Brazil

Brazil's Achievements and Challenges

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Introduction

Brazil has come a long way over the last 15 years or so. Different administrations have maintained and built on a macroeconomic framework combining inflation targeting, a flexible exchange rate and rules-based fiscal management. This policy setting has served the country well (see Table 1). It has paved the way for a gradual stabilisation of government indebtedness, which has allowed for a countercyclical response to the slowdown in activity brought about by the global crisis of 2008–09 in an environment of reasonably low and stable inflation. Structural reforms during the 1990s, not least to liberalise the country's trade and investment regimes and to make regulations in product markets and network industries more pro-competition, have yielded important productivity gains and alleviated several structural impediments to faster growth. Good policies have been essential, but external conditions have also been supportive. Brazil benefited from a stable global economy and rising commodity prices during most of the 2000s. Equally importantly, the benefits of strong growth are being shared more equally across social groups, leading to an improvement in Brazil's notoriously skewed income distribution.

Brazil's growth prospects also appear to be improving. A resumption in investment and robust employment growth have raised the economy's potential output growth. But the country's ability to sustain stronger growth over the longer term will depend on further structural reform to remove existing impediments to investment, job creation and productivity gains. The agenda for further reform is vast: it will require consolidating macroeconomic stability to allow the country to reap the benefits of external support in good times and to withstand adverse shock in bad times. It will also call on the new administration that took office on 1 January to address the short-term challenges associated with an overheated economy and to make headways in structural reform areas where progress has so far been difficult.

This chapter briefly reviews trends in Brazil's economic growth history over the last quarter of a century to highlight strengths and weaknesses, and to identify the policy challenges that will need to be tackled to improve the country's growth prospects and to sustain strong growth in the years to come. The chapter then lays out the main pro-growth structural reforms that would need to be implemented to address current weaknesses and identifies areas

Table 1

Basic macroeconomic indicators 1995–2012

	1995–99	2000–04	2005–09	2010	2011	2012
Real GDP growth (annual, %)	2.0	3.0	3.5	7.5	4.5	4.5
Inflation (CPI, annual, %)	9.6	8.6	4.7	5.6	5.8	4.7
Budget balance (public sector, % of GDP)	..	– 5.0	– 3.5	– 3.0	– 2.9	– 2.2
Primary budget balance (public sector, % of GDP)	..	3.8	3.5	3.3	2.8	3.0
Current account balance (% of GDP)	– 3.4	– 1.3	0.0	– 2.6	– 3.2	– 3.3
Net government debt (general government, end-period, % of GDP)	..	49.5	45.6	40.9	39.2	38.0

Source: Central Bank of Brazil and median market expectations for 2011–12 (Central Bank of Brazil survey).

