The employment puzzle



Despite the fall in economic activity, the labor market has been surprisingly resilient. But for how long?

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A RESILIENT LABOR MARKET but low economic activity definitely do not go together, yet Brazil has been living with this situation for almost two years. After surviving the severe global crisis of 2009 with only a moderate decline of 0.6% and then advancing 7.5% in 2010, GDP has since been in free fall, recording 2.7% in 2011 and likely to fall below 2% in 2012. Yet the unemployment rate has fluctuated around 5.5% of the total labor force—the lowest level in history.

Possible explanations for this discrepancy are lower growth of the economically active population, relocation of workers from industry to services, and retention of workers (labor hoarding) because of both the high costs of firing workers imposed by the labor laws and expectations of economic recovery. The question for Brazil is this: if economic recovery does not materialize soon, how long can employment stay high?

DEMOGRAPHICS

The contradictory labor market outlook results from a combination of several factors. The first is demographics: as the population growth slows down, there is a decline in the number of new participants

in the labor market, which helps to boost employment. In recent years the labor force has been growing less than 2% a year, implying a more limited supply of labor. "Between 2010 and 2011, the labor force grew by 1.3%, against 1.8% between 2003 and 2005," says Fábio Romão, an economist with LCA consultants.

Another factor is related to the impact in the last decade of the increase in the real incomes of workers. Romão explains that "Between 2002 and 2012, the total population of the country grew by 11.5%, while the number of those not economically active went up 9.7%. The age groups that most influenced this decline were those between 15 and 19 and those above 50. This means that families today are able to keep their young people studying, and fewer retirees need to return to active duty." Although this will increase the supply of skilled labor in the future, in the present it constrains growth by reducing the supply of labor. "If the country is to grow without generating pressure on [the labor] market, productivity must be increased," warns economist José Márcio Camargo of Opus Investment Management.

INDUSTRY VERSUS SERVICES

Increasing productivity has been a major challenge for industry, which has been losing share in GDP and jobs to the service sector. This continuing structural change also helps to explain the gap between economic activity and employment. "The economic slowdown is occurring primarily in the industrial sector, where flexibility is much lower than in the service sector, which has slowed much less than industry or even continues to grow," Camargo says.

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Júlio Gomes de Almeida, an economist at the Institute for Industrial Development Studies (IEDI), draws attention to two aspects of transition: the significant growth of the construction industry, which is labor-intensive; and the emergence of 40 million new consumers in the domestic market, which has strengthened the services sector and increased demand for more specialized activities. Demand has increased for call centers and personal services, which are more labor-intensive than industry. João Felipe Santoro Araújo, economist at the National Trade Confederation (CNC), adds that the service sector pays higher wages and attracts professionals from other sectors, particularly industry.

Industry's difficulties reinforce another hypothesis about the resilience of the labor market despite the fragility of the economy: the mechanism for the transmission of the slowdown throughout the economy. Industry, pressured by such adverse circumstances as an over-valued exchange rate, global competition, and the high wages in the service sector, was the

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first sector hit by the economic slowdown, although eventually it will be followed by the service sector.

Industrial production decreased 3.8% in the first half of the year compared to the same period of 2011, and manufacturing employment fell by 1.2%. Paulo Francini, director, Department of Economics, Federation of Industries of the State of São Paulo (FIESP), points out that "We recorded five straight quarters of decline in manufacturing, losing 89,000 jobs between June 2011 and July this year. The projection is that industry in São Paulo will end the year with 90,000 fewer jobs than in 2011." Guilherme Mercês, manager of economic development, Federation of Industries of the State of Rio de Janeiro (Firjan), says that it has taken time for the decline in industrial production to affect employment in Rio de Janeiro state.

Francini points to the competition from imported goods as a major reason for the weakening of domestic industry and vehemently refutes the idea that Brazil's transformation into a service economy is natural and beneficial. "There isn't a virtuous transition, because we have not reached a level of income per capita [that supports a service-based economy]," he says. "It is instead a process of deindustrialization, the result of adverse policies and situations for Brazilian industry. In the 1980s, manufacturing accounted for 25% of GDP; today we are down to 14% while China is at 39%, Korea, 33%, and Germany 24%."

