2º SEMINÁRIO INTERNACIONAL DE PREVIDÊNCIA COMPLEMENTAR

O papel da Previdência Complementar em meio ao cenário atual de mudanças

Thoughts on Multi-pillar approach in Brazil

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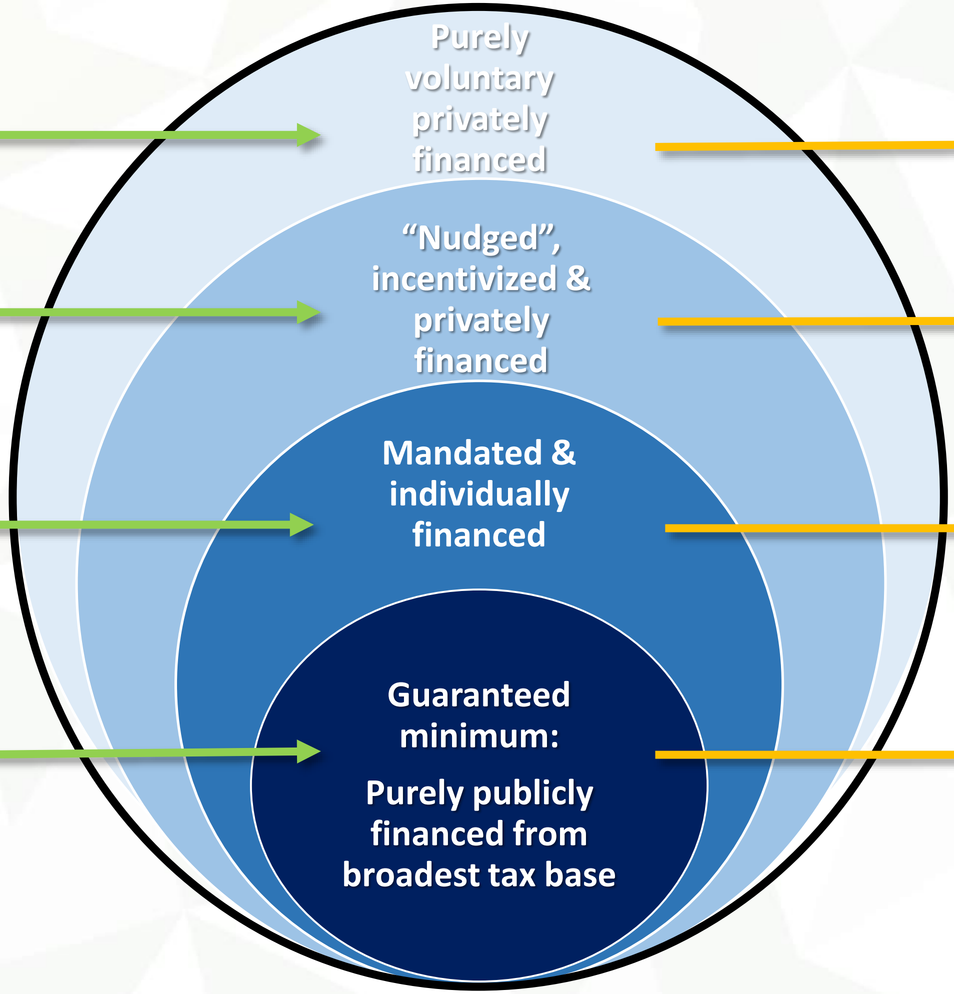
CONTENT

- **World Bank's updated multi-pillar model**
- **How does current Brazil's pension system fit into it?**
- **What is involved in moving to "pure" multi-pillar model?**
  - Revision of subsidies and their financing mechanism
  - Finding financing sources for population aging and transitions costs (in case of funded pillar)
  - Accepting that long term fiscal and social sustainability in big part comes at a cost of lower benefits
- **What is international experience?**
- **In practice, how are funded and notional schemes different from textbook?**

AN UPDATED VIEW ON COMPREHENSIVE "MULTI-PILLAR" PACKAGE OF PROTECTION, focused on goals of multiple pillars rather than tools of achieving them



Common losses;
Most frequent;
Negligible external cost;
Some external social benefit.

→ Regulated market provision of secure savings & insurance;
Micro finance saving and insurance.

Non-trivial losses;
Frequent;
Minimal external cost;
Some external social benefit.

→ Default opt-ins;
Information.

Large losses;
Relatively frequent;
Some external social cost.

→ **Minimally adequate smoothing**
Notional/DC accounts;
Actuarially-fair DB.

Largest losses;
Relatively rare;
High 'external' social cost;
Most acute market failures.

