government assets in order to continue paying unsustainably high pensions to a relatively small group of economically privileged government workers, after having reduced pensions for otherwise similar workers who just happen to work in the private sector.

Table 1
THE OBJECTIVES OF SOCIAL SECURITY REFORM, AND MEASURES CONSISTENT AND INCONSISTENT WITH THESE GOALS

Objective	Steps Consistent with Objective	Steps Inconsistent with Objective
Fiscal balance	(1) Structural reform of RJU, along the lines of RGPS reform (2) Longer reference period in RJU, along the lines of RGPS reform (3) Minimum retirement age in ***both*** regimes	(1) Not increasing the reference period for the RJU. (2) Introduce reserve funds for government workers--allowing states to move pensions off-budget—without first reforming the RJU.
Equity	(1)) Increase reference period ***uniformly*** for RJU and RGPS (2) Introduce graduated ***replacement*** rates, with lower ratios for high wage earners. (3) Higher contribution rates for RJU ***retirees*** and workers (4) End all special regimes, except for few risky occupations (5) Have a lower time of contribution for women, but the same ***age of retirement*** (6) Merge federal, state and municipal RJUs with RGPS	(1) Pay past dues of INSS to state and municipal RJUs to keep paying unsustainably high RJU pension benefits (2) Use privatization proceeds to pay unsustainably high RJU benefits. (3) Maintain special regimes for primary and secondary school teachers in PAYG component (4) Have lower age of retirement for women. (5) Restricting funded component only to high wage earners.
Redistribution and safety net	(1) Introduce ***graduated replacement rates***, with lower ratios for high wage earners. (2) Continue ***rural old age pensions*** (3) Make first pillar "minimal"	(1) End rural old age pensions, or making rural pensions susceptible to budget cuts by separating its administration from contributory pensions
Actuarial balance	(1) Extend reference period for PAYG components to entire working life (2) Make all funded components defined contribution (DC)	(1) Restricting funded component only to high wage earners.
Labor market efficiency	(1) Merge federal, state and municipal RJUs with RGPS (2) Reduce employer to employee payroll tax ratio, currently 2:1 in the RGPS and RJU (3) Introduce ***retirement age*** of at least 55-60 years in RGPS. (4) Indexing to inflation	(1) Raise INSS payroll tax rates (2) Raise share of employer (currently 20%) in payroll tax (3) Index to salary levels (4) Reform RGPS further without also reforming RJU
Savings and long-term capital markets development	(1) Stronger regulation of private funds. (2) EET rules for open funds (3) Reduce first-pillar benefits. (4) Convert the FGTS into a mandatory retirement plan.	(1) Have separate agencies for regulating open and closed funds. (2) Introduce reserve funds for government workers without first reforming the RJU. (3) Raise first pillar benefits.

Table 2
THE REGIME GERAL DA PREVIDENCIA SOCIAL:
PROBLEMS, BEST PRACTICE, AND POLICY RECOMMENDATIONS

Problem	Diagnosis	Best Practice	Policy Recommendation
Lenient eligibility, with no minimum age of retirement	With no minimum retirement age, the result is ***equal*** periods of time contributing and receiving benefits.	Individuals in most countries spend ***twice or three times*** as long contributing as receiving pensions. Minimum retirement age of about 55-60 years is key factor in inducing this behavior.	1. Establish a minimum retirement age at which retirement benefits commence; while the "fator previdenciario" lowers benefits for early retirees, it does not eliminate the need for a minimum retirement age.
High benefits	The Constitutional Amendment of 1998 makes the replacement rate 100% of ***gross*** wage, well above 100% of net wage.	Mandatory benefits of ***30-50%*** of average wage are more likely to be fiscally sustainable without huge labor market distortions.	2. Lower first-pillar benefits to replace a fraction of average lifetime earnings, accomplished to a significant degree by the new benefit formula 3. Diversify the burden and risk of income security in old age to multiple pillars
High evasion	Contribution rates are ***about 30%*** and pension is based on last 36 months' salary, leading to ***underreporting of earnings***.	Contribution rates ***not much above 15%*** lead to lower evasion. Countries moving toward using ***lifetime*** earnings for determining pensions.	4. The new benefit formula marks a move toward lifetime earnings for calculating pension; however, diversifying into ***multiple*** pillars would allow lower mandatory contribution rates.
Multiple receipt of benefits	It is possible to complete requirements for both length of service and old age pensions and receive two pensions.	Internationally, individuals receive ***only one pension***: old age, or disability, or as survivors.	5. Eliminate multiple benefits; the new benefit formula requires stronger control against workers switching to relatively lenient Old Age pensions and Disability benefits.
Contributory system functions as social assistance system	Old age program – especially ***rural pensions*** – serves as a valuable social assistance system, but at a cost to contributory pensions.	Social ***assistance*** and social insurance are generally separated, so that unintended redistribution is minimized.	6. Old Age program should probably ***not*** be separated from social security and should be retained under the first pillar to ensure political resiliency, but 7. Its targeting to elderly poor could be improved through rigorous evaluation and reform of delivery mechanisms..

