Getting **productivity back on track**



Brazil's growth will not resume without policies to make Brazilian business more productive.



Solange Monteiro

The END OF THE FIRST QUARTER was marked by the realization that tight monetary and fiscal policies may take time to correct the economy's imbalances and that high inflation and low growth may last longer than hoped. Out of this realistic assessment also emerged the view that, as the economy adjusts, policy makers should be moving to build up the economy so that future expansion is stronger and more sustainable.

The consensus on what to do is not exactly new: to grow more robustly, the country must tackle a wide range of problems that have undermined the economy's productivity. This problem is not unique to Brazil. Last year's Inter-American Development Bank (IDB) study showed that despite the growth wave in the last decade in Latin America, low productivity prevented the region from attaining higher income levels.

In fact, today on average Latin American and Caribbean countries have lower per capita income than in the 1960s and are far from converging to the income levels of developed economies like the United States.

The IDB study also indicated that, more than the lack of investment in machinery and equipment or more training for workers, the main problem in the region is inefficiency in the use of these inputs—in other words, low total factor productivity (TFP). Low growth is related not so much to the fact that a country has fewer or worse production factors as that these factors have been poorly organized. According to the IDB, in the last 50 years, despite Latin America having expanded its labor force and its capital stock faster than the United States, its TFP growth was lower.

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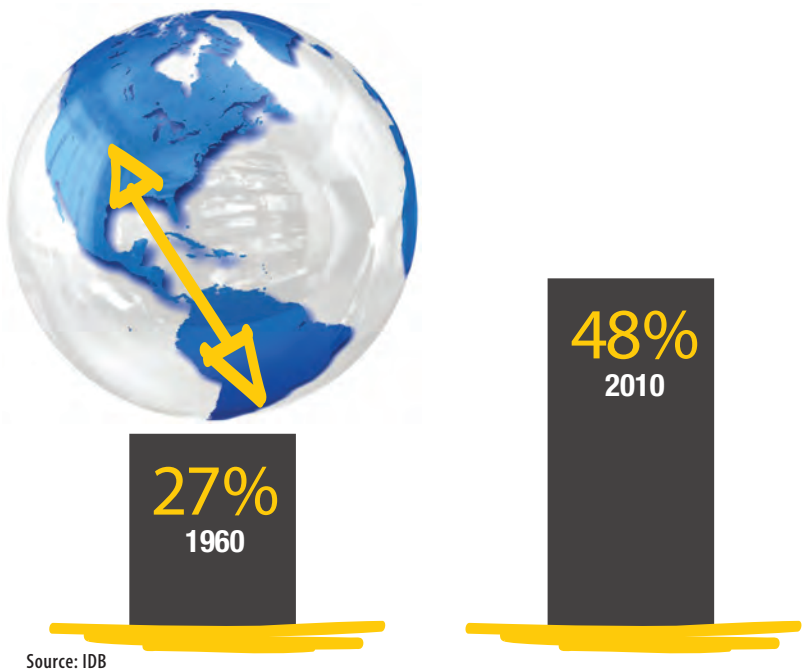
The efficiency gap between a typical Latin American country and the U.S. went up from 27% in 1960 to 48% in 2010—which explains much of the decline in per capita income. In contrast, a typical country in East Asia reduced the efficiency gap from 51% to 33%.

"This invalidates the idea that what Brazil lacks is investment," says Pedro Ferreira Cavalcanti, professor and researcher of the Graduate School of Economics of Getulio Vargas Foundation (EPGE/FGV). "Traditional theories see physical capital as the engine of growth, but international evidence shows the opposite. Today, increasing efficiency would bring about more GDP growth than injecting money into large projects," Cavalcanti says, while pointing out the importance of having adequate infrastructure.

Samuel Pessôa, IBRE associate, researcher, an unwavering supporter of investment and savings for sustained growth, says there is no opposition

An even greater distance

The efficiency gap between the average Latin American country and the U.S. has increased in the last 50 years.



Source: IDB

"Today, increasing efficiency would bring about more GDP growth than injecting money into large projects."

Pedro Cavalcanti

between the two ideas. He explains that upturns in the economic cycle begin with accelerating productivity, which leads to a higher return of capital, which launches a new investment cycle and reinforces expansion of the economy.

Economy's multiple chains

The study of productivity is the flagship of FGV Growth and Development, a new FGV center of studies, created by Cavalcanti, João Victor Issler, and Roberto Castello Branco. At the April seminar inaugurating the new center, Cavalcanti said that low productivity accounts for almost two-thirds of the total income gap between Brazil and the U.S. His bitter conclusion is that the causes of low productivity are not only Brazil's lack of ports, airports, and roads themselves, or the economic guidelines, but also a heavy burden of bureaucracy and pervasive corruption that distorts the allocation of capital and the quality of Brazil's business environment. "We're talking about institutional factors and excessive distortions, such as discretionary government intervention in markets and pricing," Cavalcanti says.