→ **Minimum DB****
- Transfers;
- Subsidized premiums

} Prevents poverty and catastrophic losses

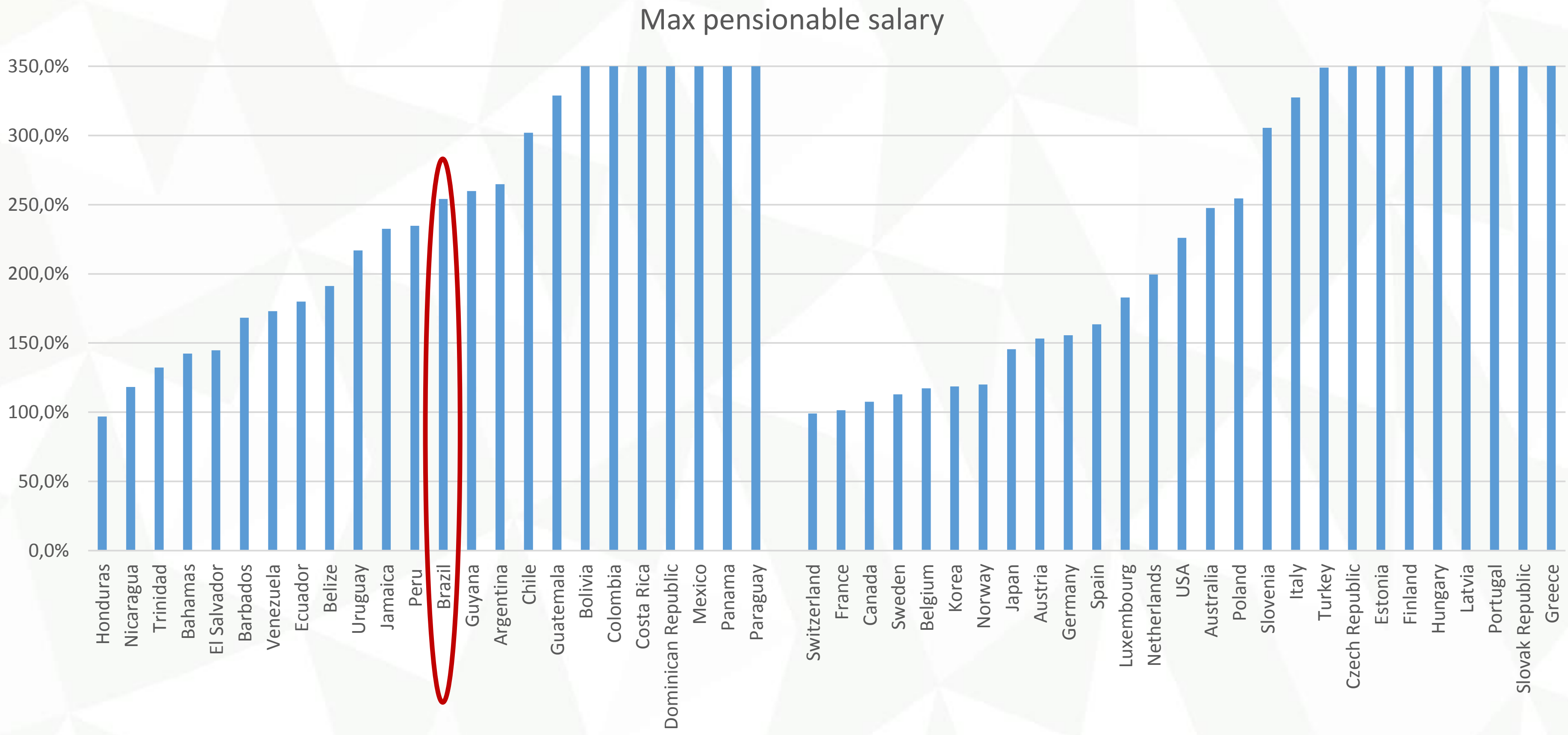
} Sufficient to ensure income above the minimum, safeguarding against moral hazard

Based on Ehrlich and Becker (1972); Gill and Ilahi (2000)

** Replaces contributory guarantees and tax incentives

WHERE IS THE APPROPRIATE LINE BETWEEN 2ND AND 3RD PILLAR?

