

Regis Bonelli (insert) participated in the discussions on industrial policy. (Photo: David Venturini)

Industrial policy: Recurrent errors

Experts criticize the government's policies for stimulating the economy and industrial activity

Solange Monteiro, *Rio de Janeiro*

A DISCUSSION AMONG a group of economists gathered at the Brazilian Institute of Economics, Getulio Vargas Foundation (IBRE-FGV) in November, made it clear that there has been no shortage of studies and diagnostics on the Brazilian economy in the last 40 years exploring possible paths to growth. But ultimately the experts participating in the seminar, "Patterns of Industrial Development in Brazil: Past and Future"—in honor of the 70th birthday of Regis Bonelli, economist and IBRE researcher in applied economics—concluded that the tendency to repeat past mistakes is recurrent in Brazil.

The criticism had a clear target: the protectionist trend apparent in the industrial policy of President Dilma Rousseff and her government, which was compared to the policy of incentives adopted in the 1970s to boost domestic industry. "There is some difficulty in dealing with a proper understanding of our not-so-distant past,

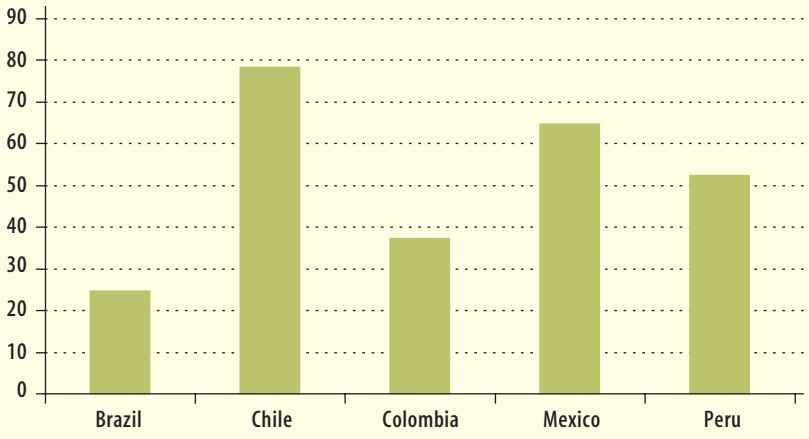
and the nostalgia for a past that is not coming back," said Pedro Malan, former Minister of Finance. Eustaquio Reis, researcher at the Institute of Applied Economic Research (IPEA), added that "Even though previous experience has demonstrated that type of growth to be unsustainable, despite two decades of stagnation and reconstruction, including the scrapping of domestic industries that received subsidies in the 1970s, those policy strategies are still echoing today. From the past to the present, the myth of the great Brazil is an illusion."

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> *Luiz Schymura*

Marcelo de Paiva Abreu, professor of economics, Catholic University of Rio de Janeiro (PUC-Rio), noted that the recent roll-backs in trade openness are made obvious by the increasing prominence of preferential tax treatment and legal requirements to hire and buy parts locally. He also underscored "the increased direct and indirect government presence in the economy, particularly in oil and gas and electricity, and interference in the management of private companies by means of the pension funds of state-owned companies. That is not even to mention the credit subsidized by the National Bank of Economic and Social Development [BNDES]." Luiz Guilherme Schymura, IBRE director, pointed out that the requirements to hire and buy parts locally and the tax benefits granted by the current administration to protect domestic industry rest on a shaky foundation: on one hand, due to high public spending and greater difficulty in meeting the budget primary surplus target, there is little room for fiscal maneuvering, and on

Brazilian economy is not as open as its neighbors.

(Total imports plus exports, % of GDP)



Source: Armando Castelar, FGV/IBRE.

Brazil invests less than its neighbors.

(Average 2005-11, % og GDP)

Brazil	18.7
Chile	22.5
Colombia	22.7
Mexico	25.2
Peru	22.8

Source: Armando Castelar, FGV/IBRE.

the other, there is a lack of clarity in evaluating these policies to confirm that they are worth their high cost. He added, "We know that such policies have worked only in countries that conducted preparatory studies, identified performance goals, and set deadlines . . . The Brazilian public bureaucracy is not ready to do the same."

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THE IDEAL INDUSTRY

Evaluating the actions the government has taken to encourage industrial activity means addressing another equally controversial issue: What should be the ideal weight of industry in the Brazilian economy considering the growing participation of the service sector, falling export competitiveness and industrial investments, and a difficult business environment. "Brazil has become an efficient producer especially in agribusiness, mining, and forestry, and is about to do the same in oil. When these types of exports grow faster than GDP, it is natural to have to import more manufactured goods," said Rogerio Werneck, professor of economics, PUC-Rio. Added to this is the growth in domestic consumption, which has to be fed by imported products. Werneck emphasized, "The political resistance to this increased share of imports has been exacerbated by the loss of competitiveness of the manufacturing industry, which only recently ceased to be exclusively associated with the exchange rate." He argued that the situation should not be corrected by restricting imports. In fact, Sandra Rios, Center for Integrative and Development Studies (Cindes), added, if there is any correlation between the level of imports and industrial competitiveness, it is positive. A recent Cindes study, she said, "indicates that the sectors that performed worse were those with low exposure to imports."

