Public Finance
A simpler tax system

Economic Policy
A conversation with
Dani Rodrik

Interview
Renato Alves Vale
President of CCR Group



THE BRAZILIAN ECONOMY

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Unemployment: How much longer?

The current distressed labor market is likely to take a long time to improve

FGV IBRE

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THE BRAZILIAN ECONOMY

Economy, politics, and policy issues

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THE BRAZILIAN ECONOMY

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Cover Story

8 Unemployment: How much longer?



Employment has begun to reflect the recession more intensely; the immediate question now is how much higher it will climb. But experience has shown that employment will be the last variable to react positively when economic activity recovers, because at first there are simply not enough new jobs to absorb the number of people looking for work. Chico Santos consults the experts to find out what factors contribute to unemployment in the first place and what it will take to reverse the current depressing trends.

Economic Policy

18 Conversation with Dani Rodrik

Harvard Professor Dani Rodrik, an expert on globalization, sat down with several IBRE staff members to discuss his opinions about how Brazil is dealing with such global concerns as productivity, industrial competitiveness, the exchange rate, and the trade. He also talks about the role of the WTO and what he thinks are the most overrated and most underrated areas for reform.

Public Finance

20 "A simpler tax system, more legal certainty, and more growth"

Recognizing the daunting complexity of Brazil's sales tax system, the Tax Citizenship Center (CCIF), led by director and economist Bernard Appy, has come up with a program to replace the numerous programs with just two new value-added taxes (VATs), one federal and the other subnational. The proposal is modeled on that of New Zealand, which is considered to have the world's most productive VAT. Appy explains to Solange Monteiro what the program entails, why it should be phased in over time, and where resistance is most likely to come from.

Interview

23 "Restore confidence and respect contracts"



One of the most successful concessionaires in Brazil is the CCR group, which manages highways that carried 400 million vehicles in 2015 as well as airports. Renato Alves Vale, president since CCR was founded in 1998, says that although Brazil's concession program is in principle good, a major problem is that, as in Brazil, "Where a government does not respect contracts, investors prefer not to invest, or require higher rates of return." In his conversation with Solange Monteiro he also discusses CCR's ambitious expansion plans in the U.S. and elsewhere in South America.

Editors' Note

The unemployment rate in May, 11.2%, was the same as in April. It represents 11.4 million people without work, 3.4 million more than in the same quarter a year earlier. This is the highest unemployment rate since 2012. Average worker income adjusted by inflation fell 2.7% in the same period. The labor situation is without a doubt the cruelest face of Brazil's current recession. There has been a feeble recovery of industry and confidence indicators, but even if the economy has started recovering—as some analysts believe—there is consensus that the labor market will not respond with the same speed and intensity. Today, unlike 2014 and part of 2015, the labor market is stagnating as businesses wait for firmer signs of economic recovery before they hire workers. IBRE staff estimates that even as the economy recovers, average unemployment will still rise to 13% by the end of 2017.

Meanwhile, ascending inflation is still haunting households and businesses. Although the government insists that it is feasible to meet the 4.5% inflation target by next year, there are many obstacles that must be hurdled. The highest, undoubtedly, is the sorry state of public finances. Even given the trajectory of inflation today, the central bank is not expected to start cutting interest rates until the country's finances are in better shape. However, recent increases in public employee salaries, federal government debt relief to states, emergency assistance to Rio de Janeiro state, and topping up cash transfers to the poor through the Family Grant that are far above inflation (just to mention the main measures) are sure to make the public finance problem worse. Analysts are betting that the central bank will not start cutting interest rates until the end of this year. Although the markets are forecasting inflation between 7% and 7.5% for 2016, estimates for 2017 are very unclear because of the uncertainty of the political situation and how the investigations of corruption at state-controlled Petrobras are unfolding.



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POLITICS

Temer linked to Petrobras scandal

Brazil's interim President Michel Temer has been linked to one of the country's biggest corruption scandals by Sergio Machado, former chief executive of state oil company Petrobras, who said that Temer had asked for money from the company to fund his political campaign and those of other members of his party. Temer has denied all involvement in the Petrobras scheme, a sweeping scandal in which contractors overbilled the company by some US$2 billion.. (June 16)



Photo: Valter Campanato/Agencia Brasil.

Interim President Michel Temer has faced many challenges in his first month.

Third minister leaves government

After just 35 days in charge, the interim president has lost a third minister to accusations of corruption, Minister for Tourism Henrique Eduardo Alves. Last month Romero Jucá (Planning) and Fabiano Silveira (Transparency) were forced to resign after a leaked audio implicated them in attempted obstruction of justice. (June 17)

Former Rousseff minister arrested

Paulo Bernardo, former telecommunications minister in the Rousseff administration, has been arrested in connection with an alleged US$30 million paid in bribes of public officials, authorities said. Police also searched the São Paulo headquarters of Rousseff's Workers Party during a series of raids across five Brazilian states. (June 24)

Impeachment vote

Impeachment vote against Rousseff will take place after August 25, said Senate President Renan Calheiros. So far 38 Senators have declared they will vote for her removal; 54 votes are necessary to approve the impeachment. The impeachment charges Rousseff with using accounting tricks to hide the budget deficit when she ran for re-election in 2014. (July 1)

ECONOMY

Six-month US$23.6 billion trade surplus

Brazilian exports exceeded imports by US$23.6 billion in the first half of the year. Sales were strong not only for commodities but in Latin America also for vehicles according to the Ministry of Industry, Trade and Services. (July 5)

Unemployment still at a peak

The unemployment rate remained at a record 11.2% at the end of May, statistics agency IBGE reported, with 11.4 million people officially out of work. A year ago, the jobless rate was 8.1%. (June 29)

Industrial output plateaus

After two months of modest growth, Brazil's industrial output in May was unchanged as a pick-up in automobile production offset a decline in food processing and oil refining. Compared with a year ago production was down 7.8%, according to IBGE. (July 1)

Inflation eases

Consumer prices, as measured by the official price index, rose 8.84% in the 12 months through June, easing from 9.32% in May. Prices rose 0.35% in June, down from 0.78% in May. A smaller increase in food prices, falling airfares, and the recent strengthening of the Brazilian currency probably helped. (July 8)