Among those factors are the weakening of the institutional framework for infrastructure concessions and the questionable resource allocation strategy of the National Development Bank (BNDES) that discourages investing in Brazil. "If we do not correct the practices that led to inadequate pricing, the supply of goods and services will also be inadequate, and so we run the risk of having low growth for much longer, "says Silvia Matos, coordinator of IBRE's Macro Bulletin.

Many factors contribute to low productivity and sagging competitiveness. In the *Global Competitiveness Report* 2014-2015 prepared by the World Economic Forum, the ranking of Brazil's public institutions dropped eight positions, to 104th (out of 144), compared with its ranking in 2010, and the ranking of the labor market sank 13 positions, to 109th. Factors that contributed to the decline in the labor market ranking were high payroll taxes, the difficulty of hiring and laying off workers, and a lack of flexibility to set wages.

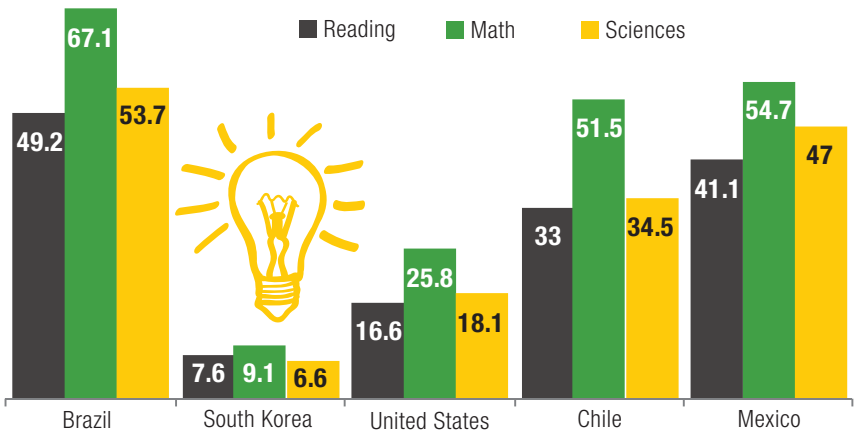
In terms of the institutional framework, Brazil ranks 143rd on government regulation, and 137th in wastefulness of public spending. With regard to market efficiency, it ranks almost at the bottom: 142nd in number of days to start a business, and 139th in the effect of taxation on incentives to invest. Brazil's cumbersome tax system exacerbates the inefficiency. An IDB survey in 2007 pointed out that the time it took to pay taxes in Brazil was 2,600 hours a year. In Latin America, the average is 360 hours and in high-income countries 177 hours.

The World Bank's *Doing Business* report ranks Brazil 120th among 189 economies.

Relatively low trade openness and the poor quality and the high cost of Brazilian logistics infrastructure also contribute to low productivity, Cavalcanti says. "Brazil's TFP made an important leap during the trade liberalization in the early 1990s. Since then, we have not advanced, and today we are uncompetitive because we are not part of international business chains as we cannot import the best machinery and equipment. As a result, many companies end up specializing, even if only temporarily, in sectors they are not good at," he laments. To illustrate the effects on resource allocation, in Latin America, reallocation of capital and labor would raise the TFP of industry by 60% and in Mexico by 100%. Cavalcanti estimates that in Brazil elimination of allocation distortions could raise TFP by 49%.

Poor school performance undermines future labor productivity

Young people below the basic level of proficiency in PISA 2012 (%)



Source: OECD.

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IDB's study *Rethinking Productive Development* (2014) offers policy recommendations to correct this situation. It also makes the point that every economic problem does not necessarily require prompt government intervention or establishing a new policy for the productive sector. For example, if a country's financial market is undeveloped, that does not necessarily call for creation of a public bank; instead, the government should look into what is preventing development of the financial sector. The IDB study also suggests improving the capacity of institutions that carry out policy; lack of capacity in public institutions may be contributing to the failure of public policies. In Cavalcanti's opinions, "In Brazil, we need tax reform, better regulation, stable rules, and economic liberalization. There is no other way."



South Korea's example

If Brazilian workers had the same average schooling rates as South Korea's, they would be 40% more productive.

Seoul, South Korea.
Photo: Qingqing/Shutterstock.com

with high productivity and education, but they employ only 1% of the workforce, while commerce employs 17%."

