Revitalizing Brazil’s Economy through Reforms

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President Michel Temer and his administration are currently focused on securing the necessary 308 votes to approve pension reform, which is considered critical to restoring the nation’s fiscal credibility. We believe this reform would reduce future deficits, encouraging higher business and consumer confidence and a return to sustainable growth. However, the window for action is quickly closing as the October 2018 presidential election approaches, making a weakened version of pension reform more likely.
After President Dilma Rousseff was impeached in 2016 for violating Brazil’s fiscal responsibility law, President Michel Temer seemed headed down a similar path. In May 2017, a taped conversation was released, which allegedly implicated the president in acts of corruption. However, Temer, a seasoned backroom political dealer, survived both a vote by the Electoral Court upholding the 2014 presidential election results and two votes in Brazil’s lower house of Congress for alleged racketeering and obstruction of justice. Temer is now focused on passing a series of reforms to help restore the nation’s fiscal credibility.

In June 2016, we wrote *Latin America: An Update on Reforms* where we explained that the Brazilian economy was in need of credible structural reforms. If a significant majority of the proposed reforms, including social security, labor, bankruptcy, political, and tax reforms, are passed, Brazil could markedly regenerate its economy and create an environment of considerable productivity and profit improvements. These reforms are important to gradually adjust Brazil’s government spending, boost its savings rate and investment-to-GDP ratio, and, ultimately, lift GDP growth.

### 20-Year Spending Cap: An Encouraging Start

In 2016, Temer secured congressional approval for a constitutional freeze on increases in inflation-adjusted public spending. As such, for the next 20 years, growth in government spending cannot exceed the annual rate of inflation. Currently, gross general government debt is more than 70% of GDP and is expected to peak between 80%–90% in the coming years (Exhibit 1).³ Government departments that fail to apply the fiscal cap will be required to take a range of corrective measures, including freezing public sector hiring and salaries. In addition to the approval of the spending cap bill, in an effort to control the budget deficit, the Senate de-earmarked and released up to 30% of federal tax revenues, allowing the government to use the proceeds for other purposes, including investment, education, and public sector wages.

#### Social Security Reform

Without adequate social security reform, the government will not be able to comply with its spending cap requirement. This could potentially put public debt on a rising and unsustainable path. Approximately 40% of the federal government’s primary spending, or 50% of mandatory expenditures, is consumed by social security system benefits (Exhibit 2), which have been growing at least 4% per year in real terms.²

Brazil is one of the few countries where participants can retire after contributing to social security for a certain amount of time. This results in a large distortion where—after 30 years of contributions for women and 35 years for men—participants can retire at a relatively young age. Benefits are generous and among the highest in emerging markets. In fact, despite a young population, Brazil’s pension spending is similar to the Organisation for Economic Co-operation and Development (OECD) average (Exhibit 3). Among the OECD member countries, pensions, on average, replace nearly 60% of pre-retirement income. That figure is 80% in Brazil. The average retirement age in Brazil is 58, eight
years younger than for Americans and 14 years younger than for Mexicans. Widows in Brazil, as long as they are at least 44 years of age, are entitled to receive their spouses’ full pension benefits in addition to their own. Additionally, the government has linked benefits to the country’s minimum wage rather than inflation, which means that benefits have a tendency to increase in real terms.

The reliance on, and significant expense of, social security benefits has been built into Brazil’s culture. Following two decades under military rule, the 1988 constitution sought to cover health care, pensions, and social assistance for all Brazilians. It equalized the rights of rural workers, who had not been required to make contributions to the social security system, with urban workers, who were required to do so, essentially growing the amount of benefits at an unsustainable rate (Exhibit 4). With declining birth rates, rising life expectancy, and generous benefit-granting rules, Brazil’s financial stability depends on social security reform. Some goals of social security reform include the equalization of benefit-granting rules between private sector workers and public employees and between rural and urban workers, as well as a clearer definition of benefit values for all Brazilians. Implementing social security reform, the Finance Ministry estimates, could save Brazil R$680 billion, approximately 41% of Brazil’s nominal GDP or equivalent to US$210 billion, over 10 years. Key changes are expected to include:

- higher minimum retirement age;
- longer minimum contribution time; and
- limits on total benefits received.

Currently, there is no minimum retirement age for those employees who retire based on contribution time. In order to qualify for full pension benefits, employees must satisfy the “85/95” rule, which is calculated based on the sum of a person’s age and the number of years of contribution. For women, it must equal 85 years, for men, 95. Under a progressive retirement age program, the average retirement age is projected to gradually move from 53 to 62 for women, 55 to 65 for men, with the minimum contribution time to qualify for benefits expected to move from 15 to 25 years. Participants can expect to receive 70% of their average salary after 25 years of contribution with distribution of 100% of pension benefits after 40 years.

We expect some dilution to pension reform. In fact, President Temer has already made concessions to states and legislators to help gain approval for the core of the proposal. Pension reform at the state and municipal levels will be excluded from this round of voting and will only be addressed after the 2018 presidential elections. As states wield significant influence in the lower house of Congress, the Temer administration is expecting the remaining core issues to be approved with limited changes. Raising the retirement age or increasing the years of contribution would keep employees in the workforce longer. This should generate additional taxable revenue that would begin to address Brazil’s fiscal imbalance and more efficiently allocate capital to those areas of the economy that can generate productive growth, such as the education and infrastructure sector.