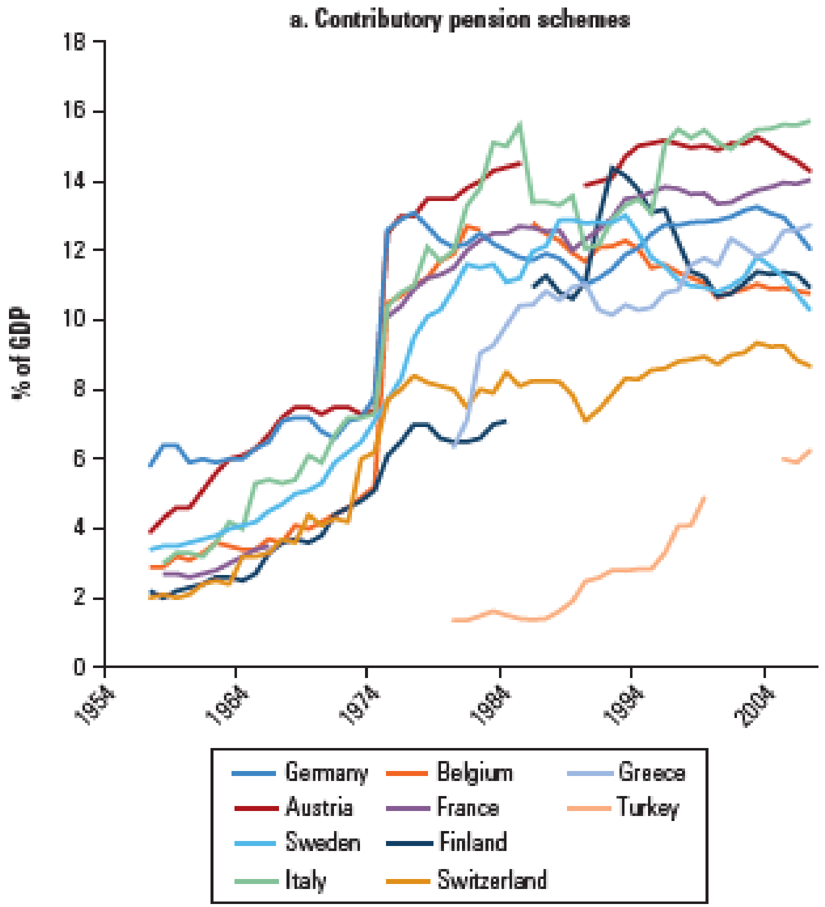
- Mandatory overinsurance of high incomes is not justified and can be costly
- Overly generous tax treatment of third pillar introduces regressive redistribution
- Justification for mandating and/or subsidizing higher income insurance gets harder as financial markets develop

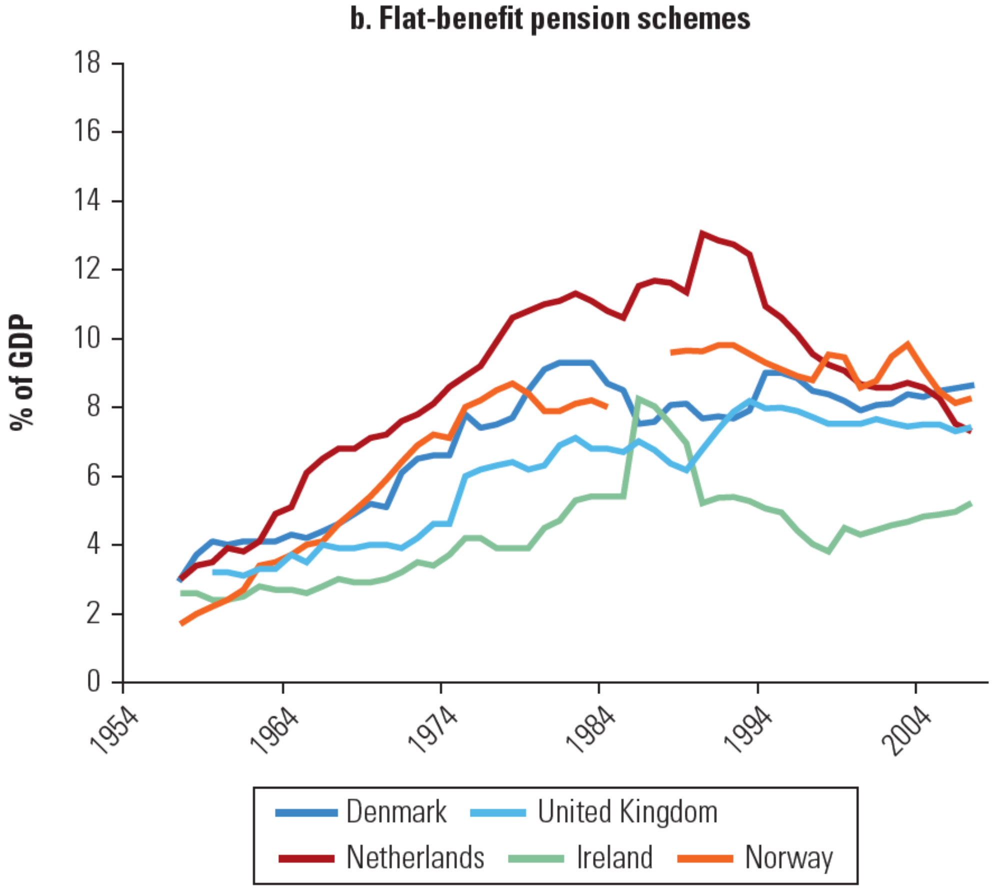


“The Inverting Pyramid”, World Bank, 2014

WHAT ARE THE CHOICES IN 1ST AND 2ND PILLAR MIX?