ECONOMIC POLICY

Long-term government spending cap announced

Brazil's interim President Michel Temer is proposing a public spending cap of up to 20 years, signaling a victory for economic hardliners in his cabinet, led by Finance Minister Henrique Meirelles, after another political faction pushed for a shorter period. The government posted a fiscal deficit of more than 10% of GDP last year because of spending overruns and declining tax revenues as the economy slid into the worst recession in decades. (June 15)

Monetary Policy Committee: no room for a rate cut

The minutes of the central bank's June 8 meeting, which left its policy rate unchanged at 14.25% in a unanimous decision, shows that the monetary policy committee sees no room for an interest rate cut. The minutes reiterate that policy will be set to guide inflation within the target band, below 6.5% by the end of 2016 and down to the median of 4.5% by the end of 2017. Although the views expressed in the minutes do not necessarily reflect those of the new board, the new governor, Ilan Goldfajn, who did not participate in the meeting, also believes that bringing inflation down is critical for economic stability. (June 17)

Debt relief for state debts announced

Brazilian states will get a six-month grace period on paying back what they owe to the federal government, followed by a year and a half of reduced payments, interim President Michel Temer announced. Five credit lines from national development bank BNDES will also be extended for another 10 years, he said. The debt relief should give some breathing room to debt-saddled states, especially Olympics host Rio de Janeiro, that have struggled to pay public servants and retain social programs during the recession. (June 21)



Photo: Antonio Cruz/Agencia Brasil.

Finance Minister Henrique Meirelles leads economic policy hardliners in the government.

Federal government back in deficit for May

Brazil's federal government, which covers federal ministries, the central bank, and social security benefits, posted a primary budget deficit (excluding interest payments) of R$15.494 billion (US$4.68 billion) for May, compared to a surplus of R$9.751 billion in April. (June 28)

Central Bank ups 2016 inflation projection

The Brazilian central bank acknowledged that the long fight against inflation is far from over, but sought to reassure markets that it remains firmly committed to taming price increases. The bank raised its forecast for Brazil's consumer-price index for 2016 this year from 6.6% in March's report to 6.9%, but cut its inflation forecast for 2017 from 4.9% to 4.7%. The bank's governor, Ilan Goldfajn, expressed confidence that price pressures will weaken relatively rapidly with the help, among other things, of stricter fiscal policies. (June 28)

Government lends US$895 million to Rio for Olympics

Federal government disbursed US$895 million to cover Olympic games security to the state of Rio de Janeiro, which has declared a state of fiscal emergency just weeks ahead of the global sporting event. The emergency loan is an effort to guarantee the safety of half a million foreign visitors in the midst of Rio's worst crisis in decades. (June 30)

Government announces budget deficit of R$143 billion in 2017

Finance Minister Henrique Meirelles announced that the government will target a 2017 primary budget deficit of R$139 billion, notably lower than the R$170.5 billion target for 2016. He highlighted that the target is a big effort and represents a break with the past sharp growth in the public deficit and expending. (July 8)

DICOM

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Unemployment: How much longer?

The current distressed labor market is likely to take a long time to improve and is hitting the young most.

Chico Santos

THE SECOND HALF OF 2014 was confusing: the economy showed clear signs of slowing down but the labor market showed few signs that the recession might have been deepening. In the fourth quarter of 2014, in fact, the unemployment rate closed at 6.5%. It is true that job creation was already starting to slack off, but the balance was still positive, although as the year ended, the 153,000 new job vacancies were just a fifth of the 731,000 jobs generated in 2013.

However, as the economic crisis deepened in the first quarter of 2015—GDP plummeted 2% over the same period a year earlier, the fourth consecutive decline—employment began to reflect the recession more intensely. Nationally unemployment jumped to 7.9%, but it reached 9.6% in the Northeast, and it kept on climbing. By the second quarter of 2016 it had reached 11.2%. That meant 11.4 million people were looking for jobs—almost 30% more than a year earlier. From January 2015 through this April Brazil lost 2 million formal jobs: industry alone shut down 663,000 jobs, services 449,000, and construction 399,000.

The question now is how much higher unemployment will climb. The debate has gained momentum as there was some

slightly good economic news. According to government statistics agency IBGE, GDP fell less than expected; it was down only 0.3% in the first quarter compared to the previous quarter, seasonally adjusted. There were also improvements in industry performance and a gradual recovery of business confidence.

The sense is that if all goes well, the economic crisis may have hit rock bottom, although that perception may not be confirmed before the end of August, when the IBGE releases its GDP estimate for the second quarter. But for those looking for jobs, the general perception is that the pains of the labor market are unlikely to be resolved for quite a long time.

Based on both current labor market numbers and past history, analysts believe that, just as the labor market took a long time to react negatively when the signs of recession were clear, employment will be the last variable to react positively when economic activity recovers. "For 2016, even if there is an improvement in economic activity, there is not much room for the labor market to improve because it tends to be more rigid during recoveries," says Bruno Ottoni, researcher at the Brazilian Institute of Economics (IBRE). Ottoni, a labor market analyst, has revised up his forecast for unemployment in the next few quarters as IBGE figures in April reflected a worsening of the labor market. His unemployment forecast for the second quarter was raised to 11.6%, up from the previous estimate of 11.1%. Average unemployment forecast for this year rose from 11.5% to 11.6%, and for 2017 from 12.7% to 13%.

As the economic crisis deepened in the first quarter of 2015—GDP plummeted 2% over the same period a year earlier, the fourth consecutive decline—employment began to reflect the recession more intensely. Nationally unemployment jumped to 7.9%, but it reached 9.6% in the Northeast, and it kept on climbing.

The pessimism is largely associated with a characteristic of labor markets during recovery: even when more people become employed, this happens more slowly than the number who actually wants to work—the labor force is in fact the sum of those who have work and those who are looking for work.

