Brazil's growing pains

Brazil needs saving, investment, and productivity if the economy is to grow sustainably.

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Which formula is best? Increase public investment to stimulate the growth of the economy, reduce the budget surplus target, and risk interrupting the decline of the benchmark interest rate? Or sacrifice growth to meet the surplus target, and hope that falling interest rates will eventually reduce payments on public debt enough to clear space for more public investment? This dilemma is what is dividing opinions in the Rousseff administration today.

A new Brazilian Institute of Economics (IBRE) study shows that if current macroeconomic conditions prevail, the GDP growth rate that would allow the economy to grow without inflation is 2.8% for 2012. Even compared to other emerging countries, Brazilians and their government save and invest little and are not very productive. The average savings-to-GDP ratio was 18.9% of GDP between 1970 and 1979 and today it is still just about 18%. Meanwhile, China has pushed up its ratio from 27% to 43%, India from 18% to 28%, and Vietnam from 22% to 33%. A comparison of average investment is similar: Brazil is out-invested by all three countries.

IBRE estimates that if investment in Brazil increased from the current 20% of GDP to 25%, even if productivity stayed flat, potential GDP growth would reach 3.6%; if productivity rose by 1%, with no change in investment, potential GDP growth would be 3.8%.

The situation is even more grim with regard to investments in infrastructure, which are crucial for sustainable economic growth. Between 2001 and 2010, investment in Brazil, primarily on electricity, telecoms, and roads, averaged only 2.3% of GDP. Even at the peak of the government's Growth Acceleration Program in 2010, total investment was only 2.5% of GDP—1.5% invested by central government and public enterprises and 1% by the private sector.

"THE MOST SERIOUS PROBLEM"

According to the World Bank, "investing less than 3% of GDP is not enough to cover the depreciation of fixed capital," says economist Claudio Frischtak, president of InterB, an international business consultancy. "In 2009–10, India invested 4.8% of GDP in infrastructure, and China invested 13.4%. Chile invests around 6%, and Colombia 5%. Comparatively, Brazil is an outlier."

To invest, you need to save. And here Brazil falls very short. Historically, households, businesses, and government have saved little. "The most serious problem of the Brazilian economy is the lack of domestic savings," says Albert Fishlow, an expert on Latin America (see interview, page 16). "Brazil is behind Chile, Argentina, and Mexico in the availability of domestic resources for investment. We must reverse past practice. The government should save, instead of just spend."

"Between 1981 and 1983, there was a collapse of investment, and Brazil has never recovered," says economist Edmar Bacha, former president of the Brazilian Institute of Geography and Statistics (IBGE) and the National Bank for Economic and Social Development (BNDES). And, he adds, "The high levels of investment at the end of the 1970s were supported by an inconsistent model based on foreign savings on one side, which generated great debt, and on forced savings through inflation on the other."

THE SAVINGS HABIT

Why has Brazil historically saved so little? Like the United States before the global crisis, says Luiz Carlos Mendonça de Barros, a former president of BNDES and partner of Quest Investments, "Brazil is among the countries where household savings are too low and consumption too high." But, he explains, the habit of saving as the Japanese and Chinese do "is a very strong social value" and whether you are a saver or not a saver, the habit is difficult to change. Moreover, Brazilians have demanded a policy of income transfers to the poor to relieve the country's unequal distribution of wealth and historical deficiencies in education and health services. The social security scheme does not favor savings

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IBRE consultant Samuel Pessoa questions whether Brazilian society is really interested in changing the current model, whether it needs to, and if so, what would be the right time. He argues that, as the majority through elections has shown a preference for income transfers, for Brazilians economic growth is apparently not a priority. "Growing more means depriving yourself of things now to have a future benefit. This applies to both the individual and the society," he says. The trade off cannot be imposed; it has to be mediated by a

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democratic process. Pessoa adds that, since the administration and Congress seem to be doing what the public wants, "it is reasonable to assume that Brazilian society is satisfied with their choice." Further, he says, to change, "there must be political debate, and we see no candidate advocating alternative proposals."

Frischtak agrees that one reason for the sluggish growth of the Brazilian economy is society's decision to choose income distribution but thinks the problem is in how the model is applied: "The 1988 Constitution establishes a better income distribution compact, but certain policies are not covered.

There are distortions in public pensions, corruption, and waste of money: There are billions of dollars misallocated that are not part of the income redistribution compact. If these expenses were more rational, there would be resources [for investment], regardless of income transfers to the poor and elderly." He also disagrees vigorously with the idea that Congress reflects society's choice. A major weakness for Brazil, Frischtak says, is "the bad example of our political elites, who generally give poor examples of conduct, and the deterioration in the quality of our Congress, which is far from mirroring the nation, which leads to a certain disillusionment with democracy."

WHERE EDUCATION FITS IN

Bacha also questions whether Congress faithfully represents the minds of voters. He thinks it tends to transfer more benefits to interest groups that have more lobbying power than the average voter. "The Brazilian government allocates almost 25% of GDP to social spending, including education, health, security, social security, and incomes policy. But most social security pensions go to public sector employees and higher income earners rather than to the poorest. And we spend five or six times more on college education than on basic education. Except for programs like the Family Grant, our social policies do not represent an actual transfer of income from the rich to the poor. This is not a social pact, it is an elite pact." Bacha favors "a radical process of containment of current expenditures by the government to increase capacity for public investment."

Barros argues that "We need to increase competitiveness and investment through modernizing institutions, tax cuts, and more efficient government." Instead, he says, "what we have achieved in recent years was a precarious balance between domestic and foreign savings and the volume of investment possible in an unfavorable environment." He points out that the significant growth in consumption observed in recent

years, thanks to the policy of raising the minimum wage in real terms, brought no additional investments in infrastructure and human capital: "There are shortages of skilled labor that can only be corrected through investment in public education."