- Having both provides risk diversification
- Earnings-related first pillars tend to cost more
- Earnings-related first pillar address similar goals to 2nd pillar, and subsequent switch between the two is easier (Poland, Colombia)

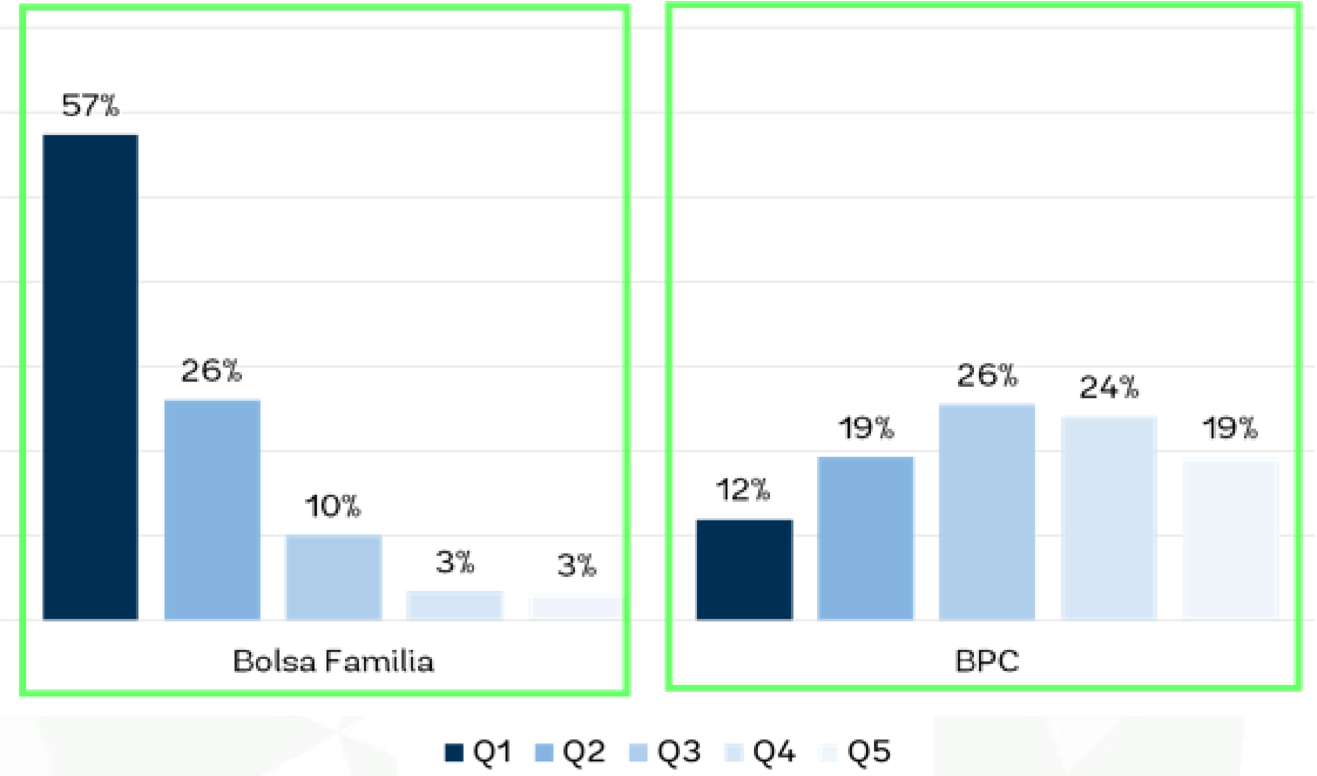




"The Inverting Pyramid", World Bank, 2014

BRAZIL'S CURRENT MIX OF ZERO- AND FIRST-PILLAR (1)

- **BPC** - is it a zero-pillar guaranteed minimum transfer?
  formally, means targetted and general budget financed (7% of RGPS expenditure),
  ... but targetting not effective, benefit level very high