IBRE projects that this year the number of Brazilians employed will decrease compared with 2015 by 1.6%, to 90.6 million people, but the labor force will grow 1.9%, reaching 102.6 million. In 2017 the number of those employed will grow by only 0.48%, to 91.1 million, but the labor force will grow by 2.1%, to 104.7 million. IBRE also sees a decline of 2% in of labor income adjusted for inflation this year, although in 2017 it will recover slightly, by 0.6%.

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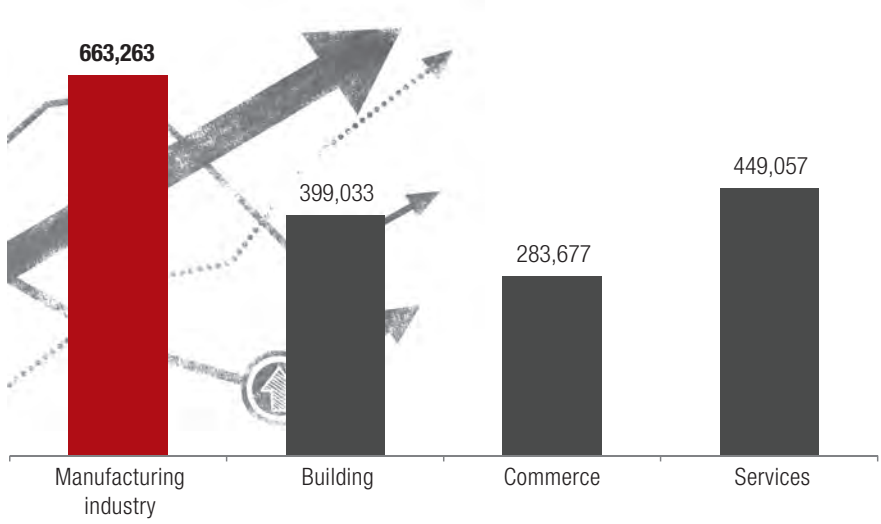
Trend reversal

Ottoni explains that labor force growth above employment reflects the reversal of a phenomenon that occurred during the boom phase of the economy, when women and youth left the labor market. During the boom, the income of husbands and fathers allowed women to look after the household and young people to devote themselves exclusively to study. As those women and youth return to the labor force, they increase unemployment.

There has also been an increase in self-employed persons. As employed workers fell by 8.6% in the first quarter of 2016, self-employed workers rose 6.5% to 2.6 million. The increase in self-employed workers prevented an even greater reduction in the labor force, although it still declined by 1.5%.

IBRE researcher Fernando de Holanda Barbosa Filho explains that self-employment is associated with a first phase of a labor market crisis when workers who lose formal jobs use severance payments to try to launch a business. This phase, he believes, cooled by April, when IBGE reported that total self-employed declined from 23.2 million in the quarter ending in March to 22.9 million in the quarter ending in May. When self-employment shows signs of exhaustion, he says, families seek options they previously avoided, such as being household help. In the first quarter of 2016, employment as maids went

Brazil's employed population declined by nearly 2 million in one year. Industry employment fell by 663,000.



Source: IBGE.

up 3.4% over the same period last year, to 6.2 million workers.

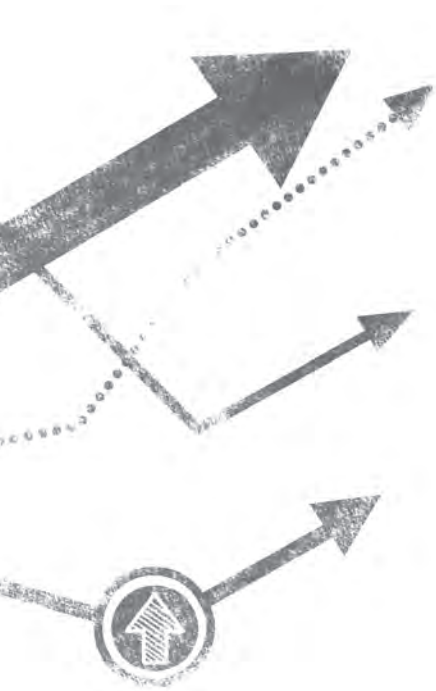
Barbosa Filho explains that unemployment trailed the fall in economic activity because initially companies tried to avoid severance payments and loss of skilled labor, but it also varied by sector. He pointed out that the crisis hit the industry first, which "employs relatively few and had been cutting jobs for a long time." In contrast, the labor-intensive service sector, took longer to slow down. He believes that in the next few weeks, as work in Rio de Janeiro related to the 2016 Olympic Games is completed, layoffs will speed up in the construction sector.

Barbosa Filho also thinks that, although informal work is expected to increase soon, the situation is more cyclical than structural and so informality is not likely to be as much as in the past. Research by Barbosa Filho and IBRE's Fernado Veloso has found that informal employment in Brazil increased slightly in the 1990s, measured by number of workers without a formal contract or self-employed, but plunged between 2002 and 2013, when the share of informal workers in the employed population

Self-employment is associated with the first phase of a labor market crisis when workers who lose formal jobs use severance payments to try to launch a business.

IBRE projects Brazil's unemployment at 13% and workers' income growth of 0.6% in 2017

Change (%) same quarter a year earlier



	Worker's income adjusted by inflation, R$	Change, %	Unemployment
1st Quarter 2016	1,974	-3.2	10.9
2nd Quarter 2016	1,989	-2.0	11.6
3rd Quarter 2016	1,969	-1.8	11.8
4th Quarter 2016	1,947	-1.1	12.3
Average 2016	1,970	-2.0	11.6
1st Quarter 2017	1,971	-0.2	13.0
2nd Quarter 2017	1,995	-0.3	13.1
3rd Quarter 2017	1,986	0.8	12.9
4th Quarter 2017	1,973	1.3	13.1
Average 2017	1,981	0.6	13.0

Source: IBRE.

The factors that contributed to the fall of informal work—increased education and the adoption of electronic invoicing—are still present, making a permanent increase in informal employment unlikely. But … the employment outlook in the short and medium term is very discouraging.

dropped from 43.7% to 31.1% and the self-employed from 22.4% to 20.3%.

