

EXECUTIVE SUMMARY



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INTERNATIONAL
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STUDIES ON
GROWTH WITH EQUITY



BRAZIL

**AN INNOVATIVE
INCOME-LED
STRATEGY**

Executive summary and policy recommendations

Economic growth with equity is possible – as the case of Brazil demonstrates – if policies are well-designed and sufficiently integrated.

It is often argued that policies to promote social inclusion and equity affect economic growth, suggesting the inevitability of a trade-off between economic and social goals. The case of Brazil, however, shows that there is no such a trade-off – provided that the right policies are implemented.

The present review shows concretely how the growth-cum-equity strategy was designed and implemented in Brazil. It also analyses the extent to which the strategy helped Brazil overcome the global financial and economic crisis which erupted in the aftermath of the collapse of Lehman Brothers in 2008. Finally, the review identifies key pending challenges and formulates possible policy responses.

Initially, the global crisis had a significant impact in Brazil...

Brazil was by no means immune to the effects of the crisis. It was hit principally through three contagion channels: (i) the fall in the value of exports due to the collapse of external demand and the decline in commodity prices; (ii) the ensuing credit crunch that cut off external credit lines (including trade lines) and resulted in the outflow of portfolio investments; and (iii) a sharp reduction in the domestic supply of credit. The economy – which had been growing at an annual rate of nearly 7 per cent in the third quarter of 2008 – contracted by 2.0 per cent (annually) in the first quarter of 2009. Industrial production was hit hardest with particularly acute impacts on credit-sensitive sectors such as consumer durables. In fact, output in the industrial sector fell nearly 20 per cent in the last quarter of 2008 and the first quarter of 2009. The labour market was also considerably affected:

- In November and December 2008 alone, nearly 700,000 formal jobs were lost – 3.6 times higher than during the same months of the preceding year.
- Among the six metropolitan areas of Brazil, 594,000 jobs were lost (or 2.8 per cent of employment) between December 2008 and April 2009. In response to the job losses the unemployment rate rose to 9.0 per cent in March 2009 (0.4 percentage points above the March 2008 level).
- The impact on the industrial sector was particularly acute: between the months of November 2009 and March 2010, half a million formal manufacturing jobs were lost in the country.

... but recovery resumed soon after the start of the crisis...

The recession, however, lasted only two quarters – the economy grew by 4.2 per cent in the fourth quarter of 2009 and is expected to grow more than 7 per cent in 2010, a pace that surpassed pre-crisis levels. Differently

from other countries, the labour market recovery started before the recovery in GDP. This helped to stimulate aggregate demand and, by most metrics, erased most of the losses incurred as a result of the crisis:

- Employment started to grow as early as February 2009, and by the end of the year Brazil had added one million new formal jobs. Job growth continued at a strong pace in 2010, with 2.2 million (6.7 per cent) formal jobs added in the first ten months of the year (in comparison, during the previous crisis in 1999 there was a net job loss of nearly 200 thousand formal jobs).
- The unemployment rate in the six major metropolitan regions started to decline in April 2009 and continued to fall steadily throughout 2009, reaching 6.8 per cent in December. In early 2010 it rose again – as more people entered the workforce in search of jobs – but as of November 2010 the rate had fallen to 5.7 per cent – far below the pre-crisis rate of 7.6 per cent in September 2008.
- The weaker performance of manufacturing was in part compensated by stronger job growth in services, where employment was relatively unaffected and continued to grow almost without interruption.

Brazil also managed to avoid a sustained increase in informal employment – as measured by workers without a contract. During crises, workers often resort to informal employment to compensate for income loss. Experience shows that it is often difficult to reverse such trends after an extended period. In Brazil, however, the increases in informal employment were short-lived and have continued their downward trend over the course of the crisis. For instance, within the six major metropolitan areas, the number of employees without a contract fell by approximately 280 thousand (or 6.5 per cent) between August 2008 and August 2010.

...due, first, to solid initial conditions combined with a quick, job-centered response...