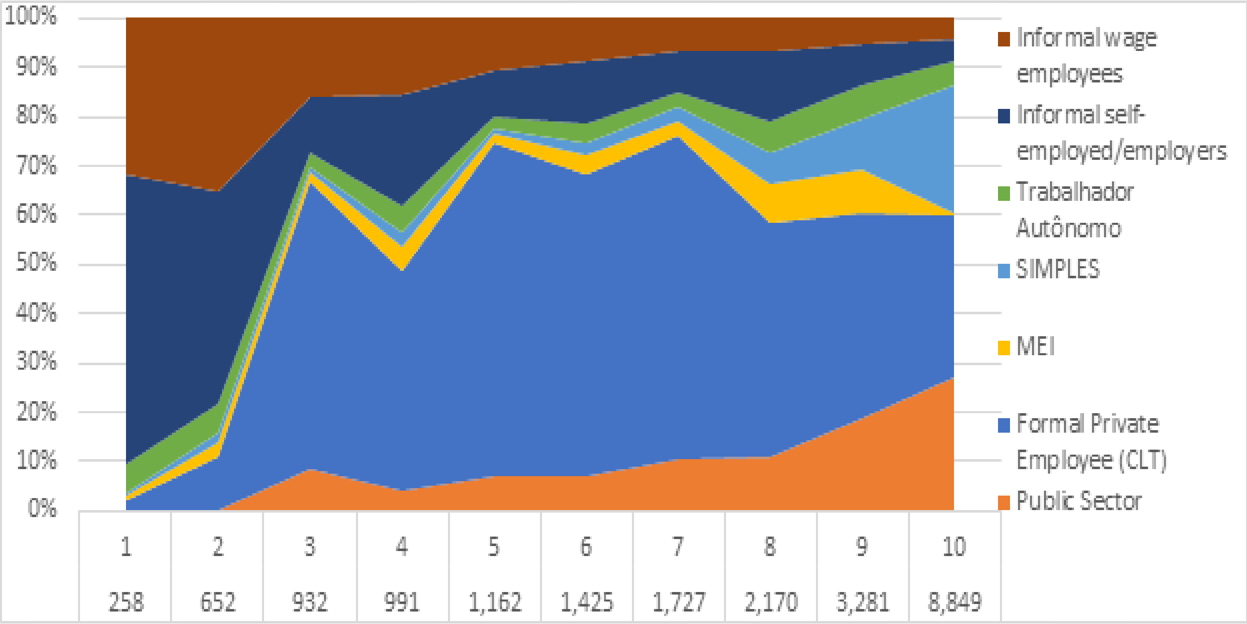


BRAZIL'S CURRENT MIX OF ZERO- AND FIRST-PILLAR (2)

- **SIMPLES, Rural contribution, MAI** - do these programs provide zero-pillar subsidized premiums?

  ... theoretically, RGPS financed, meant to increase low income coverage, but not always well targetted and expensive (R$58mln in 2016, 16% of RGPS revenues, or 12% of RGPS expenditures)

Pension scheme coverage by income



Cost of reduced contribution regimes, mln

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Desoneração da Folha de Pagamento	-	-	-	-	-	3.616	12.284	22.107	25.199	14.621
Simples Nacional	6.880	7.965	8.723	8.809	9.737	14.441	18.267	19.535	22.495	23.282
Entidades Filantrópicas	4.410	4.984	5.703	6.368	7.109	8.099	8.720	10.428	11.170	11.562
Exportação de Produção Rural	2.226	2.578	2.557	2.685	3.287	3.882	4.484	4.638	5.941	6.040
MEI	-	-	-	-	200	501	786	991	1.404	1.676
Outras	528	31	60	69	75	125	227	256	278	556
Total	14.044	15.558	17.044	17.932	20.408	30.664	44.769	57.956	66.487	57.737

Fonte: Relatório DGT – RFB – Bases Efetivas

BRAZIL'S CURRENT MIX OF ZERO- AND FIRST-PILLAR (3)

- **Minimum pension guarantee** - should it be zero- or first-pillar?
  ... currently RPGS financed
  ... <u>20 years contribution*31%</u> vs. <u>20 years of pension * 100%</u> of min. wage ---------> more than 2/3 subsidy
  ... <u>40 years contribution*31%</u> vs. <u>20 years of pension * 100%</u> of min. wage ---------> more than 1/3 subsidy

  40% of RGPS spending is on retirement and survivor benefits of min. wage or lower, so roughly 20-25% of RGPS spending is atributable to minimum pension subsidy

- **Early retirement subsidies** (women, teachers, special categories, disability) - should it be zero- or first-pillar?
  ... 5 years of early retirement added to 20 years of retirement ---------> 20% subsidy, more with lost contributions

  Around 56% of spending on new retirement benefits is awarded to women, disabled, and special retirees, and retirement benefits constitute 64% of all RGPS spending, so roughly 7% of RGPS spending is atributable to early retirement financing, even after *tempo de contrib.* retirement option is eliminated.