Barbosa Filho explains that the factors that contributed to the fall of informal work—increased education and the adoption of electronic invoicing—are still present, making a permanent increase in informal employment unlikely. But he agrees that the employment outlook in the short and medium term is very discouraging.

Social security contributions holding

IBGE coordinator of employment and income statistics Cimar Azeredo has said that despite the job losses, the loss of workers paying into social security was much lower than expected in the first quarter of 2016 compared with a year earlier. Although non-contributing workers dropped from 32.3 million to 31.1 million (3.7% fall), the number of contributors fell marginally from 59.7 million to 59.5 million (0.3% decline). "Workers are better informed about the need to keep contributing to social security, so the situation is less bad than it could have been," Azeredo said. He notes that leading up to the current crisis, the labor market had become much more formalized, so when the crisis hit and people lost jobs, they had savings and severance payments to open up businesses. Although 1.5 million people lost their formal work contracts between the first quarter of 2015 and the first of 2016, those people did not leave the workforce immediately.

"The news of the crisis is bigger than the crisis itself and while the news is in the air people will keep their foot on the brake," says Azeredo. What concerns him is that the search to recover the lost formal work stability "is increasing demand for jobs and the supply of jobs is not rising, which is pushing up unemployment." However, he explains, self-employed and informal work in general generates less labor income. Households are forced to reduce spending, consumption falls, and the crisis deepens.

Workforce participation

Economist Naércio Menezes Filho, professor at the University of São Paulo (USP) and coordinator of the Public Policy Center of the Institute of Education and Research (Insper), has looked into the recent development of workforce participation in the labor market using IBGE data. Comparing the first quarters of each year since 2012, for this year compared to the same period a year earlier he found higher participation by 0.4 percentage

point after a period of stability or slight decline. His study also confirms a downward trend in older people participating, from 9.1% in the first quarter of 2012 to 7.5% this year.

After a period of decline in the participation of young people (aged 14–24), their participation has increased in the last 12 months. In the first quarter of 2012, 51.8% of young people were working or seeking employment, but their participation declined steadily to 49.2% in 2015 before heading back up to 50.2% in the first quarter of 2016.

Menezes points out that the reason for the surge in unemployment among young people is that there were not enough new jobs for all those looking for work. First quarter unemployment of young people rose from 16.8% in 2014 to 26.4% this year. Meanwhile, unemployment of adults went up less dramatically from 5% in 2014 to 7.6% this year, though among the elderly the rate doubled in a year, from 0.8% to 1.6%.

The fall of 3.6% in the average salary in the last 12 months (R$1,986 to R$1,914), Menezes says, affected comparatively more young workers, who lost 6.2% in the same period (R$1,069 to R$1,003).

Menezes says that the return of young people to the labor market is pushing overall unemployment up after 25 years of decline because their participation had been falling progressively, from 30% in 1992 to 17% now, although female participation went up from 28% to about 36% in the same period.

Leading up to the current crisis, the labor market had become much more formalized, so when the crisis hit and people lost jobs, they had savings and severance payments to open up businesses.



The end of works related to the Olympic Games can raise unemployment in the city of Rio de Janeiro, which was **6.7%** in the first quarter of this year, the second lowest among the capitals of the states, second only to the **5.9%** in Florianopolis.

With GDP falling again this year by 3% to 4% (it was down 3.8% in 2015) and incomes also falling, more young people will be returning to the labor market out of necessity, pushing unemployment even higher.

Because the young are inexperienced, even in good times it takes longer for them to get a job, Menezes says, so when their share in the labor market share rises, so does unemployment. What concerns him more is the jump in the unemployment of adults 25 and older. "This is worrying because the adult is the home provider and loss of that job can lead to poverty," he says. However, Menezes believes, the situation will not be worse than in the 1990s because currently there are cash transfer programs such as Family Grant.

Like other labor market experts, Menezes understands that "the outlook is not good." He believes that, with GDP falling again this year by 3% to 4% (it was down 3.8% in 2015) and incomes also falling, more young people will be returning to the labor market out of necessity, pushing unemployment even higher. Even as growth resumes, he does not see employment improving until the second half of 2017.

Researcher Sandro Sacchet de Carvalho of the Institute of Applied Economic Research (IPEA), points out that the fall in income affects more dramatically those who earn less than the minimum wage, with a loss of about 10%. He too expects that the increase in unemployment will be larger the greater the population looking for work. According to his IPEA colleague José Ronaldo de Castro Souza Júnior, the labor market will improve only when businesspersons have more confidence in the economic outlook and resume investing. "The economy has now



Unemployment grows more among the young and less educated

Unemployment (%) in the first quarter of each year by age group and educational level

	Total	Young	Adult	Elderly	Incomplete basic education	Basic education (1st to 8th grades)	High school	College
2012	7.9	18	5.5	1.3	6,5	10.6	9.4	4.3
2013	8.0	17.9	5.6	1.1	6.8	10.3	9.3	4.5
2014	7.2	16,8	5.0	1.1	6.0	9.5	8.3	4.1
2015	7.9	19	5.6	0.8	6.5	10.5	9.4	4.6
2016	10.9	26.4	7.6	1.6	9.1	15.0	12.8	5.9

Young: 14 to 24 years. Source: IBGE.

fallen more than in the 1980s, the so-called lost decade," he says, underscoring how that "The young are entering the labor market with no experience and can only work when demand for hiring is very large," which is not the case.

Chronic unemployment

A survey by the Inter-Union Department of Statistics and Socioeconomic Studies (Dieese) has found a significant increase in the time it takes to get a job in four major cities, Fortaleza, Porto Alegre, Salvador, and São Paulo. It found that the share of unemployed who take more than five months to find a new job jumped from 34.5% to 39.4% in Fortaleza; in metropolitan Porto Alegre, the jump was even greater, from 32.8% to 46.4%. In Salvador, Brazil's capital of unemployment at 18.4% for the metropolitan area, the long-term unemployed jumped from an already stratospheric 57.9% to 67.1%.

Dieese economist Lúcia Garcia believes the findings suggest that in Brazil unemployment is becoming chronic. She points out that the loss of employment "is hitting the core of the workforce"—breadwinners and skilled workers. Although she acknowledges that industrial activity has "stopped worsening," she notes that employment in commerce and services is still being affected by the deep fall in industrial activity.

