

## Brazil: Making progress but still far to go



### Angel Gurría

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Since Angel Gurría of Mexico took over as Secretary-General of the Organization for Economic Cooperation and Development (OECD) in 2006, he has reinforced the OECD's role as a hub for global debate on economic policy issues. He has also launched "New Approaches to Economic Challenges," an OECD process for reflecting on and learning from lessons from the global crisis. In 2011 OECD launched the Better Life Index, which shows how the population of the 34 OECD members plus Brazil and Russia perceive their quality of life. Last June, with support from FGV Projects, the report was published in Portuguese. "It is clear that Brazil has recorded significant progress in the last decade regarding the quality of life of its population," said Gurría. However, he calls for developing countries to speed up structural reforms and argues for investment in policies that boost productivity and competitiveness to lead the country to more balanced growth.

***The Brazilian Economy***—In June the OECD published the **Better Life Index**. How does Brazil compare with other countries?

**Angel Gurría**—The Better Life Index, launched in 2011, consists of regularly updated well-being indicators and an analysis, published in the report *How's Life?* and as an interactive web application. The Index allows citizens to compare well-being across 36 countries, based on 11 topics the OECD has identified as essential in terms of material living conditions and quality of life.

Brazil has made significant progress over the last decade: In general,

Brazilians are more satisfied with their lives than the OECD average, with 80% saying they have more positive experiences in an average day compared to the OECD average of 76%. In Brazil, over 67% of people aged 15–64 have a paid job, slightly more than the OECD average of 65%.

However, the Index also shows that Brazil must deal with significant challenges, particularly social. In Brazil, 43% of adults aged 25–64 have earned the equivalent of a high-school degree; the OECD average is 75%. Among people aged 25–34, 57% have the equivalent of a high school degree compared to the OECD average of 82%. That shows significant progress in educational attainment.

Basically, Brazil ranks above average in subjective well-being, work-life balance, and social connections, but below average in civic engagement, housing, jobs and earnings, environmental quality, health status, personal security, education and skills, and income and wealth.

**The Brazilian Institute of Economics (IBRE) charges that the main challenges the country faces are domestic. Does the OECD agree?**

We agree that most of Brazil's challenges are domestic, especially since the global economy is recovering slowly. Brazil's exposure to international trade is fairly low; exports are only about 13% of GDP so domestic demand will

remain the main pillar of growth in Brazil. But with the right policies, exports could do much more for Brazil's growth.

To take advantage of this opportunity, Brazil would have to improve its competitiveness. Supply-side constraints, such as pressing infrastructure bottlenecks and a high tax burden, exacerbated by an onerous and fragmented tax system, are increasingly impeding

growth. A tight labor market and continuing skill shortages have caused surges in wages. And although credit is rising at a substantial pace, investment financing at longer maturities continues to be scarce. Lack of private participation is impeding development of long-term credit markets, owing to an uneven playing field caused by strong financial support to the National Development Bank, which dominates long-term lending. Competitive pressures could also be strengthened by lowering trade barriers, as domestic producers continue to be shielded from foreign competition.

It is also crucial to continue the progress on reducing poverty and income inequality. Conditional cash transfers have proven effective in addressing poverty and inequality and enhancing incentives to invest in human capital. However, social expenditures have been heavily focused on pension payments. Wider access to education has allowed more Brazilians to move into an expanding number

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of better-paid jobs. However, the quality of education has not kept pace with the impressive expansion of the system. There are severe shortages in physical infrastructure, a large number of students still drop out of secondary education, and vocational education is limited, although increasing.

**Should the next Brazilian government change the economic model to prioritize domestic consumption?**

Brazil certainly needs more investment. The recent slow-down has exposed structural weaknesses in the economy's supply side, which were less visible during the commodity boom; among these weaknesses are a fragile manufacturing sector and too little investment and savings relative to GDP. Rebalancing demand from consumption to investment could raise output growth, increase the resilience of the economy, and even have beneficial effects for productivity. So how do we get there?

To attract investment demand requires addressing such structural economic constraints as infrastructure deficiencies, high labor costs, low skill levels, a high tax burden and an onerous tax system, excessive administrative burdens, shallow credit markets, and barriers to international trade.

**How do you evaluate the social policies that have reduced inequality in Brazil? Will it be**

**possible to maintain the same strategy when public finances are less favorable?**

Brazil has made remarkable social progress. While income inequality continues to be high by international standards, both inequality and poverty have fallen substantially over the last two decades. Economic growth can explain almost half of this progress, but social policies have helped many households to escape poverty. The two pillars of the successful

policy strategy to support social progress have been improved access to education and increased transfer payments.

The conditional cash transfer *Family Grant* program has proven to be a powerful and well-targeted tool to reduce poverty with hardly any leakage. By making transfers conditional on school attendance and basic health check-ups, it also lays the foundations for families to move out of poverty over time. The authorities could now consider raising *Family Grant* benefits, which currently cost

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less than 1% of GDP.

The federal minimum wage, whose real value has almost doubled over the last decade, has reduced income inequality but has also driven up labor costs, which affects Brazil's competitiveness. As a share of the median wage, it is 69% higher than in any OECD or BRICS country except Turkey. The current rule for automatic increases, which expires in 2015, could be replaced by a rule that indexes annual

minimum wage increases to the consumer price index for low-income households, plus only part of productivity gains for a given period. Such a rule would protect the purchasing power of minimum-wage earners, and reduce without halting, future real increases in the minimum wage.

Pensions have also reduced inequality and poverty, but the automatic rule that individual pensions cannot be lower than the fast-rising minimum wage has made the pension system increasingly expensive. ...