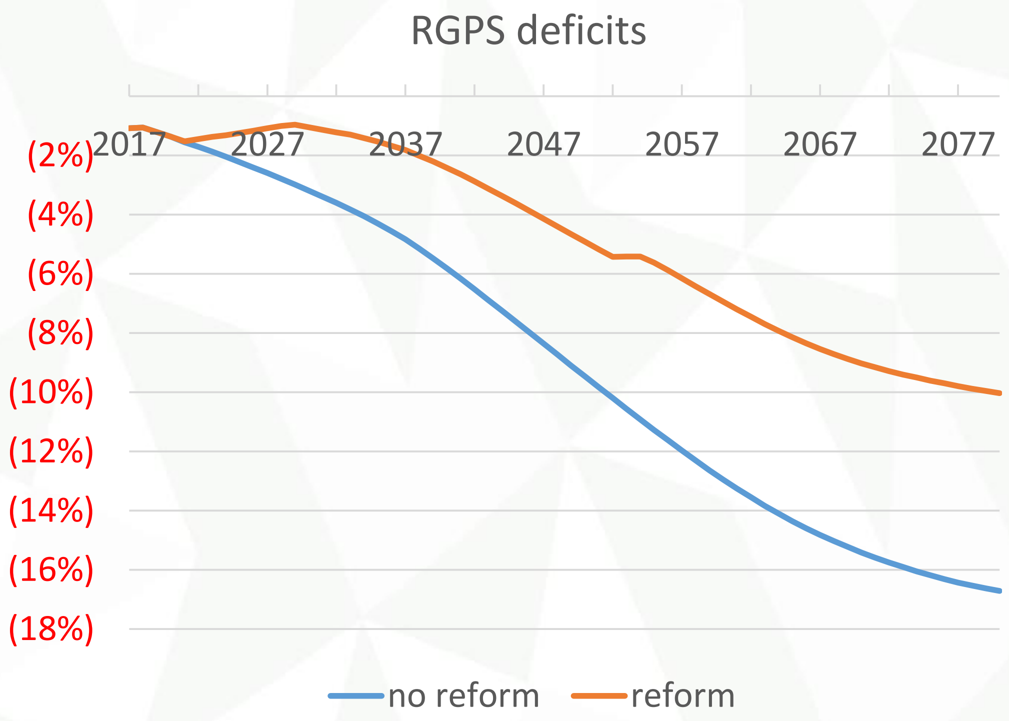
- **Auxiliary and maternity benefits** comprise 5% of RGPS spending

HOW MUCH OF RGPS SPENDING NEEDS TO BE FUNDED BY TREASURY, RGPS CONTRIBUTION POOLING, OR BENEFIT CUTS?

- In total, BPC, reduced contributions, minimum pension guarantee, disability and early retirement, auxiliary and maternity benefits roughly comprise 45-50% of RGPS spending or **4.3-4.8% of GDP** (including tax expenditures) and cannot be funded from individual account

- In addition, Brazil is facing high aging costs:
  - Chile's old age dependency rate rose from 10 to 16 between 1980 and 2010, 60% rise at a time when transition costs needed to be paid
  - Brazil's old age dependency rate will rise from 16 to 40 between 2020 and 2050, a 150% rise
  - Even with reform, aging is estimated to result in the rise of pension deficit of **3.6% of GDP**

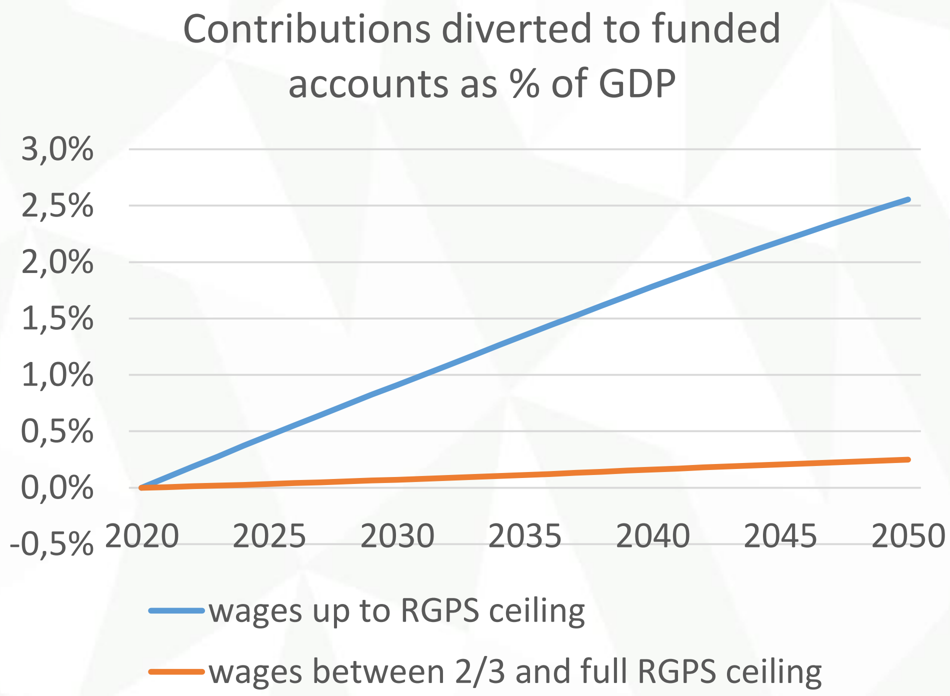
- In sum, dedicated financing in the order of **8% of GDP** needs to be in place by 2050 to finance subsidies and population aging, **before** contribtution rate for individual saving is set