A survey by the Inter-Union Department of Statistics and Socioeconomic Studies has found a significant increase in the time it takes to get a job in four major cities, Fortaleza, Porto Alegre, Salvador, and São Paulo.

"Trade unions are very concerned," Garcia says, adding that the fiscal policy proposed by



Bahia's capital, Salvador, has the highest unemployment in the country. In the metropolitan area, unemployment grew from **14.6%** in the fourth quarter of 2015 to **18.4%** in the first quarter this year. In the city, the increase was even higher, from **13%** to **17.4%** in the same period.

The labor market will improve only when businesspersons have more confidence in the economic outlook and resume investing.

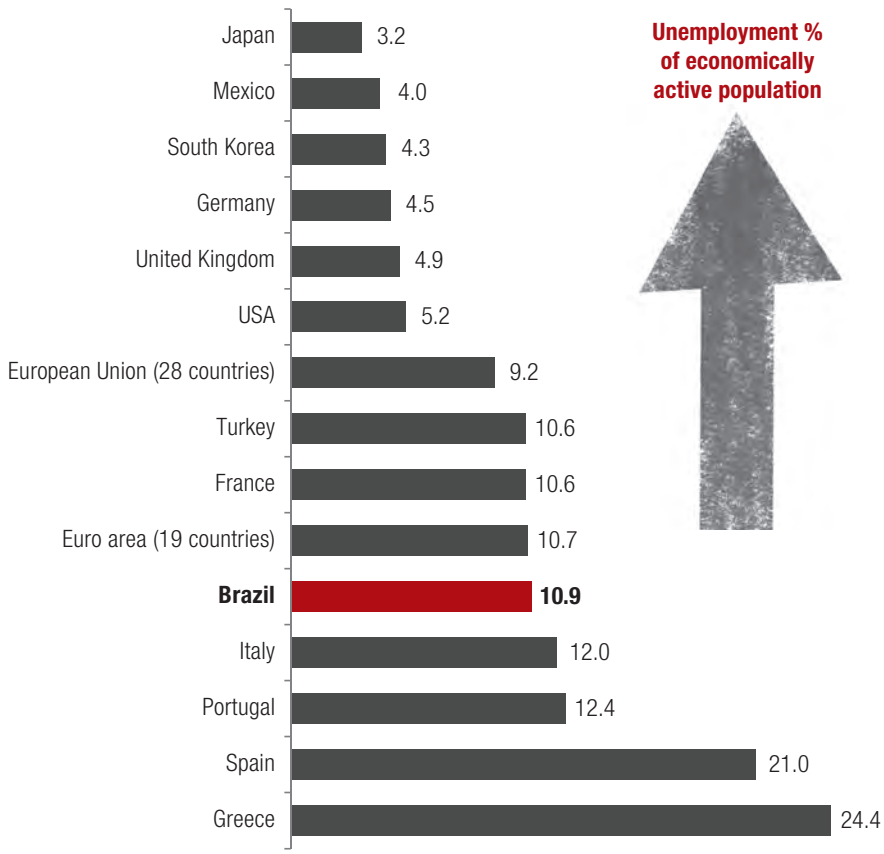
Acting President Michel Temer could bring the country into a situation similar to that of the front-runners in Western unemployment, Spain with a rate of 21% and Greece at 24.4%.

Guilherme Mercês, chief economist for the Federation of Industries of Rio de Janeiro State (FIRJAN), believes the best way for recovering employment, or at least mitigating the effects on it of the recession, is to liberalize the labor market. FIRJAN argues for more flexibility in relations between workers and companies. Mercês calls for free negotiation of labor contracts, which he says, would open the possibility of differentiated working conditions, such as alternatives to the eight-hour working day.

Mercês would also like to see a law allowing the outsourcing of any activity and a more flexible minimum wage rule that permits paying less when the economy is doing badly and paying more when it goes well. He believes that "flexibility in labor contracts and outsourcing would be a huge gain in terms of security to invest," and consequently increase employment.

Unemployment in Brazil reaches the high levels of European countries

Selected countries, 1st semester 2016



Sources: OECD and IBGE.


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Photo: IAS



Conversation with Dani Rodrik

Professor of International Political Economy at the John F. Kennedy School of Government at Harvard University

Since he first criticized the globalization process in *Has Globalization Gone Too Far?* (1997), the scholarly work of Turkish economist Dani Rodrik is among the studies most cited when issues like economic integration, trade, and development are discussed. In June, IBRE researchers[1] talked with Prof. Rodrik about such issues as productivity, industrial competitiveness, and trade. These are some extracts from the conversation.

In your opinion, which policies to improve productivity would be more effective in economies like Brazil, where the service sector accounts for two-thirds of employment and 70% of GDP, but education and the quality of institutions are still low?

I wish I knew of a magic recipe for this. But unlike in manufacturing, where promoting a few successful industries can propel the economy forward even if the rest of the economy is lagging in productivity, in services there is really no option other than a broad-based accumulation of fundamental capabilities. This is because most services are generally non-traded across the borders (no foreign competition) and cannot greatly expand without an increase in domestic incomes, which in turn requires productivity growth in other services. So the recipe for services is the boring, orthodox recipe of investment in education, institutions, and infrastructure—and these all take time to deliver returns.

There may be some traded services that are not particularly skilled and have the capacity to absorb lots of labor. Tourism is the classic example, and it is one that requires the tools of industrial policy, coordination and support. But there are not many others that I can think of.

Considering that improving education and institutional quality is a long process, what can be done to raise productivity in the short and medium term? Are there any institutional changes that could increase services activity and productivity faster?

The general tools of growth diagnostics can be helpful in identifying priorities: First, which services have the capacity to increase productivity without shedding too many workers? Second, regulatory or other reforms are likely to make the biggest bang in terms of growing those sectors. In some countries, the tax burden on formal labor is very high, which may deter the growth of more productive, formal-sector firms. In those cases, shifting the burden of taxation elsewhere would be important. In other places, services productivity may be hindered by restrictions on foreign investment (e.g. retail). Again, I don't think there is a general recipe here.

