ARE YOU BEING SERVED?

Responsible for almost 70% of the wealth generated in Brazil, the service sector is changing the structure of the economy and increasingly attracting foreign investors. But there are problems with productivity and quality.

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The service sector has become indispensable to the future of the Brazilian economy. In 2009 it contributed 72% of all new jobs, in 2010 it contributed 67% of gross domestic product (GDP) exclusive of the public sector, and in the first quarter of 2011 it grew 4.0% over the same period last year (industry grew 3.5%.) From January to May, it received 60% of total foreign direct investment, compared with 29% in 2010.

Yet experts and sector leaders are beginning to recognize vulnerabilities in this heterogeneous sector. Services comprise not only the dynamic financial, telecommunications, and information technology sectors but also such traditional sectors as transportation and retail and all activities, often informal, that cover personal services. Productivity is low because large segments have long been dominated by the government, there are old restrictions on foreign investment, and there is a shortage of skilled workers.

Industry's problems

In general, as a country becomes richer and its people can afford more goods, demand then moves into services: someone who already has a home and a car can invest in entertainment, education, and health. Moreover, as technological development makes production of industrial goods more efficient and thus cheaper, it reduces the share of industry in a country's GDP.

In Brazil, "Until the 1980s … the country had too many industries,'" recalls Samuel Pessoa, consultant to the IBRE. Today, however, industry's share in Brazil's GDP is surprisingly falling to the levels of industrialized countries. "I think we have a structural trend — not reasonable, given our per capita income — for industry to reduce its share," Pessoa says. Two factors explain this situation. First, savings are low (17% of GDP) even though Brazil has an economically active population. Low savings are related to the huge welfare state that reduces risks for individuals but also reduces incentives to save. "Ample social insurance produces a huge tax burden. Now, with a huge tax burden on one side and substantial social insurance on the other, why should anyone save in Brazil?" Pessoa asks. He also points out that in the last 15 years, with the minimum wage rising an active worker's retirement benefit grows faster than his earnings, so "It just does not make sense to save in those conditions."

The second factor Pessoa cites is Brazil's privileged position as a supplier of commodities to the world, especially Asia, where a third of the world is becoming rich but which is poor in natural resources. The upward trend in prices for agricultural commodities encourages Brazil to produce primary goods. Pessoa says, "In this scenario, I cannot see much future for industry."

A natural progression?

For some experts, however, the current predicament of industry does not imply confrontation with the service sector. "It's not a zero-sum game," says André Rebelo, advisor on strategic affairs to the Federation of Industries of São Paulo (FIESP). He points out that in part the service sector is growing because certain activities previously done within companies, such as cleaning or computer support, have migrated out.

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Similarly, Ernani Torres, head of economic research, National Bank for Economic and Social Development (BNDES), argues that the structural growth of the service sector due to changes in the production chain is normal. "Sectors change, leave, and start other processes . . . . It is part of the market economy," Torres, says adding that industry and services have their own logic and operate independently.

While agreeing with FIESP's Rebelo's views, Torres notes, however, that in some situations industry and services benefit from each other's progress. In 2010, BNDES channeled nearly R$47 billion in financing for infrastructure services. In Torres's view, there are significant opportunities for services growth.

Productivity is low because large services segments have long been dominated by the government, there are old restrictions on foreign investment, and there is a shortage of skilled workers.

Today the demand for services is exerting more influence on Brazil's economy, prompting the government to intensify efforts to correct growth deviations. It is also raising concerns about inflation. With overheated demand and an expansionary minimum wage policy, service sector inflation has been exceeding average inflation. "In 2011 and the beginning of 2012, we will be on the alert," says Salomão Quadros, IBRE coordinator of economic analysis. "This year, it seems Brazil's growth rate will be half of last year's rate, which, along with a good harvest and imports of consumer goods, will generate some balance between supply and demand."

For FIESP's Rebelo, services are not worrisome for inflation targeting: "We have to separate the effects of inflation due to high demand from those due to a structural correction. Incorporating more than 30 million new consumers takes time — but it is a good kind of problem."

Pessoa underlines the structural factor: "Brazil has good institutions and good business opportunities and is attracting investment. If investment increases but savings do not, the difference has to be paid by foreign savings, but you cannot import services." That is, foreign savings, which can only come in the form of goods, generate inflation of services. And "expensive services mean an overvalued exchange rate," Pessoa says.

Quality and productivity

The supply of services suffers from low productivity in some sectors and poor services quality. Humberto Ribeiro, Secretary of Trade and Services, Ministry of Development, Industry and Foreign Trade (MDIC), says, "We must look to those segments that induce competitiveness and support

The service sector has attracted more foreign investment in 2011

(Billions of U.S. dollars)

	Jan.-May 2010	2010	% of total	Jan.-May 2011	% of total
Agriculture and mining	2.6	18.1	34.5	3.3	12.7
Industry	8.6	19.3	36.8	7.14	27.0
Services	4.4	15	28.7	15.9	60.3
Telecomunications	0.6	0.9	1.3	5.9	22.5
Utilities	0.1	1.1	2.2	2.6	9.8
Commerce	0.6	2.5	4.8	2.0	7.7
Real estate	0.3	1.1	2.1	0.9	3.4
Financial services	0.7	1.8	3.5	0.8	3.3

Source: Ministry of Development, Industry and Trade.