Lowering future pension increases while ensuring that pension purchasing power continues to rise would release funding for *Family Grants* and benefit children and youth, whose poverty rates are well above average. ... It has been estimated that the effect on inequality of a marginal increase in *Family Grant* benefits is many times greater than an increase in pensions.

**Critics of the Brazilian growth model say that the quality of the growth it has generated is low and low-productivity services represent a significant share of GDP. Would the OECD agree?**

Industry's real labor costs have been rising steadily in recent years, outpacing productivity by a sizable margin even as productivity growth slowed. The concurrent loss of external competitiveness can only partly be explained by nominal exchange rate developments. Industry is more exposed to external competition than services and there is also a gradual

structural shift from industry to services, where the scope for productivity gains is much more limited than in other sectors. Addressing the policy challenges that hold back industrial productivity and competitiveness would lead to more balanced growth across the board.

**How does the OECD evaluate the use of "creative accounting" and other transparency issues, such as the concession of areas of deep sea oil to the state oil company without a public tender?**

Trust in public administration is needed more than ever. Enhancing integrity and transparency and preventing corruption should be the priorities of every public administration. The OECD recently published an Integrity Policy Review which recognizes that Brazil has made significant progress with regard to transparency in public expenditure, using new technologies to provide

free real-time access to information through the Transparency Portal and other transparency pages.

The OECD also has a number of Principles for Integrity in Public Procurement. The prominence of procurement as a policy instrument relates to its total value: general government procurement accounts for 4% to 14% of GDP in OECD member countries. In Brazil, conservative estimates suggest that general government procurement accounts for about 8.7% of GDP. However, enhancing integrity in public procurement is not simply about increasing

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transparency and limiting management discretion but also about recognizing the risks inherent throughout the entire procurement cycle, specifying appropriate management responses to the risks, and monitoring the impact of risk-mitigating actions.

Brazil's fiscal framework calls for a gradual decline in the debt-to-GDP ratio by generating primary surpluses; the current nominal target is 3.1% of GDP. Although this has delivered good results, there have been recent instances where the level of spending could not be reconciled with the nominal primary surplus target without unusual accounting measures: quasi-fiscal operations involving public banks, and exempting certain expenditure items from the primary surplus. While legal, these measures were not used as much in previous years and complicate analysis of the actual fiscal policy stance, suggesting that it might be more expansionary than highlighted by the primary surplus alone. Fiscal clarity should therefore be reinforced by avoiding quasi-fiscal operations, changes in definitions, and special exemptions.

Brazil might also have a legitimate need for more flexibility to conduct countercyclical fiscal policy. This could be obtained by redefining the fiscal rule so as to take cyclical factors into account. One relatively easy way forward could be to replace the current fiscal target by a rule that public spending would only be allowed to expand along a pre-

terminated path, defined by medium-term expenditure ceilings. Since automatic stabilizers operate mainly through the revenue side, an expenditure rule allows them to operate almost fully. This is an attractive choice because it is relatively easy to explain to a broad audience and easy to monitor. Expenditure rules are also useful to support fiscal consolidation and are consistent with the general conclusion that fiscal adjustment is best done on the spending side.

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**What are key factors for Brazil to promote the competitiveness of its economy?**

In Brazil, supply-side constraints are increasingly impeding growth. At the same time, participation in international trade and its integration into global production chains is less than what would be expected in an economy as large and sophisticated as Brazil's, and domestic producers continue to be shielded from foreign competition.

Continuing efforts to consolidate indirect taxes into a single value-added tax are paramount, as the costs of tax compliance in Brazil are exceptionally high. The rise of labor costs could be limited by containing minimum wage increases as previously suggested. Private long-term credit markets could be fostered by gradually phasing out financial support to BNDES, and by focusing BNDES lending on the financing of infrastructure, small and medium enterprises, and innovation. Brazil should also reduce tariff protection, phase out local

content requirements, and target support to specific sectors.

### **How do you see the insertion of Brazil, and Latin America generally, into global value chains?**


The Brazilian economy has fairly little exposure to international trade. Together, imports and exports are only about a quarter of GDP, significantly below that of countries of similar size, even though the comparison does not account for differences in geographic remoteness and other factors.

This low integration is somehow emblematic for Latin America, although an exception is Mexico, which has strong import content in its exports, rising from 26% in 1995 to 30% in 2009. In Chile, which unlike Mexico does not have a large developed country as a neighbor and has a significant share of mineral exports, 18% of the value of its exports comes from imports, twice as high as Brazil's 9%. In a world dominated by global value chains, the low level of foreign content in Brazilian exports might make some industries less competitive.

Despite some progress producers are also more shielded from foreign competition in Brazil than in other countries. Higher tariff protection reduces competitive pressures that

would spur firms to reach global best practice; it also hurts downstream sectors that use these products as intermediate inputs or capital goods. Meanwhile, Chile, Colombia, Mexico, and Peru have actively promoted integration with large markets such as Japan, China and the United States through bilateral agreements. Brazil should give preference to horizontal policies to improve the cost competitiveness of local producers, rather than trade protection measures, even temporary ones, that blunt competitiveness.

Services account for only 14% of Brazil's gross exports but more than 33% of its exports in value-added terms, indicating that Brazil's exports of goods rely intensively on services inputs. In 2013 Brazil exported services worth US\$39.1 billion and imported services valued at US\$86.6 billion. ... According to the latest AT Kearney Global Services Location Index, Brazil is the 12th most competitive international location for offshore services. However, this industry requires regulation

that ensures a favorable business environment. The OECD Service Trade Restrictiveness Index (STRI) shows that Brazil has more restrictions on trade in services than in any other sector except accounting.... The sectors with the highest STRI scores for Brazil are air transport, courier services, and broadcasting. 

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