Pessoa is also concerned about education. "There are several measures that could be taken to reduce the cost of building infrastructure in Brazil. But … we lack know-how." He adds that transforming the Brazilian model from a consumption to a saving society may be induced through the ballot box by the emerging middle class: "If economic growth, even mediocre, lasts for many years, the emerging middle class will tend to separate from the poorest classes and worry more about the problems of the Brazilian government, especially infrastructure and public services. The emerging middle class will have cars and they will complain of congested streets, they will aspire to upward social mobility for their children and they will find that public education is unsatisfactory. At that point, increasing investment and improving the quality of public services will become a priority, creating a political agenda that leads to growth."

Pessoa sees no reason for urgency in this process: "We have bottlenecks, discomfort, which will addressed as the physical infrastructure deteriorates. The ports work and trade is growing." Frischtak disagrees: "The more we wait, the higher the cost. And people are increasingly dissatisfied with the quality of collective goods."

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BEST OF BOTH WORLDS?

Nor is there any consensus on the ideal rate of growth for the Brazilian economy. "There isn't an optimal growth rate," Pessoa says. "The ideal rate is the maximum possible," replies Barros, adding, "It is perfectly possible to see sustainable growth of 5% or 6% a year—once the right policies are adopted."

Frischtak is more skeptical about very rapid growth rates: "If you ask me if it's a good idea for Brazil to grow 8% or 10% a year, I would say no. In my opinion, the ideal growth rate would be about 4% to 5% of GDP, consistent with the improved well-being of the population and capable of projecting Brazil abroad adequately but not putting excessive pressure on natural resources." Bacha recalls that Brazil has managed to grow at rates between 7% and 7.5% of GDP for long periods in its history. In theory, he says, that growth rate would be the ideal, and a World Bank study seems to suggest it would be a reasonable objective for developing countries. However, he cautions, "when Brazil was growing at

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7% or 7.5% a year, the population was growing at 3%. Now, the population growth rate has fallen back to about 1%, so if we could grow at about 5% or 5.5% … in per capita terms [that] would be replicating the best times, from 1940 to 1970."

But how do we get there? Here there is more convergence of views. There seems to be general agreement that to raise Brazil's growth rate sustainably, through increased savings and investment and productivity gains, it is necessary to go through the private sector, especially when it comes to infrastructure. Barros notes that large firms in Brazil tend to be highly profitable because of an uncompetitive economic environment, and they mainly finance their investments through retained earnings. Yet there is evidence that aggregate corporate savings have been stagnant as a share of GDP in recent years. "In China," Barros says, "the increase in savings from 40% to 50% of GDP in the last decade was due mostly to corporate savings. The same pattern occurs in other countries. So why has the corporate savings rate not increased in Brazil? Possibly because taxes penalize production and investment. So one way to boost corporate investment and savings," he argues, "would be a massive program of tax cuts."

Industry is a worry for Pessoa, however: "It is easier to grow based on industry than on services, because industry can generate income and productivity even if human capital is not qualified, but the service sector depends more on skilled personnel." Because the economic agenda gives priority to social justice at the expense of savings and growth, he says, the services sector is likely to grow relatively more than industry in coming years. "That means we will have a service sector with low education," he warns. Frischtak thinks, however, that productivity gains are possible without compromising the social agenda—if the government's planning is of reasonable quality. "If the public sector does not hinder, and improves sectoral planning, including appropriate regulation and privatization of critical assets, it will be enough to support an explosion of private investment," he believes. "We can keep the social compact of 1988 and at the same time boost investments in infrastructure in Brazil without touching a penny in public resources."

PRIVATE SECTOR CAPACITY

The country will not be able to raise its growth rate quickly. Barros points out that "The Brazilian government has a very high level of current expenditures, especially considering taxes of 35% of GDP. Therefore, to maintain a primary budget surplus that stabilizes the debt-GDP, it must run a very low level of

investment. The result of this precarious balance of public finances is even more pernicious considering that to get to it, the government overtaxes Brazilian companies," says Barros. In the case of infrastructure, Frischtak argues that even if the government could expand its capacity to save and invest, the scenario would change very little. "If Brazil can double investment in infrastructure from 2.5% to 5% of GDP over the next five or eight years, we will make a small revolution," he says. "Is it enough? No, but we should not dream of 8% or 10% of GDP. It turns out that to achieve this 5%, even if it reduces its nominal debt, increases savings, and reallocates resources, the public sector would increase its investments by 1% of GDP to 2% or 2.5%. So most of the increase in investment has to be done by the private sector, not only because of the government budget constraint but also for the sake of efficiency in resource allocation."

Frischtak, Barros, and Bacha also agree that without tax reform and with the policy of cuts in current government spending, the most efficient way to increase public sector investment would be to deepen the privatization program and grant concessions in the areas of services and infrastructure. "Look at the case of airports," Frischtak suggests. "The private sector should have been investing in airports for over 20 years, but only now, because of major events—World Cup and Olympics—is the first auction coming up. With regard to ports, state-owned dock companies, with rare exceptions, are not doing a proper job and should have been privatized long ago." Barros adds, "The government is beginning to acknowledge slowly the need to attract the private sector, as shown by the auction of some federal roads and airports. But it always moves shyly. In the case of airports, the government is demanding that the government company that manages airports (Infraero) retain up to a 50% stake, which is obviously a burden to anyone interested in participating in airport concessions. In the case of roads, some toll rates are so low that they make private investments unfeasible."

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Bacha believes that the problem is mostly at the federal level. "Public-private partnerships are stalled in the federal government but have proliferated in state governments, which are closer to the everyday population, especially in the areas of health, education, and public works. Then, something moves. The problem is how to make things move in Brasilia."