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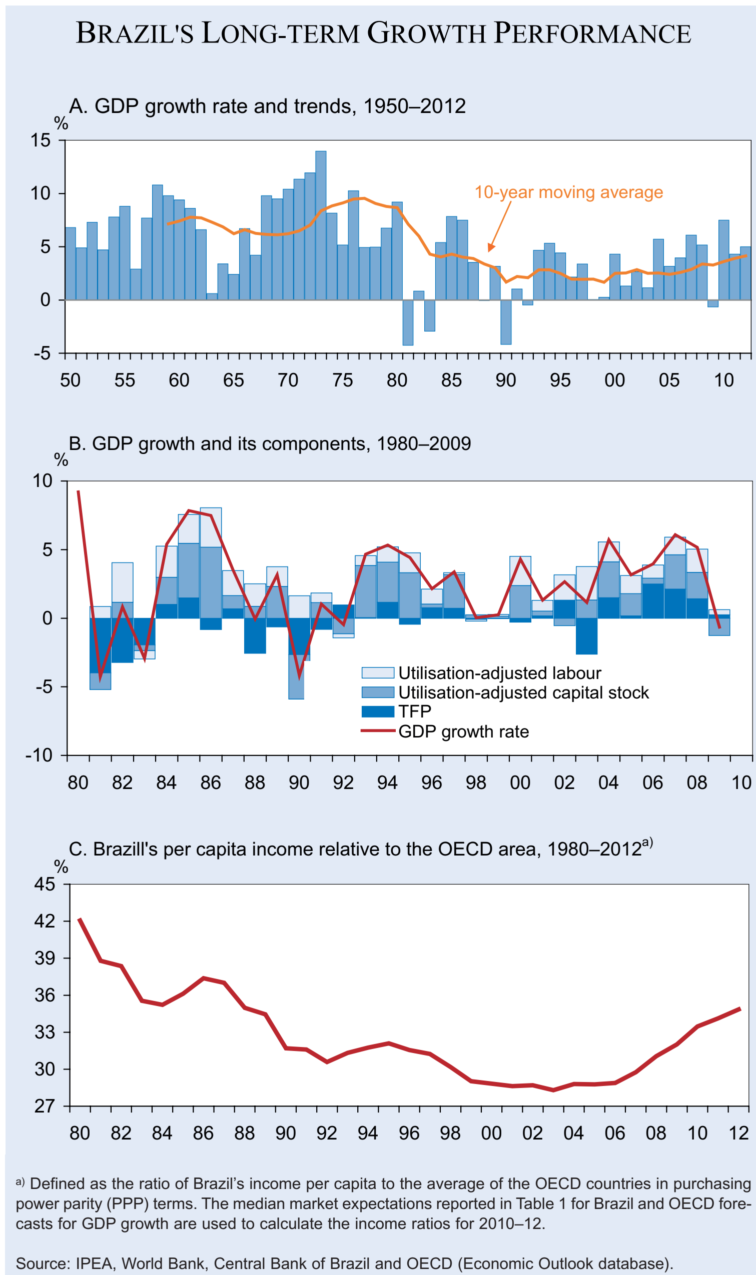
where further reform will be necessary to consolidate macroeconomic stability.

Figure 1



a) Defined as the ratio of Brazil's income per capita to the average of the OECD countries in purchasing power parity (PPP) terms. The median market expectations reported in Table 1 for Brazil and OECD forecasts for GDP growth are used to calculate the income ratios for 2010–12.

Source: IPEA, World Bank, Central Bank of Brazil and OECD (Economic Outlook database).

Laying out the task ahead

Brazil's overarching policy challenge in the years to come is to build on and sustain the improvement of the recent years in the economy's growth performance. Following a quarter-century-long period of lacklustre growth that started in the early 1980s, Brazil's GDP growth rate has picked up since the mid-2000s, despite the slowdown associated with the global crisis of 2008–09. As a result of this improvement in growth outcomes, the gap in Brazil's per capita income (measured at purchasing power parity) relative to the OECD average has narrowed, although it is estimated to remain large, at about 65 percent in 2010.

Effective utilisation of inputs – physical capital and labour – as well as productivity enhancement will be needed to sustain robust growth in the years to come. GDP growth has been driven essentially by a recovery in physical capital accumulation, albeit from very low investment levels (discussed below) and improved use of labour (Figure 1). Total factor productivity (TFP), which measures the overall efficiency with which inputs are combined in production, has also been on an upward trend, despite having often acted as a drag on the expansion of output, especially in the 1980s and early 1990s (de Mello 2008). This is an important development, because overall productivity gains, captured by TFP growth, accounts for most of the variation in output growth across OECD countries.

Extrapolation of recent trends in factor accumulation and productivity enhancement suggests that Brazil's potential GDP growth is on the rise. It is difficult to estimate potential output growth accurately, especially in times of rapid economic transformation. Notwithstanding these difficulties and on the basis of conventional growth accounting and plausible projections for investment and labour force growth over the medium term, most estimates point to a rate of growth of potential GDP in the neighbourhood of 4.5 percent per year over the next five years. The rate of growth of Brazil's potential output is higher than that of OECD countries on average, which is currently estimated at about 1.5 percent per year (2008–11 average) (OECD 2010). Comparison of potential GDP growth rates is instructive: if the wedge in potential growth rates could be sustained

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over the longer term, it would take about 35 years for Brazil to close its current income gap relative to the OECD area.