[1]Fernando Veloso, Maurício Canêdo Pinheiro, Silvia Matos, Braulio Borges, and Lia Valls.

Every country has to do its own work to identify the binding constraints.

You have pointed to the importance of structural change, and the growth of industry's role, in improving the competitiveness of emerging economies. Brazil has some diversity in its industry but with huge difficulties in becoming more productive. What do you think about Brazil's industrial policy initiatives and which kind of policies could be most efficient in countries like ours?

Brazil has a long history of industrial policy and, unlike many other countries in Latin America, never really abandoned it. Some of it has been successful, some less so. I believe experimentation and trying new things is crucial. So it is monitoring and evaluation to figure out what is not working so programs can be reformed. Probably the greatest weakness in Brazil is that I am not sure there is much of this kind of monitoring and evaluation.

It is important to understand that the success of industrial policy depends on the success of a portfolio of activities. There is no need for every single project to succeed. But there is also no need to continue with programs that are not working. The only way to know the difference is to build evaluation into program design.

In general, the exchange rate is a major factor in the competitiveness of industry. In countries like Brazil, which has a low level of savings, how is it possible to ensure that the exchange rate is competitive without interventions?

The real exchange rate is determined in macroeconomic equilibrium. A more competitive real exchange rate, with everything else the same, requires more saving, less investment, or both. The government can always take the lead by reducing its deficit and also by encouraging private-sector savings.

Which reforms do you think really work and which ones do you think are overrated by markets and economists?

I tend not to make broad generalizations. But financial globalization was probably the most over-rated policy of the last quarter century. The most under-rated is probably public investment in infrastructure—which, however, is coming back.

Financial globalization was probably the most over-rated policy of the last quarter century. The most under-rated is probably public investment in infrastructure—which, however, is coming back.

What role do you envisage for the World Trade Organization (WTO), given the difficulties of advancing negotiations in the multilateral arena?

Which WTO? Does it still exist? (Just kidding.) I think a serious rethink is needed to move international trade negotiations back on to the multilateral WTO fora. As I have argued, that requires that we move trade negotiations from a "market-exchange" mindset to an "exchange of policy space" mindset. In other words, the WTO has to come to grips with the idea that the primary problem in world trade today is not lack of openness but the political backlash against the openness that already exists. We cannot safeguard the latter without carving out space for both developed and developing countries to pursue their own social and developmental agendas.

What do you think are the chances that the US Congress will approve the Trans-Pacific Partnership this year?

This year, virtually nil. It won't happen in an election year.

What are the main US domestic sectors that support the Transatlantic Trade and Investment Partnership?

I would say the business sector in general and the policy elites are mostly in favor.

"A simpler tax system, more legal certainty, and more growth"

A proposed reform calls for replacing Brazil's complex sales tax system with just a federal and a subnational VAT.

Solange Monteiro



THE COMPLEXITY OF THE CURRENT Brazilian sales tax system, which involves numerous special rules, incentives, and tax rates, makes it very difficult to improve its efficiency in any way other than scrapping it altogether. In June, the Tax Citizenship Center (CCIF), led by director and economist Bernard Appy, completed a proposal that does exactly that: instead of reforming taxes that already exist, replace them with just two new value-added taxes (VATs), one federal and the other subnational. The model was inspired by the best VAT practice of 160 countries, especially New Zealand, which has what is considered the world's most productive VAT, Appy says.

The proposed legislation replaces the federal Social Integration Program (PIS) and the social security financing tax on revenue (Cofins) with a general contribution on consumption (GCC),

and replaces the state tax on circulation goods and services (ICMS) and the tax on services (ISS) with a general consumption tax (GCT). The change would take place gradually, at first phasing in the GCC over two years. During this period, the new contribution would have a rate of 1%, and the PIS/Cofins rates would be reduced gradually so that the transition would be neutral in terms of the total tax burden. After this period, there would be a phased introduction of both GCC and GCT taxes over a period of 10 years and gradual elimination of all current sale taxes. "Today we have many built-in tax incentives, and it will take time for companies to adjust to the new system," Appy says, underscoring the need for states to negotiate possible losses of tax revenues. As the GCT would be fully charged in the destination state, it is necessary to compensate states that would eventually lose revenue, which, Appy says, will require new regional development instruments. He explains that though compensation to the states would be temporary, the transition would be long, extending for several decades.

The proposal provides autonomy for each state to set its tax rates as long as they are consistent and within predetermined limits. Municipalities, in addition to receiving a portion of the GCT revenue, would be allowed to introduce an additional tax on retail sales. With the extinction of current contributions and taxes, the reform proposal would eliminate differentiated treatment of sectors—only financial intermediation would continue to be exempt from VAT. "For operational reasons, in the entire world there is no VAT on financial intermediation because it is difficult to include interest in the credit and debit required for VAT calculation," Appy explains. The reform, Appy underscores, would open the way for a general clean-up of all the distortions caused by excessive special regimes and the cumulative incidence of taxes—it would both simplify the current tax system and ensure the same tax revenue as currently.

"For operational reasons, in the whole world there is no VAT on financial intermediation because it is difficult to include interest in the credit and debit required for VAT calculation"

"There will be some sectors that will pay more, others less," he says, so that one result will be a sectoral redistribution of the tax burden, "but all companies will save on tax compliance costs and management of tax disputes; the outcome for the country will be extremely positive as it will bring about an increase in investment and a significant improvement in productivity. This is a long-term gain." The main point, Appy says, is to focus on taxing consumption, applying the same tax rate regardless of how production is organized. "The company is the agent responsible for collecting the tax, and the tax paid by consumers will be exactly what will be collected along the production chain," he explains.