Cavalcanti estimates that if Brazil's services sector was comparable to South Korea's, Brazil's income relative to the U.S. would go up from 20% to 40%. If Brazilian workers had the same average schooling rates as South Korea's, they would be 40% more productive. If in 1960–2009 Brazil had had the same educational policies as South Korea, the country would have grown 60% more, and the labor force would have been 70% more skilled than today.

Education issue

Another major factor in low productivity is poor education: Education alone is responsible for 30% of the income gap between Brazil and the U.S. South Korean workers' earn six times more than Brazilian workers thanks largely to education. "The fact is that South Koreans work in services with high-added value; most Brazilians are unskilled and work in unproductive activities," Cavalcanti says. IBRE researcher Fernando Veloso points out that in commerce only 9.5% of Brazilian workers are highly qualified compared with 52.8% in South Korea, noting that "Brazil does have sectors

To reach South Korea's standard will take decades of planning and effort. Even before the end of the Japanese occupation in 1945, the South Korean president instituted mandatory basic education. Education was also part of the industrial policies in government five-year plans, which helped to match industry's needs for skilled workers with the appropriate education and training of students. The private sector finances a large part of South Korea's educational spending, which was 7.6% of GDP in 2010. "In Brazil, education is still completely dissociated from

economic growth. We should reconsider this," Veloso says.

Veloso explains that, because it employs 62% of the workforce, the service sector virtually determines the productivity of the whole economy. The World Bank Enterprise Survey shows that in Brazil industry's main concern today is the tax burden, but the main concerns of the services sector are a shortage of skilled workers and a lack of labor market flexibility. Allowing companies to outsource more core business would make the labor

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Brazil's productivity has declined across most sectors in recent years.

		Industry				
Period	Agriculture	Mining	Manufacturing	Construction	Utilities	Total
1995-2002	5.7%	7.9%	-2.6%	-2.5%	3.6%	-2.1%
2002-2008	4.1%	1.8%	0.0%	-1.5%	1.9%	-0.2%
2003-2009	3.2%	1.4%	-1.2%	-0.3%	1.7%	-0.7%
2011-2013	7.1%	-5.6%	1.0%	-0.9%	0.3%	-0.5%
2012-2013	5.8%	-4.5%	-0.5%	-2.0%	-2.6%	-2.0%

	Services							
Period	Commerce	Transport, storage and postal services	IT services	Financial intermediation and insurance	Other services	Real estate	Public education and health	Total
1995-2002	-2.4%	-1.3%	-3.1%	-0.4%	-1.1%	-5.5%	0.6%	-0.5%
2002-2008	2.1%	0.2%	-3.9%	4.1%	0.2%	0.1%	-0.5%	0.9%
2003-2009	1.1%	0.1%	-2.7%	5.0%	0.1%	-0.4%	-0.3%	0.7%
2011-2013	1.4%	-0.9%	7.7%	-1.0%	2.0%	-0.4%	-2.2%	1.1%
2012-2013	1.6%	0.7%	7.9%	-2.0%	1.3%	1.9%	-2.6%	1.1%

Source: IBRE.

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market more flexible for the services sector immediately; however, training workers and improving their productivity is likely to take much longer. Veloso says, "At least half of our young people are below the basic level of proficiency in reading, math and sciences, according to the OECD Program for International Student Assessment (PISA) 2012."

The productivity gains of the last decade have had little to do with education. From 2007 to 2010, the main productivity gains were in commerce, intermediation, other services, and construction. From 2011 on, there was only stagnation and decline. Veloso explains that "The timing of productivity gains was due partly to the catchup effect after the recession in 2009–10, but also due to the boom in external terms of trade, which paved the way to credit market growth." He explains that during 2007-2010 productivity gains in services was large, and welfare increased a lot, reducing income inequality.

Since 2011, however, labor costs in sectors like construction have soared, because wages increased significantly more than productivity. Veloso points out that the Brazilian service sector employs less skilled workers, and as the demand for such workers had increased, raising wages. It is only recently, however, that this imbalance began to affect business costs. As a result, sectors like construction and commerce have seen the most layoffs.

Matos is concerned about how to address productivity losses during periods of economic downturn. She believes Brazil must go through a very steep slowdown to make the necessary correction, and in that context measures to make hiring more flexible become more relevant. Protecting workers too much may increase unemployment still more.

Veloso believes there is no short-term solution for education, but there are some measures that could help to mitigate the current negative situation. He suggests that Brazil should encourage professional training and qualification and stimulate sectors more connected with industry. "As industry benefits most from absorption of technology, it could have positive spillover effects on the services sector, generating productivity gains," he says. "Canada and Australia are service economies but connected to the mining industry and dependent on natural resources." He warns, however, that Brazil should not postpone a serious effort to improve education because ultimately that would compromise its potential growth.