The benefits of improved growth in a stable macroeconomic environment are being shared more equally across social groups. The resumption of strong growth has resulted in a fall in the incidence of poverty to about 16 percent of households in 2009 from almost 24 percent in 2005 on the basis of a broadly agreed national poverty benchmark. And, probability most importantly, sustained growth is beginning to make a dent in Brazil's notorious income distribution indicators. For example, the Gini coefficient fell by about 4.5 percent during 2005–09, or 0.9 percent per year, from nearly 0.57 in 2005. Increased emphasis since the late 1990s on targeted conditional transfer programmes has undoubtedly played an important role. But improvements in the distribution of labour income on the back of rising human capital have accounted for a large of the decline in income inequality according to some decomposition exercises (IPEA 2006; Paes de Barros, Franco and Mendonça 2007; Soares 2008).

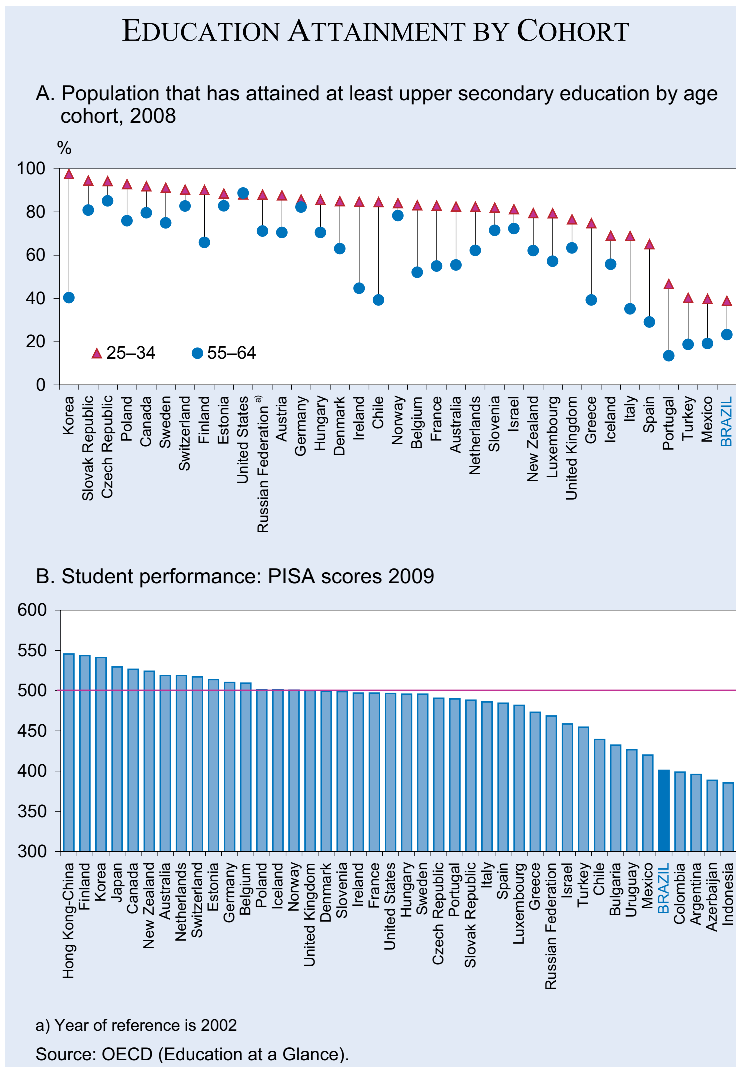
Structural reform to sustain strong growth

