

Economic Survey of Brazil, 2006

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Summary

Considerable progress has been made in recent years in achieving macroeconomic stability and restructuring the economy. Productivity has risen since the macroeconomic stabilisation of the mid-1990s and the implementation of a series of structural reforms. But Brazil's GDP growth performance (about 2.5% per year on average since 1995) nevertheless needs to improve to close a widening income gap relative to the OECD area. Reaping the full benefits of stabilisation in terms of faster growth will require consolidating macroeconomic adjustment, boosting innovation in the business sector and stepping up formal labour utilisation.

Consolidating macroeconomic adjustment

Fiscal policy has been on track, and public debt management has been exemplary. Monetary policy is delivering sustained disinflation, anchoring expectations. Brazil's overarching macroeconomic challenge is to continue to reduce the public debt overhang while improving the quality of fiscal adjustment, which has so far been underpinned by revenue hikes, rather than a retrenchment of expenditure commitments. To do so, measures will be needed to arrest the increase in current spending, especially on pensions, paving the way for subsequently reducing the tax burden, once the debt-to-GDP ratio has been reduced in a sustainable manner.

Boosting innovation in the business sector

Innovation performance is improving fast. Innovation policy is beginning to focus on the potential synergies among science and technology promotion, R&D support and trade competitiveness. But R&D intensity is comparatively low by OECD standards and carried out predominantly by the government and public universities. Despite academic excellence in many niche areas, output indicators suggest that there is much scope for improvement. The key policy challenge is to boost innovation in the business sector. To this

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end, policies will also need to bolster human capital accumulation and to encourage university-business ventures so as to convert knowledge into productivity gains at the enterprise level.

Improving formal labour utilisation

Brazil's labour force participation is comparable to that of the OECD for prime-age males. It is somewhat lower for females and is trending down for youths partly as a result of rising school enrolment, which is welcome. Informality is nevertheless pervasive, especially for the less educated, because the labour market is placing an increasing premium on skills. The main policy challenge is to improve formal labour utilisation. This can be achieved by fostering human capital accumulation on and off the job and mitigating policy disincentives that reduce the opportunity cost of informality. ■

How to improve Brazil's growth performance?

The 2005 Survey argued that the foundations for sustained economic growth were by and large in place. This assessment remains valid. The macroeconomic environment continues to improve: fiscal policy has stayed on track; the public debt-to-GDP ratio has trended down since 2003, although it remains comparatively high by emerging-market standards; and inflation has been tame at its lowest level since the adoption of inflation targeting in 1999 and well anchored around the current target of 4.5%. Ongoing external adjustment is making the economy increasingly resilient to external shocks, and asset prices are performing well in the face of the current tightening of global liquidity. Efforts to reduce external vulnerability, particularly with respect to public external indebtedness, are paying off: Brazil's sovereign credit has been upgraded, and interest premia are at historically low levels. The outlook for inflation and growth remains benign. At the same time, income inequality, which is high in Brazil, is coming down as a result of rising earnings and the successful implementation to date of targeted income support initiatives for the poor under the *Bolsa Família* programme. Continuous growth is the key to maintaining progress on this front. But there are some macroeconomic and structural problems, which, unless addressed, will continue to act as a drag on growth, preventing Brazil from reaping the full benefits of macroeconomic stabilisation. Against this background, the overarching medium-term policy objective for Brazil is to raise the economy's growth potential so as to close the gap in income per capita with the OECD area, which has widened since the 1980s.

The authorities remain committed to a broad range of structural reforms, but achieving the goal of faster sustainable growth will require concerted policy action on many fronts. To this end, this Survey identifies three main policy weaknesses that will need to be addressed to raise Brazil's growth potential:

- *First, the quality of fiscal adjustment will need to improve* to consolidate the gains obtained to date with macroeconomic stabilisation and to enhance economic resilience further. The additional fiscal effort that will be required to put the public debt-to-GDP ratio on a sustained downward trajectory would need to be based predominantly on a retrenchment of current expenditure, including on pensions, rather than further increases in the tax take, with their negative side-effects.
- *Second, the business sector will need to become more innovative to boost productivity and to enhance the economy's competitiveness.* Increasing R&D spending, which is currently sub-par in comparison with most OECD countries, and is carried out predominantly by government, can do much to boost innovation performance. The fact that Brazil's R&D intensity in the business sector would have to rise by a factor of four merely to reach the OECD average of about 1.6% of GDP illustrates the scope for action in this area.

