

Brazil's new industrial policy frustrates expectations

Claudio Accioli and Solange Monteiro, Rio de Janeiro

Disappointment and skepticism mark most of the analysis of the new industrial policy by economists of the Brazilian Institute of Economics, Getulio Vargas Foundation (IBRE-FGV). The Greater Brazil Plan announced on August 2 they believe to be insufficient to recover competitiveness and targeted mostly to providing relief to vulnerable sectors affected by exchange rate appreciation. "Protecting

the industrial sector generates only inefficiency, not growth," says economist Silvia Matos, coordinator of the IBRE Outlook.

There was consensus on aspects of the new policy. Reduction of payroll taxes for the clothing, shoes, furniture, and information technology sectors is "great news," Matos said. "For the first time, the government seems to accept the idea that industrial competitiveness can be increased by reducing labor costs.... If the policy is not ideal, it is still a step in the right direction."

More negatively, the analysts found reprehensible the 25% preference for domestic goods and services in government procurement. Matos said it "makes no sense that the government pays more for a good only because it is national The measure is an incentive to inefficiency, just when Brazil is racing against time, given global uncertainty."

Here is how IBRE economists analyzed the main aspects of The Greater Brazil Plan:

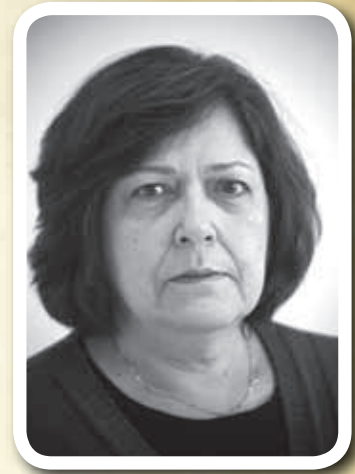
“Trade protection is not a solution.”

With regard to foreign trade, the policy is fluid, with little substance. For example, initially the government announced it would pay back exporters 4% of the total of their exports, and then said no more than 3%, depending on sector and import content. In Brazil, apparently, you announce things before you have settled everything [which means] you give lobbyists opportunity to seek more gains.

One of the sensitive issues for business is taxes on exports. The export sector argues that Brazil needs a single value-added tax. But that requires a difficult reform lacking political support, and the government tries other ways to reduce export costs. This is certainly not the solution.

The most important financing measure is the export-financing fund for micro and small businesses. Supporting this segment is always good because it creates jobs, but this measure does not solve the problem of the trade balance, because most exports originate with large companies. Also, small businesses have difficulty remaining in foreign trade, so export financing is not enough. There is a need for other policies to help small businesses become exporters.

It is important to improve defenses against unfair trade, but they cannot be used to check imports. Some sectors of the economy need imports to modernize. Another risky point is the debate to increase to 100 the products with a maximum import tariff of 35%; though temporary this could easily become permanent. Trade protection is also connected to exchange rate appreciation, but it will not solve the appreciation conundrum. We need to reduce such costs as transportation and port operation costs.



Lia Valls Pereira



Salomão Quadros

“Paying more for domestic products will create inefficiency and raise government procurement costs.”

Measures related to innovation must be long-term; those defending industry and the domestic market are targeted to resolve specific problems in the short term. This is the case with payroll tax relief, which should not be restricted to certain sectors. The service sector, for example, which has great potential to create jobs, was not contemplated. The tax relief was designed to mitigate job losses in specific sectors because of foreign competition and the appreciated exchange rate; it is not a long-term policy to stimulate employment. In the long term, gradual reduction of payroll tax rates would encourage formalization of employment and thus increase tax revenue for health and welfare programs.

As for government procurement, paying up to 25% more for domestic products will bring about inefficiency and increase the costs to government.

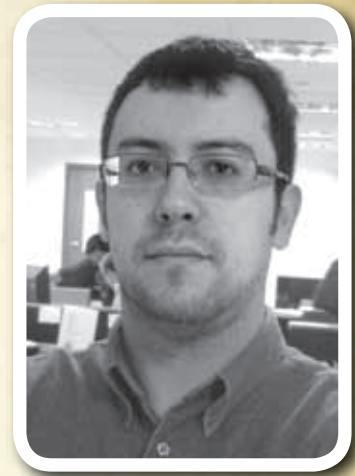


“Informal employment should fall.”

Payroll tax relief, which was limited to a few sectors, will have only a marginal effect on job generation, but it may be the first step to extend payroll tax relief to other segments of the economy. Although it created a tax on revenues of some companies, the net effect should be positive for them. The first offshoot of this measure is a likely decline in informal employment, which is not all that high in industry in general but is very significant in the sectors covered. It will stimulate formalization of employment in these sectors but probably will not be noticeable in the aggregate.

The question is to what extent companies will turn the incentive into profit or will invest in increased production, thus creating new jobs. I do not think there is a significant effect on wages, not only because they are already high but also because there is high turnover in these sectors, and the recent slowdown of the labor market tends to reduce worker bargaining power.

As for government procurement, governments do this sort of thing to promote domestic industry and encourage innovation in the production process. The positive side of this policy is that it can stimulate research and development in leading sectors and generate positive externalities for society as a whole, expanding the possibilities for general economic growth. But the federal government paying up to 25% more for domestic products will produce inefficiency and lower productivity. To avoid this, it is fundamental to put limits on the benefit, so a company does not enjoy a privileged position indefinitely. The measures adopted will have little effect on the labor market in the short term, and unemployment can be expected to hold at about 6% till year-end.