The pace of the recovery and the success in mitigating the effects of the crisis are owed to a number of factors:

1. *Pre-crisis experience and initial conditions:* Following the 1999 crisis, Brazil strengthened its macroeconomic fundamentals and continued to enhance its social protection system. In particular, it introduced a new macroeconomic regime – although criticized at the time – that focused on reducing external vulnerabilities and building fiscal surpluses. The Government also introduced – in cooperation with the social partners – mandated increases in the minimum wage and streamlined delivery of social assistance. As a result, at the onset of the crisis the Government was able to respond quickly by enacting a number of countercyclical measures and enhancements to existing social protection schemes – both made possible by the improved fiscal position.
2. *Addressing the origins of the crisis:* The financial crisis significantly affected the flow of credit in Brazil. The Government reacted decisively to restore credit to the financial system to ensure that credit continued to flow to individuals and businesses. These measures, included, but were not limited to: (i) a reduction in the policy rate target of 5 percentage points (from 13.75 per cent to 8.75 per cent) between January and September 2009; (ii) securing the flow of credit by introducing credit lines for key sectors of the economy, including small and medium enterprises (SMEs), and boosting the availability of credit in the three public financial institutions; and (iii) a series of initiatives undertaken by the Central Bank to smooth exchange rate volatility and ensure US\$ liquidity for firms, banks and exporters.

3. *Stimulating domestic demand in employment-intensive sectors:* The Government also adopted a number of measures to stimulate activity in employment-rich sectors, notably: (i) expansion of the Growth Acceleration Programme (PAC) with the majority of funding allocated to infrastructure investments that boosted job creation. This programme accounted for over 40 per cent of the stimulus efforts; (ii) the introduction of the Minha Casa, Minha Vida (My House, My Life) programme, which aimed to build one million new homes in 2009 and 2010 to stimulate growth and employment in the construction sector, which had been hit badly by the crisis; (iii) reductions in the industrial production tax (IPI) on motor vehicles and other products (some of which was intended to promote environmentally-friendly consumption).
4. *Stimulating demand and protecting the most vulnerable via enhancements to social protection:* Brazil made changes to two key social protection measures, notably the Bolsa Familia programme as well as the unemployment insurance system: (i) extended the duration of unemployment insurance benefits by two months for workers whose sector of economic activity was badly affected by the recession (such as mining and steelmaking); (ii) reiterated its commitment to the Bolsa Familia programme by improving benefit levels and extending coverage. The cost of both these amendments together was only 0.026 per cent of GDP. While comparably small in size in relation to other measures, the expansion of the coverage of Bolsa Familia helped 1.3 million additional families to benefit from the programme and an estimated additional 310,000 workers were able to receive extra support in the form of unemployment insurance. In addition, the Government also maintained scheduled increases in the minimum wage in February 2009 and January 2010, although these were not considered as part of the stimulus package. More than 20 per cent of the population benefited from these increases, as the minimum wage is also the reference for a number of social benefits.
5. *Ensuring that supply responded to demand incentives:* The Government made sure that the economy could respond to the above-mentioned stimulus measures and social policies. First, business investment was supported through the availability of credit from the three public banks, which stepped in at a time when private banks were weary of lending. The credit policies not only facilitated investments by large industries, but those of SMEs as well, as special lines of credit were developed for this business segment. Second, a stable business climate was established via social dialogue that prioritized consultation with business and union leaders in policy design, particularly regarding tax reductions. Third, product markets were made more responsive to the new incentives through the reduction in taxes and the boost in disposable income that enabled low- and middle-income families to increase their purchasing power, boosting the economies of small, rural cities. Finally, at the start of the crisis the exchange rate was competitive, which helped boost consumption of domestically produced goods and services.

...second, policy coherence between labour market and social policies on the one hand, and macroeconomic policies on the other.