Effective labour utilization: the role of low human capital and informality

The level of education of the Brazilian labour force is comparatively low and needs to be raised. On the basis of the cross-country indicators available from the OECD's Education at a Glance database, educational achievement for upper-secondary education point to a serious human capital deficiency (Figure 2). The quality of education, gauged by student performance in standardised tests, such as the OECD Programme for International Student Assessment (PISA), is also low. This is despite significant improvements in recent years, which are due in part to efforts since the late 1990s to facilitate access to education, especially up to the upper-secondary school level. By contrast, and unlike many OECD countries, potential GDP growth does not seem to be held back by insufficient labour supply, since Brazil's labour force participation is on a par with the average of OECD countries for prime-age males (aged 25–54 years), although it is somewhat lower for females (OECD 2006). Since access to education is already nearly universal until the lower-secondary level, policies are now focusing on improving access to higher levels of education and the quality of services, including vocational education and labour training. Effective follow-through is essential, because investment in education takes a long time to come to fruition. Policy mistakes, if not remedied, are therefore costly.

Labour informality also needs to be reduced further on the back of recent achievements. Nearly 35 percent of

Figure 2



a) Year of reference is 2002

Source: OECD (Education at a Glance).

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the Brazilian employed population is considered informal, defined as those workers who do not contribute to social security and/or are self-employed. By a narrower definition that excludes own-account workers, who may contribute to social security as self-employed, the informality rate drops to close to 20 percent of the employed population (OECD 2009). As far as potential growth is concerned, the problem with labour informality, however measured, is that it holds back productivity growth, because employers have little incentive to invest in the human capital of workers with a precarious attachment to the enterprise. Informal workers are also often ineligible for off-the-job labour training programmes and, as a result, are likely to be trapped in low-pay, low-skill jobs. Moreover, labour informality is closely related to business informality, which aggravates the problem, because the capacity of informal businesses to expand, invest in the human capital of employees and innovate is constrained by limited, often costly, access to credit. Informality therefore perpetuates segmentation in the labour market and in the business sector, which impedes economic growth by constraining effective labour utilisation and productivity enhancement. At the same time, the impact of informality on public finances should not be underestimated, especially against a background of already high spending on social security benefits in a country with a still relatively young population (discussed below).

Labour informality is a complex phenomenon that requires remedial policy action in different areas. First and foremost, efforts to improve the human capital of the labour force through high-quality education and labour training services would yield a double dividend of also militating against informality. There is ample empirical evidence showing that low educational attainment is a powerful determinant of a worker's probability of obtaining a formal-sector job. There is also scope for policy intervention to remove policy-driven impediments to faster labour formalisation. For example, social assistance programmes can be designed in a manner that enhances the opportunity cost of informality, by for instance making eligibility to certain programmes conditional in part on labour market status.[1] Moreover, greater flexibility in certain provisions of the labour code could reduce impediments to formalisation, so long as efforts in this area are part of broader initiatives to enhance social protection for vulnerable workers.[2] Finally, the burden of taxes on labour income (social security contributions, payroll taxes, mandated saving schemes and a number of para-fiscal levies to finance labour training programmes) could be reduced, public finances permitting, especially for workers on low pay.

Physical capital accumulation: the lack of investment

At below 20 percent of GDP, Brazil's investment rate is low and needs to be raised to sustain faster growth. The main culprits for a low investment rate include macroeconomic instability during much of the 1980s and 1990s, a lack of long-term financing for the private sector and fiscal consolidation, which has taken its toll on public-sector investment in the absence of structural reform to constrain the expansion of current expenditure commitments. Progress has been made on most of these fronts, albeit with different degrees of success, especially to improve corporate governance and promote financial deepening in a more resilient macroeconomic backdrop. A resumption in public investment nevertheless remains constrained by already high and rising current spending commitments (discussed below).