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Eliminating inefficiencies

The CCIF proposal explains the characteristics of the new taxes in detail. First, exports and investments are totally exempt from consumption taxes. "We propose that the accumulated tax credits be refunded within 60 days," said Appy, noting that today the state and federal tax authorities make it very difficult for businesses to get back tax refunds. The proposal also expands tax refunds to all purchases involving business activity; today refunds are limited to purchases of goods and services that are incorporated or consumed in the manufacturing process, as well as inputs and electricity. "For this we suggest using the same approach as the corporate income tax—whatever can be deducted as an expense in the income tax would accrue as a tax credit for the GCC and GCT," he says. That would significantly reduce the cost of tax compliance. Moreover, he explains, the persistence of the cumulative incidence of tax induces an artificial vertical integration of production, since the more value is added to the product the less tax is paid by the company. That generates severe inefficiencies.

The CCIF proposes to extend the GCC and GCT to agricultural activities, giving small farmers the choice to register as a taxpayer or not, depending on their interest in taking advantage of the tax credit. The same choice would be allowed for those included in the simplified tax regimes—Simple and Micro Entrepreneur Individual—who may choose to remain in the current system or register as payers of the new VAT taxes. Appy believes that "The new VAT system would matter most for companies in the middle of the production chain."

Appy recognizes that it will be difficult to carry out the CCIF tax reform proposal, especially in addressing state concerns of loss of tax revenues and the resistance of sectors that would pay more taxes or lose tax benefits. But he considers it to be the only possible way to achieve substantial changes in the tax system, reduce the cost of tax compliance, and reduce the inefficiencies resulting from tax distortions. "The project may face some resistance, but it would cause a significant change in the business environment in the country and promote productivity and investment. It would bring about a simpler tax system, more legal certainty and more growth," he concludes.

Photo: CCR



"Restore confidence and respect contracts"

Renato Alves Vale

President of the CCR Group

Solange Monteiro

THE CCR GROUP, operator of Brazil's most coveted highway concessions, which carried 400 million vehicles in 2015, now wants to expand its airport operations. It already manages the Confins airport in Minas Gerais state and others and is moving into the U.S. market. Renato Alves Vale, president since CCR was founded in 1998, says that although Brazil's concession program is good, it suffers from a lack of government respect for contracts. "Where a government does not respect contracts, investors prefer not to invest, or require higher rates of return," he says. Vale, an engineer who graduated from the Federal University of Minas Gerais, believes that the success of new concessions—with which the Finance Minister Henrique Meirelles aims to raise up to US$9 billion in 2017—depends critically on a better business environment, which in turn depends on good government management of contracts. "The lack of confidence that we are experiencing throughout Brazil must be overcome," he says.

The Investment Partnerships Program (PPI) is expected to find it difficult to attract investment because of the economy. What you consider important for the program to succeed?

The consensus, even in the previous Rousseff government, is that increasing investment in infrastructure requires partnerships with the private sector. What is missing in order for public private partnerships [PPPs] to take off is detailed execution plans of infrastructure projects, as Moreira Franco, Executive Secretary of the PPI has noted. Many investments in infrastructure have been launched in the past that were little more than a wish. We did not have the

Many investments in infrastructure have been launched in the past that were little more than a wish. We did not have the studies to show that the investment was viable.

studies to show that the investment was viable. It was mainly based on ideas and queries by the ministries themselves to potential investors about their interest in a particular area. There is a need for long-term planning with feasibility studies and executive projects, so that we can properly assess whether the investment makes sense. Moreira Franco has said the PPI intends to accelerate project studies. That will take one to two years, but from there we will have a project portfolio that will allow us to make decisions in the best way possible.

The second point that it is critically important is to have a stable business environment. There is a regulatory framework to ensure legal certainty that has been tested and it works. What we do not have is predictable behavior among participants of the contract. Sometimes you have a contract, and there occur changes that directly nullify that contract.

Can you give an example?

Two years ago there was a strike of truck drivers, who asked for the end of the highway toll based on number of truck axles. The federal government ended the toll without assessing the impact [on the revenue of highway concessionaries]. That engenders uncertainty among those who invest. In fact, the National Transportation Agency acted very fairly. It stopped charging trucks by the number of axles, but made up the revenue loss by raising tolls for everybody. As a result, investors were not affected, but as some road users began to pay less, others paid more, which makes no sense.

Another example: sometimes when inflation was high, governments came up with arguments for not adjusting prices as the concession contracts called for. That also heightens legal uncertainty. Where a government does not comply with a contract, investors prefer not to put in their money or they ask for a higher return. This create difficulties for future infrastructure projects.

Nevertheless, I believe we are at an opportune time, and projects will go ahead. In terms of infrastructure, we have to do everything: improve roads, build railways, upgrade ports, build up power transmission lines, and construct more dams, metrorail, and airports. And the solution is public-private partnerships like PPP or concession contracts.

What part of 1993 and 2012 concession programs failed, and can the PPI fix the problems?

This is characteristic of Brazilian governments: Instead of taking a program that has worked and improving it, because there are always things to improve, governments throw them away and start all over. We lose time and [the lessons from] successful experiences. The program of Brazilian concessions, in general, at least with respect to highways and airports, is successful. Today we have 54 concessionary operators and a very high number of successful concessions—the number of planned investments that failed and contract noncompliance account for less than 10%. … We have a very interesting example. The concession of the Rio-Niterói Bridge was perhaps the first in Brazil. We fulfilled the contract (initially with the Bridge consortium, which the CCR group joined in 2000, and which ended in May 2015). In 20 years

we made all the required investments. After that concession ended, a new tender was won by another group.… One might ask, are you not sad because you lost? No, I am happy because the concession framework worked. A concession was granted, the contract was fulfilled, and everything was delivered without any dispute.

CCR has begun operating airports outside Brazil. Is it consolidating a new area of operation?

CCR first started operating airports in Ecuador, Costa Rica, and Curaçao; from there we increased our stake in Ecuador, at the same airport with 50% of an airport operations company. … We then set up a company in the United States, CCR USA, a holding company to which we assign all the assets we have abroad. To enter the U.S. market, we bought a small operator (70% of Total Airport Service, TAS, in November 2015) to learn more about the airport operations market in the U.S. We intend to develop investment opportunities in airport terminal concessions in the U.S. and more generally in America.

Currently about 80% of CCR group revenue comes from highway tolls. How much is this revenue composition likely to change?