One of the keys to Brazil's success, and an example of how countries can best design policies, was in recognizing the interplay between employment and social policies on the one hand and macroeconomic policies and

economic growth on the other. Indeed, well-designed policies can have important mutually reinforcing effects – as the case of Brazil demonstrates:

- *Macroeconomic policies with employment multipliers:* The reductions in the industrial production tax (IPI) on motor vehicles, due to strong forward and backward linkages, gave an important boost to job creation. An estimated 25 million jobs – direct and indirect – are reliant on car manufacturing and the cut in IPI is estimated to have contributed to maintaining between 50,000 and 60,000 jobs in the Brazilian economy. Moreover, the Instituto de Pesquisa Econômica Aplicada (IPEA) estimates that each R\$1.00 spent on cars has a multiplier effect of R\$3.76 on aggregate output. Similarly, considerable support was given to the agriculture sector which in 2009 accounted for 16 per cent of the country's labour force compared to 5.2 per cent of 2009 GDP.
- *Well-designed social policies:* A preliminary estimate from IPEA demonstrates that the increased spending on the social cash transfers – Bolsa Família, Continued Benefit Provision (Benefício de Prestação Continuada, BPC), and the General Regime of Social Security (Regime Geral de Previdência Social, RGPS) – had important multiplier effects. For instance, the BPC is estimated to have a multiplier effect of 2.2 on family income and 1.4 on GDP. In fact, enhanced social transfers are estimated to have led to an injection of US\$30 billion into the economy and created (or saved) potentially 1.3 million jobs. These measures not only helped to mitigate the impact of the crisis on the most vulnerable, but also contributed to domestic demand growth by spurring local economic dynamism in employment-intensive sectors. They will also contribute to the longer-term development of Brazil.

In this respect, the lesson from Brazil is that social protection measures and macroeconomic policies, if well-designed, can contribute to economic growth, employment creation and equity. Moreover, for programmes to be effective they do not have to be costly.

Moving forward, however, the role of labour market policies could be strengthened...

Even in Brazil, where the recovery is well under way, there are areas for improvement and a number of challenges remain. One of the gaps in the crisis response concerns the area of labour market policies. Looking ahead, more attention and resources should be devoted to labour market intermediation and job training – two areas that received no additional resources during the current crisis. This would give jobseekers more opportunities to upgrade skill levels and remain attached to the formal labour market. Similarly, the temporary extension of unemployment insurance benefits could have been more widespread to include workers from other areas also hard hit by the crisis. Some consideration should be given to a number of reform areas:

- *Re-design unemployment insurance:* Efforts are needed to improve the overall coverage of the programme so that more workers are insured from job loss – fewer than 7 per cent of Brazil's unemployed received benefits during the crisis, while some key segments of the workforce, such as domestic workers, had essentially no coverage.
- *Employment retention schemes:* Given that the crisis was comparably short-lived, many companies could have benefited from employee retention schemes, particularly since dismissals have detrimental effects

on productivity and overall morale. In some instances social dialogue was used to lessen the number of dismissals by, for example, offering temporary lay-offs where workers underwent training courses and received unemployment benefits, or by organizing collective holidays. Policies such as work-sharing – whereby workers accept to work reduced hours, in some cases with government compensating the wage reduction – could have been effective in lessening the number of dismissals and the economic and social impact of unemployment. In this respect, and bearing in mind the importance of cost-effectiveness, Germany's Kurzarbeit programme could be considered a potential model of short-time working arrangements.

- *Enhanced educational attainment:* The lack of adequate skills is a serious obstacle to Brazil's future development and threatens productivity growth. Though primary and secondary enrolment has expanded notably over the past two decades, the quality of public education is of concern. Illiteracy has been reduced dramatically, but the level of functional illiteracy remains at troublesome levels, compromising the labour market prospects of a large proportion of the labour force as well as the country's competitiveness.
- *Improved integration:* More generally, Brazil needs to strengthen other labour market policies such as labour market intermediation and job training, as well as improve the integration of these programmes with the unemployment insurance system. Indeed, Brazil has an array of labour market policies, some of which have been in existence for many decades, but they could be leveraged to greater use.

Importantly, the Global Economic Linkages (GEL) Model developed at the International Institute for Labour Studies demonstrates that investments in the area of labour market policies, such as unemployment insurance, employment retention, labour market intermediation or public employment services, have important positive effects on output, employment and wages. And while such investments require expenditures in the short term, the Model demonstrates that if such policies are well-designed, public debt levels recover to values similar to the baseline scenario over the medium term. Indeed, over time the fiscal position improves, due to overall improvement in employment and wages via an improved tax base and fewer expenditures on benefits such as unemployment assistance.

... and the effectiveness of the Public Employment Service increased...