More can be done to tackle the microeconomic deterrents to private investment by making product market regulations more pro-competition. This is important, because the experience of OECD countries suggests that a regulatory framework that fosters competition in product markets is an important driver of productivity growth (OECD 2002).[3] Despite efforts to boost competition, Brazil's product market regulations remain more burdensome on average than those of several OECD countries on the basis of the OECD methodology for gauging the stringency of a country's regulatory framework (see Figure 3). In particular, Brazil would benefit from lowering administrative burdens on enterprises and reducing barriers to foreign trade and investment. Likewise, based on the most recent edition of the *Doing Business* indicators reported by the World Bank,

[1] In the case of Brazil, the fact that individuals are entitled to a means-tested social assistance pension at 65 years of age that is equivalent to the minimum wage and unconditional on labour market status discourages individuals whose earnings are at or close to the minimum wage from contributing to social security.

[2] The *Doing Business* indicators reported by the World Bank suggest that hiring and firing costs are comparatively high in Brazil, which may discourage employers from hiring low-skilled workers formally. The OECD index of Employment Protection Legislation also points to provisions of the Brazilian labour code that could discourage employers from hiring low-skilled workers formally (OECD 2005; de Mello 2008).

[3] Empirical evidence for Brazil suggests that economic liberalisation since the early 1990s, through the gradual withdrawal of the public sector from manufacturing and services, has exposed producers to competition from abroad and from domestic peers (Schmitz and Teixeira 2004). At the same time, the alleviation of trade protection seems to have been particularly important in boosting labour productivity (Schor 2004).

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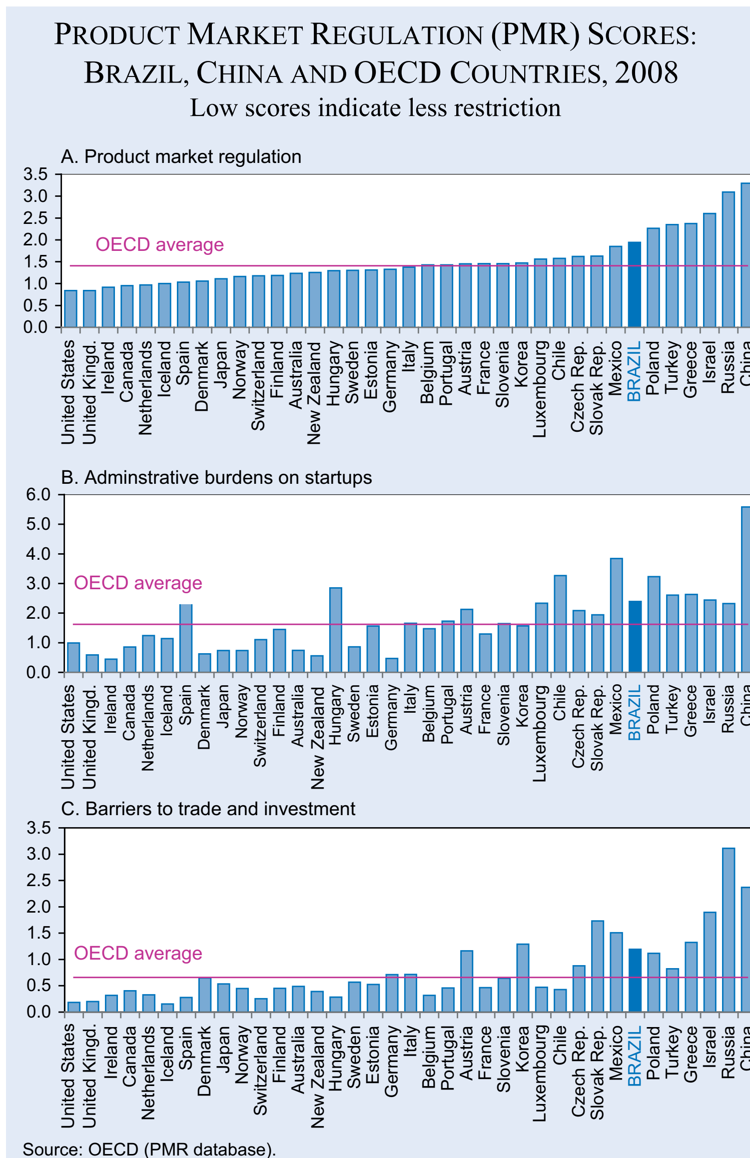
Figure 3