- Third, the use of labour inputs will need to improve through human capital accumulation on and off the job and by reducing informality. Educational attainment has risen over time but not as fast as in Brazil's main trading partners. In addition, the country currently faces the problem of widespread informality, especially among the less educated, for whom labour turnover is also high. Adding this untapped supply of labour to the formal labour market and accumulating human capital would contribute to raising the economy's potential growth. ■

What needs to be done to consolidate fiscal adjustment?

Fiscal performance remains strong. The consolidated primary budget surplus target – which has been raised repeatedly since 1999 to ensure the sustainability of the public debt dynamics – continues to be met and sometimes exceeded by wide margins. The net public debt has fallen in relation to GDP since the 2003 peak and has now stabilised, albeit at the comparatively high level of around 50% of GDP by emerging-market standards. The government has been able to sustain fiscal adjustment, despite the limited room for manoeuvre caused by a ratcheting-up of current spending over the years and Brazil's notorious budget rigidities. Nevertheless, fiscal adjustment has been achieved at the expense of cutting back on public investment and by increasing the tax burden. The revenue-to-GDP ratio rose by about 5 percentage points during 2000-05 to nearly 37.5% in 2005 – a level that is one of the highest among countries with comparable income levels. *A durable reduction in public indebtedness on the back of a retrenchment of current expenditure, rather than tax hikes, would serve to facilitate a swifter fall in real interest rates and to permit the channelling of domestic saving to finance growth-enhancing investment.* It would also lay the groundwork for removing distortions in the tax system, including by broadening tax bases.

Despite the reforms implemented since 1998, the deficit of the social-security regime for private-sector workers continues to rise. The main culprit is the increase in spending on pensions. This is due not only to an increase in the number of beneficiaries, which is related to the ageing of the population, but especially to the increase in the minimum wage in real terms, to which the value of most social-security benefits are linked. At the same time, widespread informality in the labour market has prevented a faster increase in the number of contributors. Moreover, average earnings have not risen in tandem with the minimum wage, driving a wedge between the system's revenue and expenditure growth. Policy initiatives have focused on encouraging the development of complementary private pension schemes, and more recently on improving the administration of social security, especially in the area of disability and sickness benefits, which have surged recently. Responsibility for collecting contributions is now being transferred from the Ministry of Social Security to the Federal Revenue Service. The resulting strengthening of administrative controls certainly helps but

does not tackle the root causes of the financial imbalance of the social security system. *Further reform of the regime for private-sector workers, whose pensions account for about one-third of federal primary expenditure, will therefore be unavoidable in the coming years and should be complemented by efforts to curb labour informality so as to broaden the contribution base.*

The main elements of reform for the regime for private-sector workers are threefold. First, the link between the minimum pension and the minimum wage should be severed, while maintaining the purchasing power of the minimum pension, possibly through its indexation to a price index that best reflects the consumption basket of pensioners. Second, a minimum retirement age should be introduced for both men and women under the length-of-contribution modality. Third, the minimum period of contribution for old-age pensions should be raised gradually from the current 15 years. With regard to the social security regime for public-sector workers, initiatives should focus on creating complementary pension funds for civil servants, preferably of the defined-contribution type, and on standardising entitlements between the private- and public-sector regimes. Further policy action in this area is important, because outlays on pensions to retired civil servants are accounting for an increasing share of spending at the sub-national level of government. At the same time, many provisions of the 2003 reform are in any case yet to be legislated.

The authorities are well aware of the need to contain the rise in current expenditure. They are taking steps to address this challenge within the confines of the fiscal rule, enshrined in the Fiscal Responsibility Law of 2000, which is working well. Recent initiatives in this area include the introduction of an expenditure cap in the Budget Guidelines Law (LDO) for 2006-08, which would best be maintained in the LDO for 2007-09 and in the 2007 budget law. This policy initiative is laudable. However, there are options for improvement. *Instead of being set in relation to GDP, the expenditure cap could be re-defined in nominal terms because inflation is now well anchored around the target.* Also, the need to alleviate expenditure rigidity should not be underestimated, as budgetary flexibility is an important pre-requisite for successful expenditure containment. *The gradual dismantling of extant revenue-earmarking requirements and the phasing-out of aggregate spending floors should be key policy objectives in this area.* Greater flexibility in expenditure management would allow for the reprioritisation of budgetary allocation in favour of more cost-effective programmes, such as those focused on improving human and physical capital accumulation.