Table 3
THE REGIME JURIDICO UNICO:
PROBLEMS, BEST PRACTICE, AND POLICY RECOMMENDATIONS

Problem	Diagnosis	Best practice	Policy Recommendation
Generous benefits	RJU has highest statutory ***replacement rates*** in the world, combined with least demanding ***vesting rules***.	Trend toward ***funded*** plans, and ***integration*** into national first-pillar systems. If stand-alone regime is maintained, benefits are aligned with private sector pensions.	1. Reduce replacement rates. 2. Institute ceiling on first-pillar benefits from the RJU, aligned with RGPS. 3. Reliance on funded plans for retirement income above the first-pillar ceiling.
Indexation to current salary of post from which retired	Makes RJU pensions generous and results in productivity-increasing reform being costly.	Trend towards indexation of pensions to changes in some ***price*** index, or an index combining salaries and prices.	4. Index benefits to inflation.
End-loaded benefit formula	Basing benefits on last month's salary increases abuse and public-private inequity.	Benefits based on average ***lifetime*** earnings.	5. Reference salary based on 80% highest salaries, just like the RGPS. 6. Replacement determined by accrual per year of service.
Loosely applied vesting requirements	Many current retirees became vested under the RJU after "last minute" migration into government service.	Vesting requirements should be ***uniform*** in first-pillar systems and strictly enforced.	7. Vesting periods aligned with the RGPS. 8. Full transfer of acquired rights and of contribution revenue between regimes.
Early retirement and no restrictions on benefits upon re-employment	Government workers have incentive to retire early to receive a stream of tax- and contribution-exempt income.	No first-pillar benefits before a ***minimum age***. Actuarial penalties for early retirement. Restriction on multiple pensions and reduced benefits if employed.	9. Establish minimum age at which benefits commence. 10. Actuarially fair reductions in benefits for early retirement. 11. Restrictions on multiple benefits, and reduced benefits from first-pillar if employed.
Special retirement schemes	Special vesting rules for teachers contribute to RJU deficits. Compensating low-paid teachers with generous pensions is inefficient.	Uniform first-pillar vesting and benefit parameters. Salaries in public sector aligned with private sector. Compensation for "difficult" jobs made as ***higher salaries*** and not as higher pensions	12. Eliminate remaining special regimes. 13. Establish uniform vesting and benefit parameters within first pillar pensions. 14. Increase teacher salaries in public schools to parity with private sector.
Inequity between first-pillar systems	The RJU directly contributes to income inequality, and leads – through fiscal instability and reduced economic growth – to higher poverty.	First-pillar generally provides only a ***minimum*** benefit. Tax-financed ***replacement rate does not exceed 3 times the contribution rate***. First-pillar is safety net; second and third-pillar provide bulk of pensions.	15. Strategic communications campaign to draw attention to first-pillar inequities. 16. Integration of RGPS and RJU and/or cut in first-pillar benefits. 17. Strong supervision and regulation of third-pillar SCPP and creation of second pillar.