ADDITIONAL TRANSITION COSTS FROM INTRODUCTION OF FUNDED ACCOUNTS

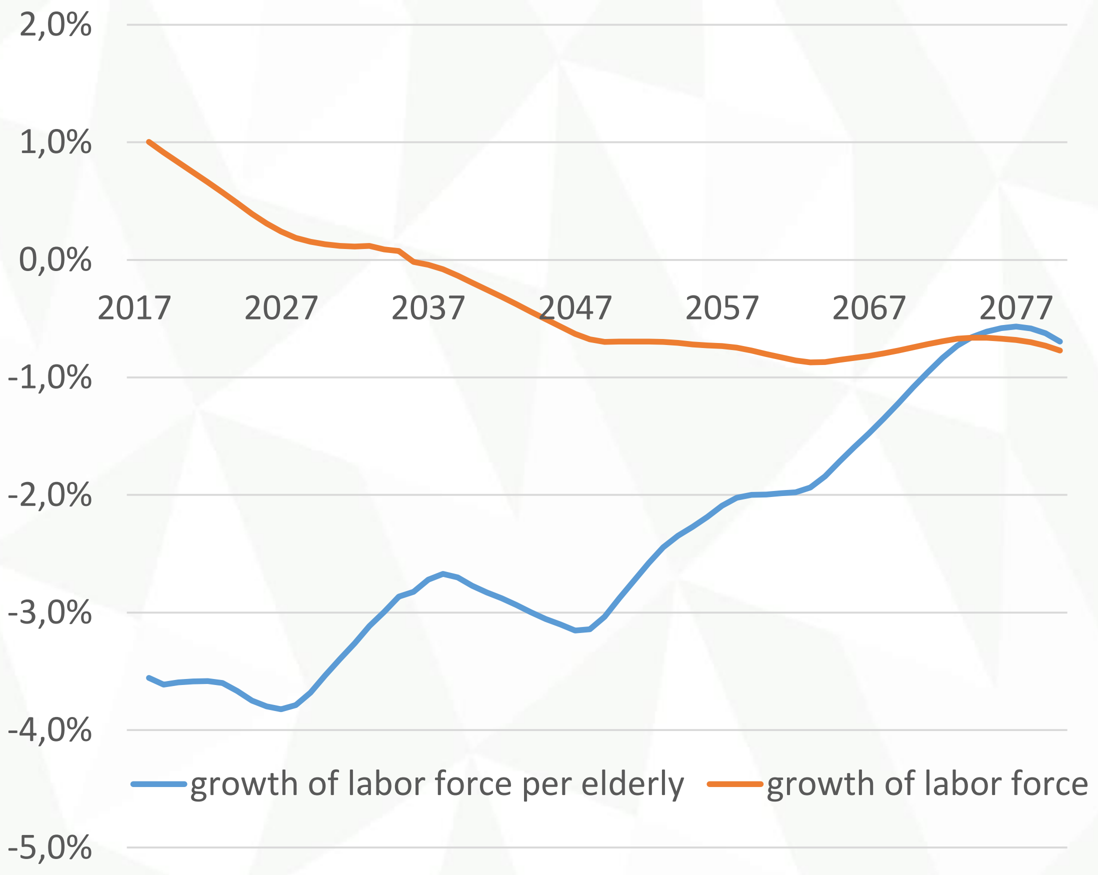
- Two scenarios of insuring new entrants via individual accounts were considered:
  - Full wage of new entrants is insured under individual funded account
  - Wage between 2/3 and full RGPS ceiling is insured under individual funded account (only 20% of males and 15% of women participate)

- Given that almost half of RGPS spending should be financed on pooled basis (either through labor or broader taxes), it is assumed that contributions of 15% of insured wage are diverted to individual funded account
- No significant decrease in pension expenditures is expected for the next 25-30 years
- Assuming 2% wage/productivity growth, 40-year career, 20-year retirement, and 3% net real returns, 15% contribution can fund replacement rate of 45% of last wage (62% with 4% return)