The voting timeline for both houses of Congress may extend beyond the fourth quarter and into 2018. A standoff between the Temer administration and congressional lawmakers appears increasingly likely. As such, equity market volatility, a weaker Brazilian real, or weaker economic growth could be the catalysts needed to convince legislators that failure to approve the reform would put the country at risk. However, through 30 September, the Brazilian equity market is up 27% in US dollar terms this year.
Passing credible social security reform could alter the fiscal trajectory of Brazil. We believe it could reduce future deficits, encouraging higher business and consumer confidence, and a return to sustainable growth. Brazil’s savings rate is currently well below those of developed economies and less than half of its emerging markets peers (Exhibit 5). Social security reform could potentially boost the domestic savings rate from the current 16% to more than 20%, previously reached in 2008, allowing investment-to-GDP and potential GDP to rebound over time. Investment and savings in Brazil continue to be driven by the private sector (Exhibit 6). Adopting investment-friendly, pro-growth policies with additional reforms across labor, bankruptcy, and taxes, could serve to raise domestic savings and investment rates over time.

**Additional Reforms**

While social security reform is the single most important reform, Brazil’s reform agenda also includes labor, bankruptcy, political, and tax reforms. Unlike many developing countries, Brazil has had considerable legislation in these areas.

**Labor Reform**

Recently approved labor reform aims to create new jobs by implementing less restrictive rules. Time spent commuting from home to the workplace will no longer be considered part of working hours. Termination of employment agreements will no longer need the approval of labor unions or the Ministry of Labor, and union contributions will be considered optional and no longer mandatory. Other aspects of reform include legalizing part-time jobs, allowing for greater flexibility in taking vacations, promoting home offices for employees, and generally granting more power to employers in judiciary proceedings.

**Bankruptcy Reform**

A recently approved bankruptcy bill aims to lower the five years that companies, on average, spend in bankruptcy down to two years. Special proceedings and specialized tribunals would streamline and expedite the process, making it easier for companies to continue operations while navigating bankruptcy courts.

**Political Reform**

Brazil currently has 35 registered political parties, and authorities are reviewing application requests for another 68. Party fragmentation has made Congress very difficult to manage, where governments must form a majority coalition through horse-trading and doling out political posts to members of smaller, recently created parties to build alliances. Under a proposed bill (PEC 282), the annual political party fund of more than R$800 million will be limited to parties that manage to elect nine federal deputies or win 1.5% of the vote in nine of the country’s 27 states5, which should help to reduce the number of eligible parties in future elections.
Tax Reform

Although unlikely to be approved this year, tax reform is under review by Congress and is expected to be debated and voted on after the passage of social security reform. Significant taxes on businesses is one reason for high labor costs in Brazil. The social security system and ongoing deficit from state pensions mandate high payroll taxes. Simplifying the tax code, including the elimination of ten taxes, nine of which could be consolidated into a single value added tax, might not only reduce confusion, but also cut the number of hours spent on tax preparation. Currently, it takes a Brazilian company more than 2,000 hours per year to prepare, file, and pay the corporate income tax, value added or sales tax, and labor taxes, compared to 163 hours for OECD high-income countries.6

More Competitive Business Environment

President Temer announced a new privatization and concessions program, Projeto Crescer, or Project Growth, which includes 57 federal holdings to generate more than R$44 billion of revenue to meet primary fiscal targets for 2017 and 2018. Key projects include electric utility company Eletrobras, Congonhas Airport in São Paulo, and a lottery run by Caixa, a state bank. State-owned enterprise Banco do Brasil announced it would make up to R$50 billion of credit available for 18 infrastructure projects. The bank and the government believe that the infrastructure sector will be one of the main drivers of economic growth for the country.7 The World Economic Forum currently ranks Brazil 72 out of 138 economies for the quality of its infrastructure.8

Concessions to operate 11 blocks of power lines across nine states and three rounds of oil and gas bids are planned for the next year. To improve the operating environment for firms bidding in future oil and gas concessions, the government is cutting local content requirements to 50% for land oil fields and 18%–40% for offshore fields. Lower onshore and offshore requirements should attract more bids and create a more competitive bidding environment.

BNDES, a national development bank and Brazil’s largest long-term corporate lender of subsidized government financing, announced that beginning in January 2018 it would adjust its long-term lending rate (TLP) to a market-based rate. The biggest benefit will be the structurally lower market-determined rates for the entire economy, not just the elite. BNDES also signaled that a lower volume of loans would be available, which should encourage more lending to corporations from commercial banks, as well as further development of Brazil’s corporate bond market. The decrease in subsidized loans should not only reduce the fiscal cost to the treasury, which is estimated at R$15 billion per year, but also weaken the political power of the bank.

Conclusion

The biggest risks to the reform agenda include officials close to Temer, or Temer himself, falling victim to the ongoing “Car Wash” or Lava Jato run in, especially in the wake of plea deals agreed to by nearly 80 employees of Odebrecht, Latin America’s largest construction company, including the former CEO. The 83 recently opened investigations are targeting over one-third of the Senate, 42 representatives from the lower house, 3 governors, and 8 ministers under the Temer administration.9

We believe that Brazil is still an attractive investment destination. President Temer appears committed to reforming the country and is focused on attracting and partnering with private capital. Meaningful social security, labor, bankruptcy, political, and possibly tax reforms could ultimately make Brazil more competitive. Temer’s administration is doubling down on concessions and public/private partnerships, putting many projects in the infrastructure sector up for bidding at what appear to be attractive rates of return. After a period of high above-target inflation, we have seen a moderation and a corresponding easing cycle in the central bank’s monetary policy. The window to implement reforms may not be wide with Temer’s term set to end next year, but if he is successful in convincing Congress to approve most of his reform agenda, his presidency may be credited with rebalancing Brazil’s economy away from consumption and high indebtedness and towards savings and investment and, ultimately, more productive growth.
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