The construction industry has also seen some decline in employment. "Nobody is immune to the economic downturn," says Paulo Simão, president, Brazilian Chamber of the Construction Industry (CBIC). "Last year, we created 309,425 jobs and we closed the year with an unemployment rate of 3.1%, lower than the rate for the economy. Through July 2012, construction created 143,000 jobs, about 4% less than in the same period in 2011, and the jobs added in 2012 are expected to be about 250,000." He adds that a reduction in the number of projects initiated is cause for concern: "Our industry has very particular characteristics. Contracting, hiring, and carrying out a construction project usually take two years . . . . All this requires more planning." But he also adds that "the sector has not been affected so directly by the international crisis," noting that the construction industry has grown above GDP for the last three years.

LABOR HOARDING

IBRE researchers attribute the divergence between employment and economic activity to companies retaining workers to avoid the costs of severance and

readmission and training, but also because they hope the economy will soon recover. IBRE researcher Leandro Rodrigo de Moura says, "The costs of adjusting the labor market in Brazil are very high . . . also, most unemployed workers today are unskilled." FIESP's Francini attests that "severance costs may be up to six times the monthly salary of an employee."

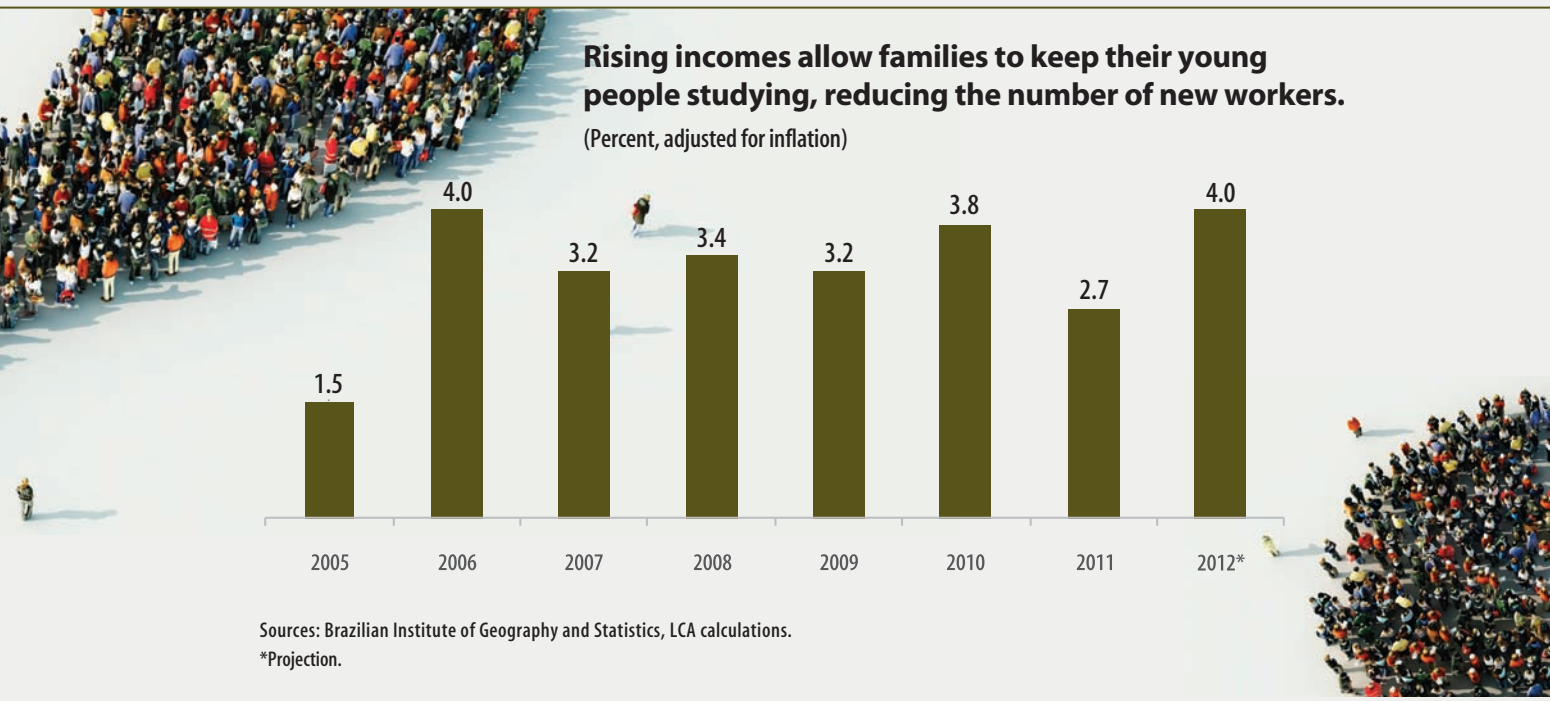
Laying off workers in Brazil is expensive, agrees José Pastore, professor of labor relations, University of São Paulo. He wonders "whether the current crisis may precipitate a modernization of labor institutions, reducing, for example, the cost of labor liabilities, which are increasing significantly due to excessive interference of the government in labor negotiations."