IPEA's Reis warned that this combination of factors in the current situation is a sign that the task of economic recovery is still to be accomplished. "We need to restore public sector savings," he said. For Samuel Pessôa, IBRE associate researcher, trying to build up industry without giving priority to domestic saving is contradictory: "If we cannot save more, how can we support industry, which is capital-intensive?" He pointed out that "Asian countries that escaped the trap of average income in the last sixty years adopted a model with a high share of industry in total production [but also] very high savings by Brazilian standards." Pessôa referred to a paper co-authored with Silvia Matos and Regis Bonelli that demonstrates the association between the share of industry in GDP and the savings-to-GDP ratio, based on an analysis of 88 countries. "China saves 35% of GDP more than Brazil," he said, "and I would explain the difference between the two countries by the difference in the savings rates." He underscored his argument by saying, "Saving economies export more than import, have to compete more, and consequently have larger industries. That may explain the high participation of industry in East Asian countries."


Photo: David Venturini

Sandra Rios, Rogerio Werneck, Luiz Schymura, and Samuel Pessôa.

Despite supporting the call for greater trade openness, Edmar Bacha, director of the Institute of Economic Policies Casa das Garças, a "think tank" in Rio de Janeiro, minimized the influence of domestic savings on the competitiveness of Brazilian industry: "Our historical experience is not a high savings-to-GDP ratio; we are like the United States—only without their productivity [but] today our capital accumulation is half what was registered through 1980 due to the increase in the relative price of investment." According to Bacha's studies, the current purchasing power of domestic savings for investment goods is 25% lower than the historical average. In other words, "our problem is not saving less, but that the same savings are buying fewer capital goods." Among factors responsible for this, he said, is that labor productivity in the construction industry grew only about 1% a year between 1950 and 2008, while productivity in the economy as a whole rose 2.3% a year. Also adding to the problems were factors such as exchange rate and pressure to reduce imports, which meant increased costs when machines from abroad are 40% cheaper.

MORE OPEN TRADE

Abreu of PUC-Rio pointed out that "Countries that have advanced more in dismantling the state and in trade liberalization have clearly performed better. Our recent policy measures undermine investment and increase its cost." Armando Castelar, IBRE coordinator of applied economics, suggested there is a need to admit that Brazil's low growth and steady decline in investment have domestic



Photo: David Venturini

Former Finance Minister Pedro Malan

causes. According to a paper Regis Bonelli presented in early November in Beijing, Brazil, Mexico, Colombia, Peru, and Chile together account for 70% of the population, 73% of GDP, and 83% of foreign direct investment in the region. "If we compare these countries," Castelar said, "only Brazil's growth slowed in 2011 and 2012." The reason, he explained, is that Brazil has the highest tax burden—34% compared to 15%–22% in the other four countries—the lowest trade openness, and the worst business environment. On the World Bank ranking of Doing Business, while the other four countries rank between 37th and 48th, Brazil ranks 130th.

Castelar went on to say, "Brazil also has the lowest investment-to-GDP ratio: 18% for 2005–2011—four percentage points of GDP less than the rest of the group. And they do not have a BNDES." He questioned how effective BNDES actually is in inducing private investment, since in recent years, though BNDES disbursements had risen substantially, private investment has not increased. "And we still have more inflation—an average of 5.5% over the past five years, while Chile, Colombia, and Peru recorded between 2% and 3% — and we are not paying attention to the fact that inflation raises uncertainty about return on investment and investment itself."

The consensus was clearly that, without a course correction, repetition of past mistakes may have serious consequences in the present.

Payroll tax reduction: Wrong medicine

THE GOVERNMENT CLEARLY must make an effort to address the difficulties of the industrial sector to make it more competitive in an economy that is overtaxed. Diagnosing the disease correctly, however, does not necessarily mean that the Rousseff administration has found the right way to treat it. One example is the decision to reduce the payroll tax from 20% to no more than 2% of sales in 15 sectors, which will be extended to 40 sectors in 2013.

To Rogerio Werneck, professor, Department of Economics, Catholic University of Rio de Janeiro, the measure will have little effective impact—only 0.17% of GDP in 2012, US$3.6 billion—and it simply underscores the government's fiscal problems. "Unable to reconcile its political program with a program of effective and substantial reduction of the tax burden," he said at the roundtable, "the government has been manipulating a showy but not transparent policy that reduces costs very little and causes new distortions to the tax system. Moreover, the rapid growth in the number of sectors included in the program only confirms the fears that the already problematic tax system will become even more disfigured."

Werneck noted that the arrangements entail increased spending, in a scenario where public spending is already high, which will limit the possibility of a substantial reduction in the tax burden. In his view, the ideal tax reform would be a reduction in the payroll tax offset by an increase in the value-added tax (VAT). Greece, Portugal, and Spain are discussing this option. By taxing final consumption rather than investment and exports, it would stimulate competitiveness.

Citing former Argentine Economy Minister Domingo Cavallo, who supports this type of tax reform, Werneck also argued that it corresponds to a devaluation of the exchange rate without any inflationary effect on domestic prices and corporation balance sheets, and it would promote formal employment and private savings. He admits, however, that it is difficult to carry out this tax reform in Brazil where the VAT is already close to 34% and would have to rise to 40% to offset a reduction in payroll tax. The government's choice, he concluded, "is a paradise of populist fiscal management—and a tremendous setback."