For labour market policies and programmes to be effective, it is important to have a well-functioning public employment service (PES). A recent evaluation of Brazil's PES, however, revealed some important deficiencies. First, only a small number of jobseekers are given referrals for labour market intermediation – in 2009 only 2.1 per cent of unemployed workers received support from the SINE (Sistema de Intermediação de Mão de Obra) during their job search. Moreover, even if referred, the placement rates from SINE are low, at around 18 per cent of the nearly six million workers registered over the period 2007–2009.

... complemented by continued improvements to integrate employment and social objectives...

Over the past couple of decades, Brazil has made substantial progress in reducing poverty and income inequality – aided by a comprehensive social protection system. However, poverty and inequality remain high by international standards. Promoting the creation of more formal jobs should help to improve social protection coverage and thus contribute to reducing the incidence of income inequality and poverty. Improving the effectiveness and delivery of labour market policies should help in this regard. However, more needs to be done to design social protection measures with labour market objectives in mind.

For example, while it is certainly laudable that more than 12 million families benefit from Bolsa Familia, the mere fact that one-quarter of the population qualifies for the programme is cause for concern. And though the social and economic benefits of the programme are well-established and well-documented in this report, future reform efforts could consider how best to integrate the beneficiaries into productive, quality and decent employment. Greater investments in basic skills and vocational training, labour market intermediation, and increased availability of child care services, could help to improve the access of workers to the new opportunities available in Brazil's booming economy.

...while further improving productive investment, the tax system and the management of capital flows.

The challenge for Brazil is to ensure that recovery is sustained and that economic growth rates remain strong over the medium to long term. Though Brazil has many leading sectors – aeronautics, biotechnology, automobile manufacturing – it needs to increase its investment rates and improve its physical and social infrastructure in order to sustain and develop leading sectors and move away from its reliance on commodity exports for economic growth. Policies to increase overall investment, redesign the tax system and ensure a competitive exchange rate would be beneficial for improving the country's competitiveness and its development prospects moving forward.

- *Increase investment rates:* Although the Government has increased its investment levels over the past years, overall levels of investment are low – at about 17 per cent of GDP – which compares unfavourably with the period of import-substitution industrialization, and is well below the levels of emerging countries in Asia. Furthermore, investment in research and development is a low 0.5 per cent of GDP.
- *Redesign the tax system.* Tax revenues in Brazil at roughly 35 per cent of GDP are comparable to some OECD countries, and well above the average for Latin America. While this is beneficial because it means the Government has the resources to finance its many expenses, the design of the tax system is regressive, as many taxes are levied on production and consumption. This is problematic because it hinders the growth of domestic demand and accentuates the already high level of inequality that exists in the country.

- *Ensure a competitive exchange rate:* Prior to the collapse of Lehman Brothers the Brazilian Real (R\$) had become over-appreciated, but with the flight of capital at the onset of the crisis the R\$ devalued by nearly 40 per cent. The positive growth scenario for Brazil, coupled with one of the world's highest interest rates, has renewed the flow of capital to the country, particularly of short-term portfolio investment. This investment has continued despite the 2 per cent tax levied on capital inflows in October 2009. As a result, the R\$ appreciated steadily over the course of 2009 and 2010, returning to its pre-crisis highs. This is problematic, as an over-appreciated currency compromises the country's competitiveness, hurting domestic industry and thus job creation. More capital controls may be needed in the country. Brazil, as a member of the G20, could play a prominent role in advocating the regulation of international capital flows, to the benefit not just of the Brazilian economy but the world economy as well.

Social dialogue as a key factor of successful crisis recovery and for the future.

Key elements of Brazil's success in the context of the crisis, such as increases in the minimum wage and extension of unemployment insurance, are owing to social dialogue. This reaffirms the notion that social dialogue can play a critical role in the achievement of mutually reinforcing labour market and social objectives. Social dialogue can also – as evidenced by the Economic and Social Development Council (Conselho de Desenvolvimento Econômico e Social, CDES) – help improve the design of policies around programme reforms.

In sum, Brazil has made remarkable progress in the past decade – particularly in the context of the financial and economic crisis that started in 2008 – but moving forward, it should build on the success to date by continuing to ensure that the recent unprecedented economic growth is both inclusive and equitable.