The fiscal rule focuses on the primary budget surplus as the key benchmark for assessing fiscal outcomes. This is because the headline budget balance has traditionally been volatile as a result of the composition of Brazil's public

debt, characterised by a predominance of securities paying floating interest rates. Under these circumstances, a case can be made for assessing fiscal performance on the basis of a budgetary aggregate that is not affected by short-term changes in monetary stance. However, little attention has been devoted to the consolidated headline deficit, which remains high, at 3% of GDP on average in 2004-05, despite the ongoing fiscal adjustment efforts. *The option of targeting the headline budget balance should therefore be considered, because the composition of the traded domestic debt stock has been improved by eliminating the associated exchange-rate risk and raising the share of fixed-rate and inflation-indexed securities.* Targeting the headline budget balance would have the advantage of highlighting the need for further fiscal action, even when fiscal performance measured by the primary budget surplus has been strong. However, it should be recognised that a change in the target would need to be communicated clearly and transparently to the public to avoid any loss of confidence in the fiscal regime.

The authorities have been working towards reducing the public sector's exposure to exchange-rate risk and have seized the opportunity of favourable global financial conditions to retire external debt. The Treasury began to issue long-dated *real*-denominated bonds abroad in 2005 and has considerably reduced external public indebtedness. International reserve holdings now exceed the government's stock of liabilities denominated in foreign currency or indexed to the exchange rate. This achievement has been instrumental in alleviating debt refinancing risk and trimming rollover costs. Nevertheless, securities paying floating interest rates continue to account for the lion's share of the domestic debt stock. *Therefore, public-debt management should focus on consolidating the achievements to date and on stepping up efforts to reduce further the share of floating-rate securities in the traded debt stock.* Attainment of investment grade for Brazil's sovereign debt placements and the resulting lower borrowing costs will be the ultimate reward for steadfast policy action in this area. ■

Would further credit liberalisation strengthen the monetary policy regime?

The perception that the authorities are committed to a monetary policy framework combining inflation targeting and a flexible exchange-rate regime appears to be suitably well entrenched. The central bank enjoys *de facto*, but not yet *de jure*, operational autonomy. The policy regime has been working well, delivering continuous disinflation since 2003 and anchoring expectations. Notwithstanding these achievements, which should not be underestimated, the conduct of monetary policy is complicated by cumbersome regulations on the allocation of credit to selected sectors, especially agriculture and housing, including through mandated saving arrangements. Compulsory reserve requirements on commercial banks are also burdensome for a variety of deposit categories, although most countries that have adopted inflation targeting as the framework for

monetary policymaking have now reduced or eliminated such requirements. These restrictions act as an implicit tax on the financial sector, against the backdrop of an already relatively high tax burden on financial transactions, including that of the bank debit tax (CPMF). *Consideration should be given to gradually removing the extant directed credit and reducing compulsory reserve requirements so as to improve the efficiency of the financial sector and adequately reward long-term saving, an aspect of the problem that is often overlooked.* The favourable domestic macroeconomic environment, with falling inflation and improving growth prospects, appears propitious for further liberalisation in this area. At the same time, the consolidation of macroeconomic stability not only creates a need to move forward but also provides an opportunity to go beyond the current policy achievements as a means of eliminating the remaining distortions inherited from the pre-stabilisation period. The payoff from reform in this area can be considerable in terms of reducing Brazil's stubbornly high real rates of interest, which weigh heavily on growth. ■

How to foster innovation in the business sector?