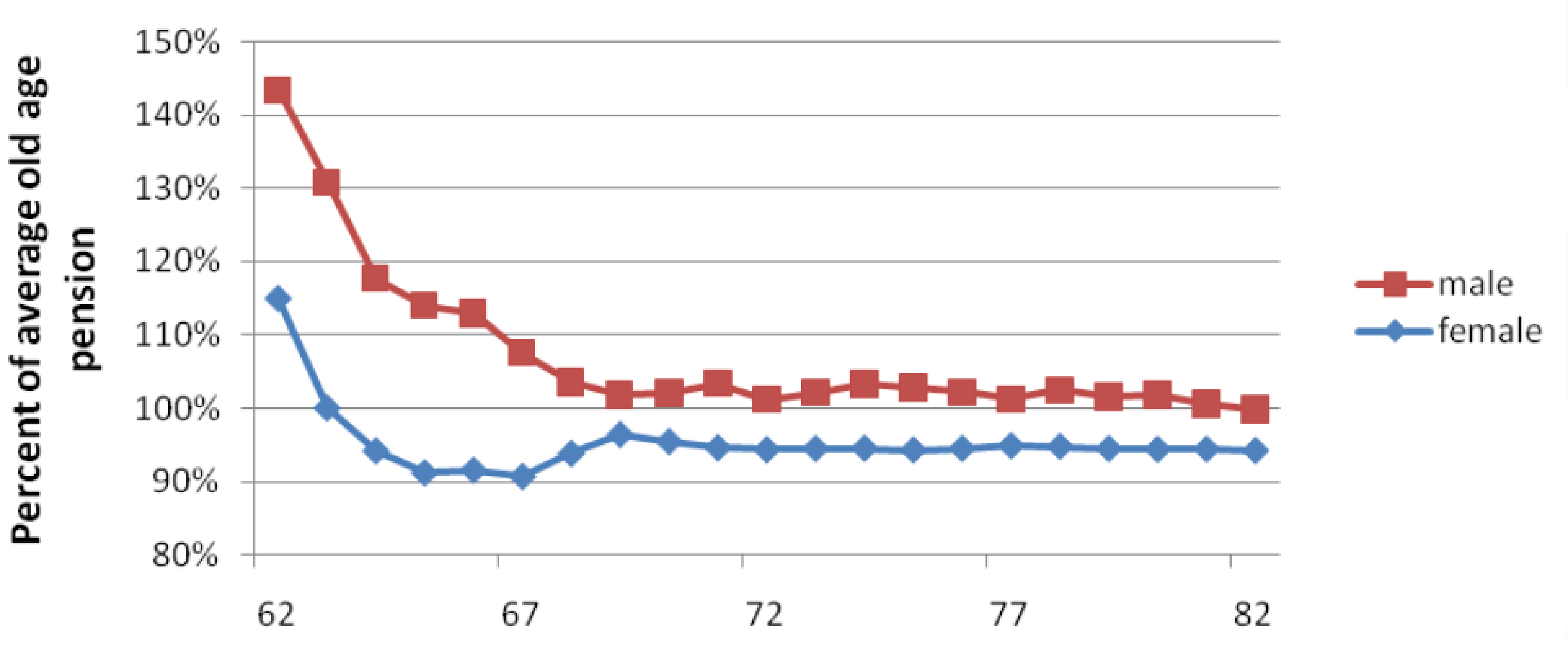
HOW MUCH INTEREST CAN A FISCALLY SUSTAINABLE NOTIONAL ACCOUNT SYSTEM PAY?

- Productivity growth + contributor growth if aging costs are paid by treasury
- Productivity growth + contributor per elderly growth if aging costs need to be internalized
- As growth rates fluctuate, the system can still experience surpluses and deficits, sometimes for decades
- Assuming 2% wage/productivity growth, 40-year career, 20-year retirement, and 1% net real returns, 15% contribution can fund replacement rate of 25% of last wage (34% with 2% return)



INDIVIDUAL ACCOUNTS CAN PRODUCE WINNERS AND LOOSERS

Pension benefit variation by cohort under notional account regime in Latvia after a period of strong wage growth, 2010



CONCLUSIONS

- **Brazil's RGPS benefits (inlcluding BPC) mix zero-pillar and first-pillar functions:**
    - "minimum" benefits and subsidized premiums are not efficiently targetted to the poorest
    - "minimum" benefits are high and offer more than just poverty prevention
    - deficit financing of RGPS mixes individual and public financing sources
    - many internal RGPS subsidies (close to half of RGPS spending) are not designed to prevent poverty, but to reward socially valued occupations or correct labor market failings
- **Moving to "pure" multi-pillar model** (with notional or funded individual accounts as 1st/2nd pillar) would involve:
    - making subsidies explicit, costing them, revising them, finding a financing source
    - finding a financing source for costs of population aging
    - finding a financing source for transition cost
    - Big part of costs to finance transition, aging, and redistribution would have to be financed by benefit reduction
- **In practice, funded and notional schemes are different from textbook:**
    - Low productivity workers will not be able to self-finance long and comfortable retirement
    - Financial and labor market volatility and demographic changes will produce winners and loosers
    - "pure system" is unlikely to remain free from political interference, notional PAYG will not be deficit-free
    - The system will not be "easy to understand"

Thank you!