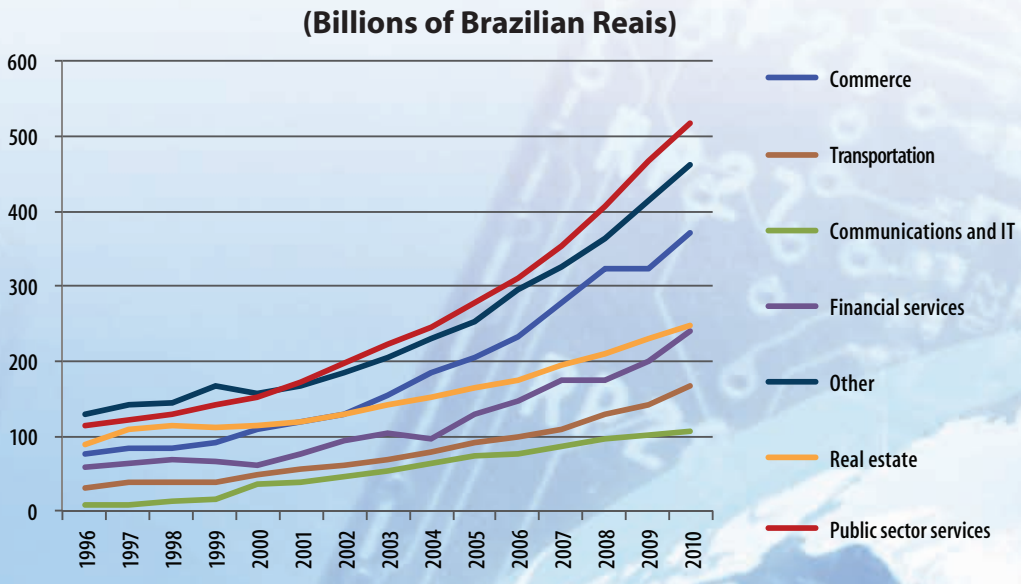
sustainable agriculture and a world class industry. We also have a policy aimed at strengthening traditional sectors such as retail; other segments, such as education, health, and leisure, that need to be better managed; and IT and telecoms, which can provide world-class services."

Pedro Cavalcanti, economist, FGV Graduate School in Economics, points out that productivity in the service sector in terms of its share of GDP is low. When the Brazilian economy is compared with those of the U.S. and Korea, Brazil's productivity gap is much worse in the services sector than in agriculture and industry. Why? Cavalcanti suggests that an important factor is education. Even with the drop in illiteracy and the increase in average years of study, he says, "The workforce in this country is still not well qualified."

Ribeiro agrees. As an example, he cites engineering services, which, after decades of timid demand due to low investment in major infrastructure and the dismantling of the heavy construction industry, now finds itself confronted with needs related to the Growth Acceleration Program (PAC), deep sea oil, and the World Cup and Olympics. The Federal Council of Engineering, Architecture and Agronomy, he says, will soon launch a national census of the skills and flexibility of engineering and architecture profes-

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Services have been growing since 2005.



Source: Institute of Geography and Statistics (IBGE).

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Samuel Pessoa

sionals; the data should support discussion on how to improve technological and technical education. "Minister Pimentel [MDIC] has called for increasing the well-being of the Brazilian consumer, and we know that this requires better services — so much so that the Competitive Development Policy, which was once focused on manufacturing, now includes the service sector," Ribeiro says.

The extensive informality in certain services segments is stimulated by demand for personal services, such as cosmetics, health, and food. "These sectors have low barriers to entry and involve little initial investment; with the amazing growth in consumption, the provider of services can earn a much higher income than from a salary," says Carlos Alberto dos Santos, CEO of Brazilian Support for Micro and Small Enterprises.

Santos points out the good results from the law promoting the Individual Entrepreneur (annual sales of up to R$36,000), which simplifies business registration and payment of taxes. In the two years since the law was passed, more than 1.2 million businesses have registered, including small retailers, beauty salons, bars, and restaurants.

To make the movement toward formalization of service providers broader and more effective, Murilo Portugal, president of Febraban, recommends action on two fronts: "The first step is for the government to adopt negative incentives—measures that directly raise the cost of informality. The second, which is being actively discussed, is to exempt payroll from taxes to reduce the excessive cost of labor." However, the exemption has to be real, Portugal warns: "Providing a tax exemption for payroll in a labor-intensive sector and offsetting it with tax increases in capital-intensive sectors would be a mistake — the increased use of capital is what increases productivity."

Growing external deficit in services.

(Millions of U.S. dollars)

	1970	1980	1990	2000	2007	2008	2009	2010
Services	- 473	- 3,039	- 3,596	-7,162	-13,219	- 16,690	- 19,245	- 30,807
Transportation	- 185	- 1,936	- 1,644	- 2,896	- 4,384	- 4,994	- 3,926	- 6,406
International travel	- 130	-241	-90	2,084	- 3,258	- 5,177	- 5,594	- 10,503
IT services	- 5	- 14	- 51	-1,111	- 2,112	- 2,598	- 2,586	- 3,296
Leasing of equipment	-10	- 292	- 513	- 1,311	- 5,771	- 7,808	- 9,393	- 13,752

Source: Central Bank of Brazil.