Fostering productivity-enhancing innovation in the business sector is an important challenge for economic policy. At 1% of GDP, spending on R&D (public and private) – a key input into the innovation process – is not only less than one-half of the OECD average, but it is also carried out predominantly by the government and public universities. Process, rather than product, innovations account for the bulk of innovative activities in the business sector. In addition, output indicators, such as the number of patents filed abroad, suggest a relatively weak performance by international comparison, a fact that reflects to a large extent Brazil's inward-oriented growth strategy until the 1980s, which was based on import substitution. Although Brazil already fulfils a few key framework conditions for innovation, such as reasonably pro-competition product market regulations and an FDI regime that is favourable to investors, average import tariffs are high in comparison with the OECD area. *Therefore, there is scope for reducing tariff barriers to trade to facilitate access by the business sector to imported intermediate inputs and capital goods embodying more modern technologies, which is conducive to sustained productivity growth.* This is important because, according to the Innovation Survey (PINTEC), the acquisition of the latest machinery and equipment is the main source of innovation in the business sector. An important remaining obstacle for improving innovation performance is the cost of capital, which will probably come down with the consolidation of macroeconomic stabilisation and the consequent reduction in real interest rates. *The liberalisation of existing directed credit requirements, discussed above, would contribute to strengthening the market environment for risky ventures, ultimately reducing the cost of capital.*

The current set of policies, which has been in place since late 2003, focuses on the potential policy synergies among science and technology promotion, R&D

support in the business sector and trade competitiveness. Such a framework is a considerable step forward in a country where innovation policies have traditionally been inward-looking and based on the protection of selected industrial sectors from foreign competition, rather than the promotion of trade competitiveness. In addition, a new law, enacted in 2005, facilitates the sharing of intellectual property rights proceeds between businesses and public universities and research institutions. *To be successful in boosting business innovation, these policies will need to be complemented by measures to continue to foster coordination within the National Innovation System, particularly across the different levels of government, and to clarify the assignment of long-term planning functions at the federal level.*

Direct government support is financed predominantly by earmarked revenue allocated to a variety of “sectoral funds”. Tax incentives have traditionally benefited the ICT industry, although recent measures have introduced across-the-board incentives for innovation as part of a broader package for reducing the tax burden on the business sector. They also include the exemption of initial public offerings from the bank debit tax (CPMF) and the elimination of taxation on capital gains accruing from venture capital investment. These steps are appropriate. However, reliance on revenue earmarking aggravates budgetary rigidity, while failing to create a stable source of funding. *Ensuring stable financing for innovation support should therefore be pursued through the prioritisation of programmes, rather than increasing budgetary rigidity. The cost-effectiveness of current policies should be strengthened through greater emphasis on cross-sectoral initiatives, including joint ventures between firms and higher-education institutions, especially with counterpart financing by businesses. In addition, the option of diversifying the range of support instruments currently available by introducing alternative modalities, such as risk-sharing, matching grants and loan subsidies, could be considered.*

To improve innovation outcomes, the attainment gap – at all levels of education – in relation to the OECD area will need to be narrowed, particularly at the higher-education level, where the performance shortfall is worsening. To this end, enrolment will need to rise and quality improve. Most of the recent expansion in the supply of higher education is accounted for by private institutions, whose students tend to perform less well on the basis of standardised tests than those enrolled in public universities, controlling for individual characteristics. In addition, private institutions tend to specialise in low-cost career streams in management and humanities, which does little to tackle the skill imbalance that currently exists to the detriment of engineering and science. Enrolment in higher education-level technological institutes is low, and, to remedy this situation, the government intends to open more such establishments in the near term. *Efforts should be stepped up to monitor the quality and market-orientation of the training offered by the technological*

institutes on a regular basis before new ones are set up. At the same time, increasing the supply of shorter tertiary-education programmes should also be considered as a means of meeting the demand for higher-education qualifications with a more practical, less academic focus. A related unresolved policy consideration is cost-recovery in tertiary education. A move from direct public financing for institutions towards the introduction of tuition fees could be considered on both equity and efficiency grounds, given that, as discussed in the 2005 Survey, public spending on tertiary education is estimated to be among the most regressive expenditure items in Brazil. This should be complemented by the expansion of student loans and/or means-tested support to ensure that the introduction of tuition fees does not work as an obstacle to the participation of students from disadvantaged backgrounds. ■

What can be done to tackle labour informality?