Flavio Castelo Branco, executive manager of economic policy, National Confederation of Industry, notes that "In the United States,

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JOSÉ MÁRCIO CAMARGO

it is perfectly possible to lay off a worker if the economy is not doing well and hire him again three months later, but here the lack of labor market flexibility prevents that." According to Firjan's Mercês, the labor cost problem could be circumvented by indexing the social security tax (20% on the payroll) to the company's revenues,



Sources: Brazilian Institute of Geography and Statistics, LCA calculations.
*Projection.

Growing micro and small enterprises

Solange Monteiro

MORE TRAINING, lower taxes, and more customers—that formula helped to confirm micro and small enterprises (MSEs) as an important source of employment in Brazil. Currently, MSEs employ more than half of Brazilians that have a formal job. Their businesses account for 40% of total wages and generate about 70% of new jobs, according to the Brazilian Service for Supporting Micro and Small Enterprises (Sebrae). "In the last decade, MSEs have created six million jobs in Brazil," says Sebrae executive director Luiz Barretto.

A major driver of these businesses was the emergence of about 40 million lower-middle-class consumers, since more than half of the 6.5 million MSEs (56%) are in commerce. Barretto explains that "The survival of these companies depends more on the domestic market."

Better-trained entrepreneurs have also contributed to this result and to a fall in MSE "mortality." According to Sebrae, ten years ago half of new MSEs closed their doors within two years; today 73% survive this most critical phase. "Moreover, in the last decade real average wages (adjusted for inflation) rose more in the MSEs (14%) than in medium and large companies (4%)," says Barretto, noting that this contributes to the retention of employees.

Barretto says that reducing red tape and cutting taxes were important milestones for reducing informality. "The major breakthrough was the creation of the Simple [a greatly simplified tax system for MSEs]. Also the individual microentrepreneur has emerged, reaching 2.5 million people over three years, a fantastic milestone that no other country has achieved in such a short time," he says. For payment of about R$35 (US$17.5) a month in taxes, individual microentrepreneurs maintain their place on the National Registry of Legal Entities, their right to issue invoices, and their social security benefits. Barretto adds that "We expect that the social security tax relief under the Greater Brazil Plan for sectors dominated by MSEs will allow these companies to continue hiring workers.

as was done in some segments of industry and services under the Greater Brazil Plan. "There are things we can do that do not need new legislation," he says.

There are other costs that also weigh on the decision to retain workers. Júlio de Almeida of IEDI points out that besides paying higher wages, companies have invested more in expensive training programs so their workforce is more highly qualified. "In other circumstances," he says, "a drop in industrial production of almost 4% would certainly lead to laying off more workers than has been the case. But … the entrepreneur is concerned that, if the economy recovers tomorrow and he has laid off more qualified workers, he must bear the cost of hiring and training [new workers]. If he thought that 2012 is lost, he will certainly lay off workers. But if he thinks that some time in the second half, there may be a recovery, he will think twice about it."