PRODUCT MARKET REGULATION (PMR) SCORES: BRAZIL, CHINA AND OECD COUNTRIES, 2008
Low scores indicate less restriction

Source: OECD (PMR database).

Brazil fares particularly poorly in comparison with OECD countries in matters related to the ease of opening and closing businesses, and on the basis of administrative burdens to fulfil foreign trade procedures. Reform in these areas is growth-friendly to the extent that more pro-competition product market regulations unleash opportunities for investment and facilitate the diffusion of technological change through the economy.

Consolidating macroeconomic stability

Brazil has strengthened its public finances essentially through revenue hikes, rather than by containing the growth of expenditure. Different distributive and social protection programmes have been introduced since the early 1990s, including means-tested transfers to the elderly and the disable. At the central government level alone, spending on payroll is on the rise, following several years of stability (Figure 4), and pension outlays already account for about 12 percent of GDP (including both social assistance and insurance programmes benefiting private- and public-sector workers), which is a high share for a country of Brazil's demographic structure and income level. These expenditure commitments, together with sizeable primary budget surpluses needed to service a large public debt, have been financed through successive revenue hikes in a fiscal landscape that, unlike most emerging-market economies, already combines a comparatively high ratio of revenue to GDP with a fairly complex tax system. Greater effort is therefore needed to break this vicious spend-and-tax circle (de Mello 2007), which may be difficult to sustain over the longer term without further prejudice to the economy's growth potential.

Further increases in the current expenditure-to-GDP ratio should be prevented in order to stabilise the tax take in relation to GDP and create fiscal space for a recovery of public investment. Expenditure containment should focus on capping additional increases in payroll commitments, as well as on further pension reform to strengthen the financial sustainability of the social security system over the longer term.[4] Also, there are important policy challenges in the tax area, not least to reduce the tax burden on business and labour, especially on workers on low pay (discussed above), and to reform the value added tax at the state level to improve the efficiency of the tax system and to

[4] Several proposals have been put forward in this area, focusing on options for severing the links between pension benefits and the minimum wage, while preserving the purchasing power of the minimum pension, and the introduction of minimum retirement provisions, among others Draft legislation to cap pension benefits and to create complementary pension schemes for civil servants has been in discussion in the legislature since 2003 – see Giambiagi and de Mello (2006) for more discussion.