Reducing widespread informality and the tax evasion that it entails will be essential for improving growth performance through a better use of labour inputs. It may well also contribute to alleviating income disparities. Low human capital is a key determinant of informality, but several features of the existing social protection programmes discourage the formalisation of labour relations. The introduction of a number of old-age and disability-related benefits since the early 1990s has served the purpose of strengthening the social safety net. However, such initiatives reduce the opportunity cost of informality, because eligibility is not conditional on social security coverage, although social assistance benefits are means-tested. This is especially the case for minimum-wage earners, who can apply for an old-age assistance pension (which is equal to the monthly minimum wage) at age 65, instead of receiving an old-age pension on the basis of lifetime contributions. Incentives for formality are weakened further, while undoubtedly serving a valid social objective, by universal access to publicly funded health-care services, which are not conditional on formal labour-market status. There are additional incentives for informality arising from the design of severance insurance (FGTS) in the event of unfair dismissal, which discourages employers from hiring with formal contracts. *Against this background, efforts should focus on correcting these policy distortions, while striking the right balance between adequate, cost-effective social protection and incentives to work in the formal sector. Another important consideration is the affordability of social insurance coverage for individuals on low incomes. In this regard, the option of reducing social security contributions for minimum-wage earners should be considered both because it reduces the cost to employers of hiring formally and, since the minimum benefit is fixed, because it would make formal employment relatively more attractive to workers.*

Brazil already ranks high by international standards in terms of labour force participation for prime-age workers. A gender gap nevertheless remains, especially if account is taken of part-time work, which is more prevalent among females. The share of women working less than 20 hours

per week is above the OECD average. In general, mothers with young children may opt for part-time work as a means of reconciling household and work responsibilities. There is nothing wrong with this situation, unless individual choice is distorted by public policy. For example, a number of these part-timers may want to work longer hours and are prevented from doing so by the scarcity of publicly funded pre-school education and formal child care. *Budget conditions permitting, current efforts to tackle the supply bottleneck should be stepped up by extending to pre-school education the financing mechanisms in place for primary and lower-secondary education (i.e. FUNDEF), which are working well.* The potential benefits of this initiative go beyond the labour policy area: international experience suggests that access to early childhood education can improve school outcomes later in life. Another consideration when designing policies to lift labour supply is that of early retirement, given that Brazil's average effective retirement age is much lower than in most OECD countries. *The introduction of a statutory retirement age for private-sector workers, recommended above, would contribute to improving the use of labour resources, in addition to strengthening the long-term sustainability of the social security system.*

The empirical evidence reported in this Survey suggests that educational attainment is becoming an increasingly important determinant of employability. Properly designed active labour market policies can therefore be used to boost human capital, especially for those groups with the weakest attachment to the labour force, such as youths, women and the less educated. Activation programmes differ from conventional public employment services because they make participation in, for example, training and job-creation programmes compulsory for targeted groups. Brazil's experience with such programmes is relatively recent, comprising federal training programmes (PLANFOR/PNQ and PNPE) for the unemployed and vulnerable segments of the labour market. *Although the cost-effectiveness of these programmes has yet to be fully assessed, the option of making participation in an activation scheme compulsory for unemployment-benefit recipients should be considered.* Also, it is essential that employment services ensure that recipients look for jobs while participating in such schemes. ■

How can the accumulation of human capital be encouraged for those already in the labour force?

Demand for labour training is likely to rise, because the labour market is offering increasing rewards for skills. This phenomenon is closely related to the pro-competition reforms of the 1990s, including trade and investment liberalisation. Labour training will therefore be crucial for the accumulation of human capital by those individuals who are already in the work force and will not, or cannot, engage in formal education. Labour training is currently provided predominantly at the sectoral level by the so-called "S" system, which is made up of non-governmental organisations financed through para-fiscal levies on enterprise payroll. By contrast, publicly funded

vocational education is in short supply, essentially because the Brazilian system does not have separate vocational and general education streams. Efforts to improve the supply of vocational training while integrating it into upper-secondary education, as is planned by the authorities, are therefore commendable. *But labour training can become more cost-effective through increased contestability. This could be achieved by replacing direct transfers to the non-governmental service providers within the “S” system by vouchers that could be granted to individual workers and redeemed against training received from accredited institutions.* For this policy measure to be successful, labour market information and vocational guidance services for potential participants should be expanded to help workers to choose which training to undertake.

There is no national system of skills certification in Brazil. This prevents the marketability of the human capital acquired through labour training. *A national skills certification system should therefore be introduced.* As a first step in this direction the pilot certification programmes that are currently in place in the industrial sector in the metropolitan region of São Paulo could be extended to other sectors, such as construction and services, where informality is more widespread, and to the poorer regions of the country. *National standards should be set and compliance monitored regularly and transparently.* To the extent that less educated workers who are currently trapped in the informal sector may acquire marketable skills through labour training, they can compensate for a lack of formal education. ■

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