Table 4
PENSION FUNDS FOR PRIVATE SECTOR WORKERS: PROBLEMS, BEST PRACTICE, AND POLICY RECOMMENDATIONS

Problem	Diagnosis	Best practice	Policy Recommendation
Restricted coverage	Maximum benefit in RGPS is R$ 1,255 per month, used by companies as a break point for contributing to complementary system.	Most OECD countries ***do not have eligibility constraints related to salary level.***	1. Supervisory agency to ensure that plans are offered to all employees, regardless of salary level.
Uncertain tax treatment	Government has maintained a dispute with pension funds over the need for EET taxation.	Most OECD countries have ***EET*** taxation.	2. Commitment to EET taxation, where contributions and fund earnings are exempt, but benefits are taxed.
High administrative costs	Operational costs in closed funds (employer-provided, mainly DB***) higher than in Chile*** (individual, only DC). ***High fees of open funds***, often above minimum return of 6%.	Not identified, but well regulated and supervised employer pension plans should in principle have much ***lower*** administrative costs than individual pension plans.	3. Evaluate causes of high administrative costs among closed funds. 4. Eliminate 6% minimum return rule in open funds, or 5. Ensure comparability between plans and transparency
Inadequate regulatory structure	No vesting and portability rules, low funding and auditing standards, weak sanctions, poor investment rules, distortionary minimum return rules, limited disclosure.	The Netherlands for vesting, portability, funding, auditing, and disclosure standards. Netherlands and Chile for valuation and diversification rules.	6. Update regulatory framework, as envisaged in proposed complementary legislation.
Ineffective supervision	***Duplicated supervisory roles*** in SPC and SUSEP. Understaffing and ***lack of autonomy*** of SPC. ***Weak supervision*** and low information requirements of pension funds.	The Netherlands, and the newly created independent agencies in Latin American countries such as Argentina and Mexico.	7. Integrate closed and open fund supervisory agencies into one. 8. Ensure administrative, functional, and financial autonomy of new supervisory agency.

Notes: "EET" signifies a tax regime where contributions and fund earnings are exempt, but benefits are taxed. DB is the acronym for defined benefit pensions, where the benefit level is determined by length of service and salary levels. DC is the acronym for defined contribution pensions, where the benefit levels are determined by the contributions made by and on behalf of the individual, and the investment returns on these funds. SPC is the Secretariat of Complementary Pensions in the Ministry of Social Security, which regulates closed or company-sponsored pension plans. SUSEP, in the Ministry of Finance, is the supervisory agency for other funded pension plans, insurance companies. OECD is the Organization for Economic Cooperation and Development.

Table 5
PENSION FUNDS FOR GOVERNMENT WORKERS: PROBLEMS, BEST PRACTICE, AND POLICY RECOMMENDATIONS

Problem	Diagnosis	Best practice	Policy recommendation
Lack of diversification of sponsor risk and limited risk-pooling in RJU plans.	Civil servants' plans (RJU and pension funds) are administered by the ***same entity***, the sub-national government.	US FERS consists of three mandatory parts: national social security, a DB pillar administered by the government, and a funded DC pillar managed by mutual funds.	1. Integration of at least a major ***component*** of the RJU plans with the RGPS.
Imminent depletion of fund reserves.	Pre-funding pension liabilities is ***not viable*** unless drastic parametric reforms are carried out in the RJU.	Fully-funded systems with viable contribution and benefit structures, such as the FERS and most state pension plans in the US.	2. Creation of pension fund should be conditional on adequate parametric reforms.
Inefficient administrative and supervisory structure of two component, two-fund, DB plan.	If both the basic plan and complementary plan are DB plans, there will be a duplication of administrative and supervisory functions.	The Netherlands has an integrated supervisory structure for all employer pensions and individual insurance plans. Parana has proposed a single-fund DB plan subject to a single set of regulations.	3. If DB, integrate basic and complementary plans into a single fund, regulated by supervisory agency of complementary pension system , or 4. Funded plans to be only defined contribution.
Lack of adequate regulation and external supervision of RJU (reserve fund) plans.	RJU plans fall outside the jurisdiction of the federal government: no guarantee that states will have full-funding of RJU plans, or adequate governance for reserve funds to mitigate political interference.	Parana is moving in the right direction, with a law that calls for full funding, and establishes a ***governance structure for the reserve fund similar to that of closed funds*** in the federal complementary system.	5. Full RJU plan – not only complementary part – should be supervised by agency regulating complementary pensions. 6. If this is not possible, Law 9717 should refer to the complementary pension law, or states should introduce the same laws.
Complexity and inadequate regulation of government - sponsored DB pension plans.	DB plans are more difficult to regulate than DC plans, and lead to controversial issues like ***corporate governance*** of private firms. DC plans ensure benefit-contribution links, and allow portability.	No country has dealt adequately with state's intrusion into corporate governance of private firms***; ownership control limits*** (on the share of company equity that any fund can hold) mitigate this problem somewhat.	7. Establish a significant component of RJUs as a DC plan. 8. Regardless of the size of the DC component, regulatory framework and capacity of complementary pension agency must be improved.

Notes: FERS is the US Federal Government Employees Retirement Scheme, introduced in 1986. DB is the acronym for defined benefit pensions, where the benefit level is determined by length of service and salary levels. DC is the acronym for defined contribution pensions, where the benefit levels are determined by the contributions made by and on behalf of the individual, and the investment returns on these funds.