Almeida cautions, however, that retaining a skilled and well-paid workforce in a sluggish economy takes a toll in the form of productivity losses, especially in industry. "In services, more productive segments are growing faster than the less productive ones. The most

noticeable decline is occurring only in the industrial sector," he says. Similarly, IBRE's Moura believes that "It's a temporary drop, cyclical, due to underutilization of labor, assuming that the slowdown in economic activity will also be transitory. One way for companies to circumvent the problem would be to reduce the hours worked, if possible even the hours paid."

THE FUTURE OF THE LABOR MARKET

Whether it is done to avoid costs or preserve skilled labor, the assumption behind labor hoarding is that the economic downturn will be short-lived. If recovery does not materialize soon, employment may suddenly sink, triggered by layoffs by companies that no longer can wait for an economic turnaround. The increased availability of qualified workers would reduce the cost of hiring, precipitating a cycle of layoffs.

The consensus among analysts is that the second half of 2012 is the turning point for company layoff decisions. According to the September IBRE Economic Outlook, expectations are deteriorating. Indications from consumers and different productive sectors are that the third quarter will proceed at the same moderate pace as the second. The worsened expectations reflect disappointment with the recent performance of the economy and uncertainty about the timing and speed of recovery.

On the other hand, there is a prevailing feeling that, even without the long-awaited recovery, the consequences may not be drastic, at least at first. Camargo says that "If in the third quarter of this year the economy continues to fall, it will be a clear sign that the policy of encouraging demand is not working. But I still do not think there will be a sharp increase in layoffs, because there is a perception that the government is taking more aggressive economic measures. Entrepreneurs are likely to wait to see what will happen."

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Moura and Pastore disagree. In Moura's view, "Experience shows that in periods of prolonged recession, labor is not retained. If companies find that the crisis is deepening, there may be layoffs and a domino effect."

There is clearly no unanimity about the future of the economy and employment in Brazil. Led by major infrastructure

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works leading up to the international sporting events in Brazil in coming years, and more recently by a robust package of government investments in infrastructure, those in construction are most confident about economic recovery. CBIC's Simão says, "We had been talking about this package for months, and now we are sure that there will be a renewal of work."

Regarding commerce, whose prospects usually tend to improve as the year-end approaches, CNC data for the second quarter of 2012 testify to a climate of uncertainty. The Index of Business Confidence in Commerce has been declining since 2011, suggesting that merchants are pessimistic about the present situation of the economy. In contrast, the Index of Expectations of Commerce Entrepreneurs is still at levels that reflect confidence in the future. But CNC's Araújo warns that "If these expectations are not confirmed, there may be an impact on employment levels in the near future."

As for industry, the sector that has suffered most from the slowdown, although confidence indices for the present and the next six months are declining, a gradual recovery of economic activity in the second half of the year is expected. Firjan's Mercês thinks "It is too soon to talk about large-scale layoffs. Job creation remains high and significant measures have been taken, such as cutting the central bank benchmark interest rate, that take time to produce results." IEDI's Almeida agrees: "We are moving toward better production, although not yet very substantial, [even] in industrial employment. In a negative scenario, if industry falls 3% or 4% in the second half of the year then yes, there will be layoffs. But I do not believe in that."

Although CNI's Branco is also optimistic, he says, "There is no way to plan for production without adequate manpower. Employment grows from new projects and investments, and these are not happening. If we start the fourth quarter with declining economic activity, there is a risk we will enter into a perverse labor market dynamic, with layoffs and a domino effect on expectations . . . The decreased productivity resulting from retention of workers is a cost that cannot be sustained for very long."

Employment increase by sector, May 2011 - May 2012

Industry	-45,627
Construction	79,869
Commerce	16,857
Financial services	165,774
Services (including financial)	296,649
Public administration	60,528
Total	574,050

Sources: Brazilian Institute of Geography and Statistics, IBRE staff calculations.