**Rodrigo Leandro
de Moura**



Pedro Cavalcanti

“The diagnosis is wrong.”

Even with a diagnosis that Brazilian manufacturing is experiencing a crisis caused by predatory competition of foreign products, especially Chinese, and the “currency war,” the new industrial policy will not solve the problem. Probably it will adversely affect productivity and unjustifiably benefit certain interest groups and sectors rather than the population as a whole.

The data available do not reveal a widespread crisis. There are serious problems in some sectors hit by international competition, but others, like the automotive industry, are growing at healthy rates. A second mistake is to consider the appreciated exchange rate to be the root of the problem. Even if it were, more important distortions have been ignored, such as Brazil’s costly and bureaucratic tax structure and excessively high tax burden. Moreover, to a large extent the appreciation is caused by foreign capital pouring in, attracted by high interest rates, which were aimed at curbing the inflation caused, among other factors, by excessive government spending and credit expansion.

Here, too, we are not confronting the problem. Treasury transfers to the National Bank for Economic and Social Development (BNDES) remain high and there is no long-term program to relieve fiscal difficulties. But there are positive measures, such as reducing the period of return of the social contribution taxes (PIS–PASEP) on purchases of capital goods, the industrial products tax (IPI) exemption on capital goods, and a significant increase in resources for innovation and payroll tax relief — although here expectations have been frustrated because it covers only four sectors. The few strengths, however, are not the core of the new industrial policy.



“Any industrial policy that does not address performance becomes income distribution policy.”

Past industrial policies have not been positive. They transferred income to sectors that lobbied best. For example, the National Informatics Policy of 1984 has not generated a competitive industry — IT companies exposed to competition did not survive. Our history condemns us.

Any industrial policy that does not address performance, as the Asians did, becomes income distribution policy. In some sectors contemplated in the new industrial policy, exchange rate appreciation in recent years did badly damage competitiveness. There are some good measures, such as payroll tax relief. In cases like clothing, for example, there is a high degree of informality, individual entrepreneurs, and heavy competition from Chinese products. This can really help, although the effect is not neutral: except for Social Security, there will just be a transfer of tax revenue from one sector to another. A policy that deals with the economy’s competitiveness as a whole would be better. Addressing only problems in some sectors has not worked in the past, especially when relief is not tied to performance.



**Fernando de Holanda
Barbosa Filho**





Mauricio Canêdo

“Companies innovate because they are pressured by competition.”

Brazil’s new industrial policy has very little to do long term with what is usually defined as industrial policy because many of the measures have expiration dates. The new policy seems to be more about alleviating structural problems (exchange rate issues, competition from China, the Brazil cost, etc.). Instead of innovation, as the government had earlier suggested, the emphasis is on protecting the domestic market. BNDES programs have been strengthened and the Financier of Studies and Projects (FINEP) budget increased by R\$2 billion. Payroll tax relief for some industries goes in the right direction; I hope it leads to broader reduction of the tax burden on wages. Most of the measures to encourage investment and innovation represent a continuation or extension of what has already been done.

The big challenge is to build an environment encouraging companies to innovate. We are not doing this. The preference for domestic goods in government procurement goes back to early 2010; the main motivation was supposed to be to use the purchasing power of government to encourage innovation. But companies innovate because they are pressured by competition.

“It looks like a Christmas tree.”

The most interesting measure of the new industrial policy is the payroll tax relief. Although it is protective, in the medium term it can have a major effect in Brazil by reducing informal employment. The idea of starting in some sectors makes sense both because we need to better understand the effects and because Brazil is experiencing a situation of almost full employment.

What is missing is coordination: it is difficult to understand how the initiatives relate to each other, and what the goals are. That makes it difficult to assess whether these measures are appropriate and whether together they will produce the expected result. The policy looks like a Christmas tree. In addition to evaluating each measure individually, we should analyze them together, and that is not possible. The intent may have been to show that the government is not insensitive to the difficulties industry is going through, but I am not sure there is sufficient magnitude to meet the challenge created by exchange rate appreciation.



Armando Castelar

HIGHLIGHTS OF THE GREATER BRAZIL PLAN

Defense of Domestic Industry and Market

- Reduces to zero the social security tax of 20% on payroll in the clothing, shoes, furniture, and information technology sectors.
- Institutes a preference allowing the government to pay a 25 percent premium over the lowest price for Brazilian-origin products and services that meet certain employment, income generation, and technological innovation standards.
- Creates a new regime for the automotive sector with tax incentives for investment, more value added, employment, and innovation.

Incentives for Investment and Innovation

- Extends for 12 months the IPI reduction on capital goods, building materials, trucks, and light commercial vehicles.
- Reduces the deadline for returning social tax credits on capital goods.

- Extends the Investment Support Program of BNDES to December 2012 with a budget of \$75 billion.
- Expands BNDES working capital loans for small and medium-sized businesses from R\$3.4 to R\$10.4 billion.
- Increases by R\$2 billion Finep's 2011 innovation portfolio.

Foreign Trade

- Institutes the Reintegra program to reimburse exporters of manufactured goods of 3% of exported value of taxes indirectly levied on the export production chain, such as the local service tax (ISS), the financial transactions tax (IOF), and the royalty tax (CIDE).
- Reduces delays in trade defense (antidumping, safeguards, and countervailing measures) from 15 to 10 months (investigation) and from 240 to 120 days (application of provisional right).
- Creates an Export Financing Fund for companies with revenues of up to R\$60 million.