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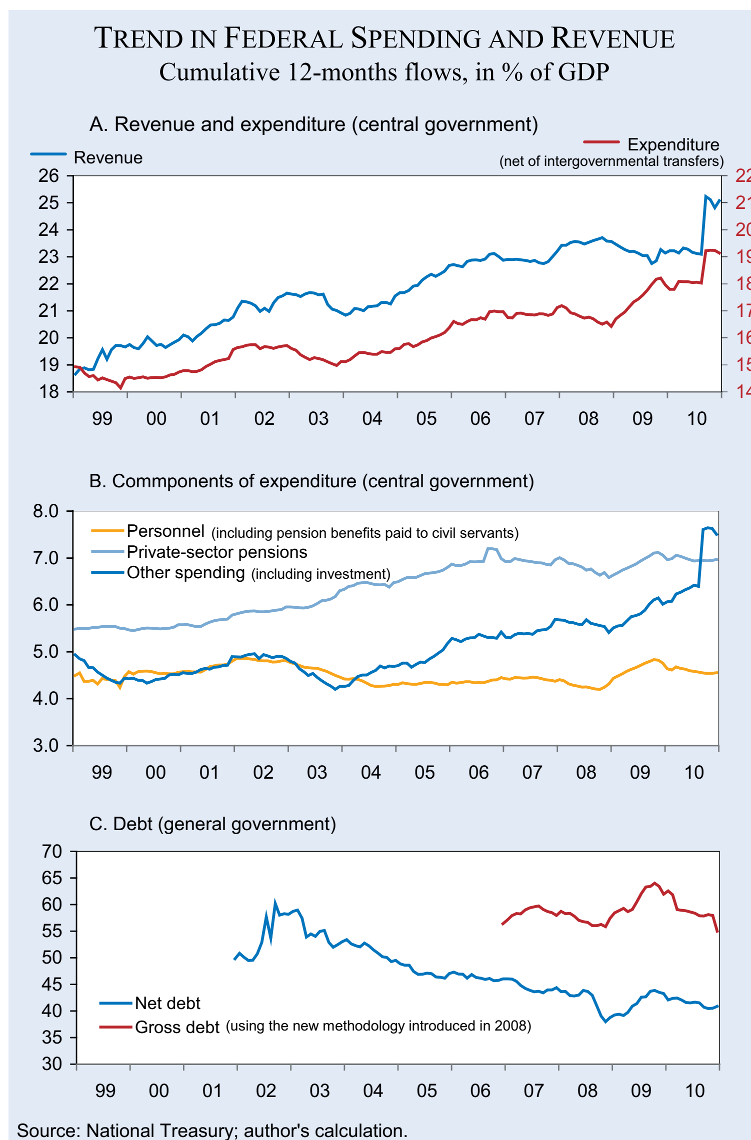
Figure 4



Source: National Treasury; author's calculation.

reduce the scope for predatory horizontal tax competition among the states (de Mello 2008). Of course, until further structural reform has put a lid on expenditure growth, policy action on the tax front should be consistent with revenue neutrality, so that high enough primary budget surpluses can be generated to secure a sustained reduction in public indebtedness over the medium term. At the same time, Brazil will need to put in place the necessary tools to make the most of the increases in revenue associated with the recently discovered oil and gas reserves, when production comes on stream, by saving those resources or using them to finance investments that generate returns for future generations.

Regained macroeconomic stability has yet to deliver a sustained reduction in real interest rates. Brazil's monetary policy framework combines inflation targeting with a flexible exchange rate and is working well: inflation has remained by and large within the formal targets, and output and inflation appear to have become less volatile over time (Figure 5).[5] Policy initiatives have also been launched to strengthen banking supervision, upgrade the country's payments system and deepen the financial system. The real cost of credit has therefore fallen over time, although it remains high, especially for individuals. More can obviously be done to promote financial deepening, including by alleviating burdensome constraints on the allocation of credit in the economy and high compulsory reserve requirements for banks. However, further reductions in real interest rates will depend to a large extent on additional, sustained declines in government indebtedness, which remains high by emerging-market standards, despite years of adjustment.

Of course, *there are short-term macroeconomic challenges that will need to be addressed.* Brazil recovered in earnest from a deep, albeit short-lived, recession in 2009 on the back of a very supportive macroeconomic policy mix. Activity is now expanding at a pace that exceeds the economy's rate of potential GDP growth, and the output gap is likely to have been closed. The current account deficit is widening. Inflation is close to the ceiling of the inflation target tolerance band, and monetary policy is appropriately being tightened, including through macroprudential measures. Fiscal policy, however, has yet to be tightened to prevent a counter-cyclical stance during the downturn from becoming pro-cyclical in the upturn, which would be destabilising.

[5] See de Mello and Moccero (2011) for empirical evidence for Brazil and other Latin American inflation targeters.