We expect that by 2020 60–65% of CCR's revenue will still come from highway concessions; the change has started.

What has been CCR's experience of operating the Confins airport in Belo Horizonte city, Minas Gerais state?

I think the Belo Horizonte airport is going very well. In November we will open the Terminal 2 on time, a year from the approval of environmental licenses, which were not our responsibility. It is a huge terminal. We will add 16 boarding points to an airport that has now 9. What did not work well? The government determined that the Brazilian Airport Infrastructure Company (Infraero) would renovate Terminal 1 for the 2014 World Cup, but it failed to do so. Infraero renovated only half of the terminal and the quality of construction was very poor. CCR invested more than R$130 million in redoing Terminal 1, which was not our obligation. Our concession contract clearly needs to be amended, and we will have to discuss this with National Civil Aviation Agency (ANAC) and the Department of Civil Aviation, so that we can resolve the Terminal 1 investment that still needs to be done, for the benefit of the users.

Sometimes when inflation was high, governments came up with arguments for not adjusting prices as the concession contracts called for. … Where a government does not comply with a contract, investors prefer not to put in their money or they ask for a higher return.

CCR has shown interest in concessions for Salvador and Fortaleza airports. What changes in the business environment do you expect if you are to realize this interest in new concessions?

It takes action. We are working on what we call the CCR understanding agenda: what needs to be addressed in Brazil, the business environment, and our business plan. And one item we consider important for Brazil is governance. At the end of the day, it comes down to this:

This is characteristic of Brazilian governments: Instead of taking a program that has worked and improving it, because there are always things to improve, governments throw them away and start all over. We lose time and [the lessons from] successful experiences.

those who are responsible for the regulatory agency or who work at the Ministry are very concerned that the Attorney General or the Court of Accounts will question their decisions being. Even though an official may be convinced that the decision is right, he feels that pressure. Then, how the government manages the business environment is under pressure. … That goes for private institutions as well. Today it is very difficult to obtain financing for investment. A private bank's credit committee has the same difficulty in approving loans, because of the bank's non-performing loans and there will be a question about who can approve the loan. The lack of confidence that we are experiencing throughout Brazil must be overcome. What will restore that confidence?

From the users' point of view, I would say our concessions program is a success. The Brasilia airport was very good, also Terminal 3 of the Guarulhos airport, and Belo Horizonte's Terminal 2 is becoming sensational. We just did a survey and found that U.S. agencies and airport operators see Brazil's concession framework as very successful. There is room for improvement, but in general the results are good.

In this sector, the CCR also has another huge project. We just acquired land in Caieiras (37 km from São Paulo city), 3,000 acres to build an airport to move 50 to 60 million passengers a year. We have the feasibility study ready, and we are working for the government to allow the airport operation. … If this happens, it will mean an investment of R$10 billion over eight years—with zero public participation and CCR taking all the risk.

Are roads out of favor with CCR?

No, there are many opportunities in highways. However, investment opportunities are moving from high-volume to lower-volume roads. The equation is always simple: If I have a lot of investment and cost, I need a lot of revenue to break even; and if there is little road traffic, the toll has to be high. An R$20 toll to go 100 kilometers in the Northeast region, where purchasing power is very low, will not work. In this case a PPP works better. Government support is not the best solution, but it is an alternative for making investments that can be development vectors. The issue the government must address is how to reassure private investors that the subsidy will be paid. The government has to focus on guaranteeing funds for these investments. Would it be better for the government to borrow money and invest in infrastructure through government agencies—which clearly have the management and governance problems I just mentioned? Does that make sense? The situation has to be studied case by case; there is no magic formula that will solve all the problems.

In 2012, concessions were stimulated by the guarantee of cheap financing through the Brazilian Development Bank (BNDES). Today,

with the fiscal situation constrained, how do you see the funding for infrastructure?

Here in the CCR, we think it is meaningless to cap the rate of return through subsidized funding. … The project itself has to generate profits. If the design is good, you can fund it through the BNDES, the World Bank, or another development institution outside Brazil. If the project is bad, cheap financing will not fix it, but that was the concession framework designed in 2012. What has happened? Well, everyone came on board, because the concession was subsidized. But now the BNDES will not finance at the agreed low-interest rates and those concessions will be very troubled or will break down.

For the past two years the Brazilian concessions market has undergone a profound crisis of confidence. This has also affected infrastructure bonds … because now concessionaires are breaking down, because BNDES did not do its part, because Brazil's fiscal imbalance was too large. Investors will ask: Should I buy an infrastructure bond from a company that may go bankrupt? No, I won't. Until we restore an environment of trust and credibility, [infrastructure bonds]] will be hard to sell.

The current fiscal framework has sparked many debates about increasing firm productivity. How has CCR addressed that?

Some economists, like Raul Velloso, say clearly that Brazil's way out of the current predicament is infrastructure and exports. Infrastructure is the only investment that can increase Brazil's productivity. If you have adequate infrastructure, agribusiness, for example, will able to export at lower costs. Within our own group, we look all the time for best practices. Because we have several companies, we seek to identify which is best in what and then try to disseminate best practices throughout all our companies.

For a company like ours that deals with service, productivity is in even the smallest things. How many cars can a cashier in the toll booth serve per minute? It takes training and setting standards. Today we have a very strong team within the company, supported by a number of consultants, working on a project called Rethink. We seek to identify what we can do better to make our company more agile and facilitate decisions to allow new investment cycles. We are preparing to grow.

Those who are responsible for the regulatory agency or who work at the Ministry are very concerned the Attorney General or the Court of Accounts will question their decisions. Even though an official may be convinced that a decision is right, he feels that pressure.

What are CCR's expectations for this year of negative economic growth?

This year we start various operations: Rio Light Rail is in pilot operation, we will begin the ViaRio [an express transport corridor] in July, Terminal 2 at Belo Horizonte airport opens in November, we are now fully operating metro line 1 in Salvador, and TAS is fully operational. We expect that though revenue will not be as good, it will be stable. But our purpose is to continue growing, with feasible investments. And for this we expect an improvement in the business environment. We must restore confidence and respect contracts. ■