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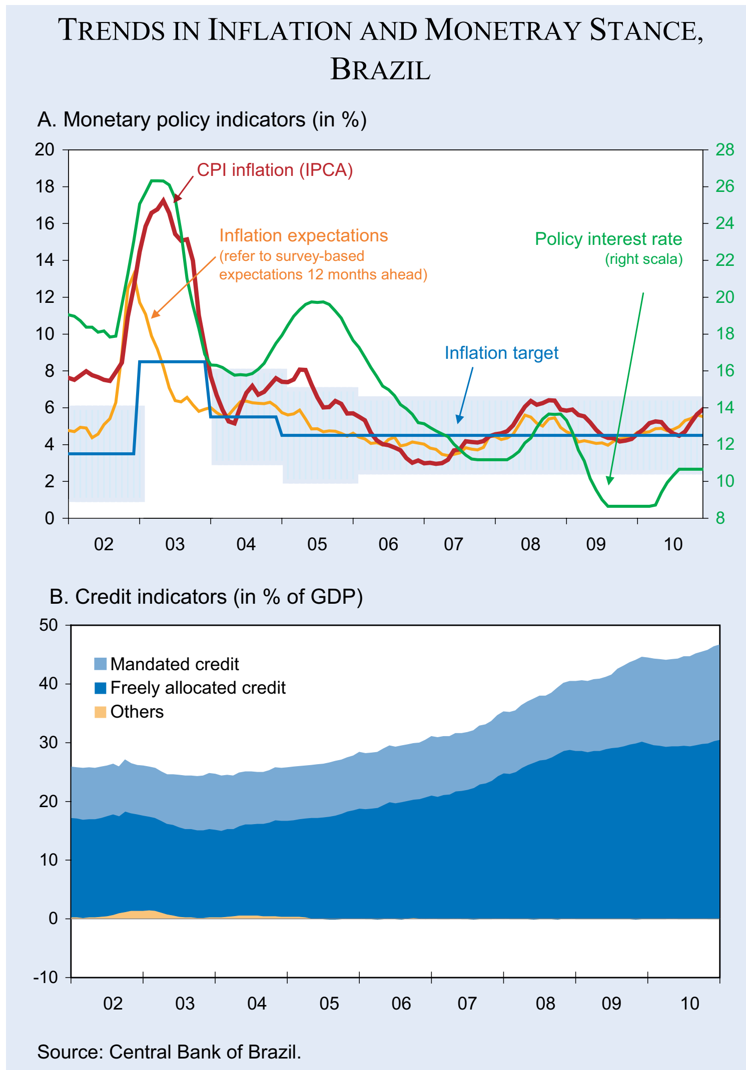
Figure 5



needed to reduce Brazil's high real interest rates. Appropriate instruments will need to be put in place to save or invest in a manner that benefits future generations the revenue that is expected to accrue to the government budget when the recently discovered oil and gas reserves come on stream.

Second, effort to close a gap in educational attainment and student performance in relation to the OECD area would put Brazil in a better stead to compete in international markets. To the extent that better education outcomes raise labour productivity, continued human capital accumulation would contribute to improving further Brazil's distribution of income, which remains skewed even by Latin American standards. Implement of much needed further structural reforms in several areas, including the tax code, product market regulations and foreign trade and investment regimes, will require resolute policy action to remove those impediments to entrepreneurship and productivity gains that ultimately stymie the country's growth potential.

Conclusions

This chapter has argued that Brazil's efforts over the years to consolidate its macroeconomy and implement structural reforms in support of economic efficiency and social development are paying off. Growth has resumed and social indicators are improving. But there is little room for complacency in pursuing the necessary additional reforms that would put the country on a trajectory of sustained, stronger growth in the years to come. Further efforts towards this end could focus on two main areas.

First, macroeconomic stability, which is an important framework condition for growth, needs to be consolidated. Effort to stem the increase in current government spending would create room in the budget for much-needed investment and pave the way for a reduction in the tax take in the future, once the public debt has been reduced further. Lower indebtedness is also

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