Session 4: Achieving income-led growth

Income-led Growth as a Crisis Response: Lessons from Brazil

Janine Berg and Steven Tobin

Abstract

Income policies that boosted incomes of the lower and middle classes were central to Brazil’s success in overcoming the crisis. The government used wage, social policies and tax cuts to increase family incomes and prop up domestic demand, thereby allowing the internal market to compensate for the fall in exports suffered as a result of the international crisis. As a result, the country’s growth strategy shifted from the export-led, commodity-driven model that characterized the decade prior to the crisis, to a policy stance focused on domestic consumption and the resumption of investment.
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1. Introduction

At the G20 meeting in Toronto in June 2009, the focus of policy makers switched from emphasizing the need to continue fiscal policy measures to boost aggregate demand to the urgent need to balance public budgets through austerity measures. In this respect, labour market and social policies – in particular wage policies and income transfers – were viewed as costly, and were thus to be avoided under the belief that a deterioration in public finances would jeopardize economic prosperity, rather than as a necessary tool for boosting aggregate demand to counter a recession.

Such an approach is ill-advised given that labour markets continue to struggle in terms of both job quantity and quality. Moreover, the experience of Brazil serves as an important case study in how income policies can play a critical role in mitigating an economic downturn and how – rather than jeopardizing economic growth – they can drive economic recovery. In particular, the Government used wage, social policies and tax cuts to increase family incomes and prop up domestic demand, thereby allowing the internal market to compensate for the fall in exports suffered as a result of decline in external demand. As a result, the country’s growth strategy shifted from the export-led, commodity-driven model that characterized the decade prior to the crisis, to a policy stance focused on boosting domestic consumption and investment.

2. Brazil before the crisis

From 2001-2008, Brazil’s economy grew at an average annual rate of 3.7 percent, and though not stellar, was a notable improvement over the lost decades of the 1980s and 1990s when the economy grew at 1.6 percent and 2.5 percent annually, respectively. This performance lies in stark contrast to 1947-1980, when the economy grew at an average annual rate of 7.5 percent while pursuing a strategy of import-substitution industrialization (ISI).

As in the rest of Latin America, the debt crisis of the 1980s led to a shift in development strategy away from ISI and towards external liberalization. In Brazil, this occurred in 1990 under the Collor administration. Import prohibitions and non-tariff barriers were removed and tariffs were reduced from an average of 32 percent in 1990 to 13 percent in 1995. Brazil’s financial markets were also liberalized, by the removal of prohibitions on foreign investment in the stock exchange as well as the loosening of regulations on foreign financing of domestic firms. The government also undertook drastic measures to ensure price stability in the wake of high inflation and in 1994 implemented the Real Plan, which was successful in reducing inflation to single-digit levels.

Financial liberalization resulted in a surge in portfolio investment that resulted in the appreciation of the real exchange rate. Unfortunately, this occurred at the same time that domestic companies were being exposed to foreign competition, after previously being protected under ISI. Domestic industries thus suffered from the high interest rates needed to attract capital investment and

1 Paper prepared for the ILO/IILS Research Conference, ‘Key Lessons from the Crisis and Way Forward’, 16-17 February 2011, Geneva. The views expressed in this paper are those of the authors and do not necessarily reflect the views of the International Labour Office.
2 The authors are Employment Specialist, ILO Brasilia and Senior Economist, IILS, ILO Geneva respectively.
maintain the value of the exchange rate. From 1993 until currency devaluation in January 1999, imports grew at an average annual rate of 18 percent, compared with 3 percent annual export growth, while the share of manufacturing in GDP plummeted from 27 percent in 1990 to 17 percent in 2000.

The Brazilian workforce underwent a difficult adjustment process. Unemployment increased from 6.4 percent in 1992 to 9.7 percent in 1999 while informality rose from 53.6 percent to 56.1 percent. During 1992-1999, annual formal job growth was a mere 1.3 percent, whereas informal jobs grew at a rate of 3.0 percent annually. Among formal jobs, growth was restricted to the service sector; during 1990-1999, there was an average annual formal job loss of 2.9 percent in the mining sector, 8.0 percent in the agriculture and fishing sectors and 1.9 percent in manufacturing. In addition, the minimum wage fell in real terms – ending the decade at R$280 (measured in 2010 R$, approximately US$150) – and average real wages stagnated. As a result, labour’s share in national income dropped by five percentage points during the decade, from 45 percent in 1989/90 to 40 percent in 1999/00 (IPEA, 2010).

With the arrival of the 2000s, the new economic model based on integration with the world economy was firmly in place. Following the devaluation of the R$ in 1999 and until 2005, the real exchange rate remained highly competitive, boosting exports and protecting domestic industries from import competition. The Brazilian labour market benefited from the new economic regime as new jobs were created, particularly in the export sector – where exports grew by 80 percent between 2000 and 2008, driven by a boost in demand for commodities, especially from China – but in all other sectors of the economy as well. Indeed, during 2000-2008, 9.7 million formal jobs were created and formal job growth outpaced informal job growth by a three-to-one ratio, reversing the trend of the 1990s.

The economy also benefited from a boost in domestic consumption due to an increase in credit, but also because of wage and social policies. Beginning in 2003, the Government undertook a concerted policy effort to increase the value of the real minimum wage; by 2008, its value had increased by fifty percent in real terms (Figure 1). The increase in wages coupled with strong job growth meant that labour regained some of its share in the national income, increasing to 43.6 percent in 2008 from 40 percent at the beginning of the decade (IPEA, 2010).

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3 Data from the PNAD household survey (Pesquisa Nacional por Amostra de Domicílios). Due to a methodological change, the data begins in 1992. There is no data for 2000 because it was a census year.
4 The RAIS (Relação Anual de Informações Sociais) is a registry of formal establishments and jobs, administered by the Brazilian Ministry of Labour.
5 Data on formal job growth is from the CAGED administrative database of the Ministry of Labour. The data track workers who are covered under the CLT (Consolidação das Leis do Trabalho labour code dating from 1943) and exclude workers covered under public sector work contracts (estatuario). Data comparing formal to informal job growth are from the PNAD household survey, the period studied is from 1999-2008, as 2000 is a census year.
Importantly, the minimum wage in Brazil plays a decisive role in boosting the incomes of workers at the bottom of the wage pyramid, who typically are not covered by collective bargaining. In 2008, 15.5 percent of formally employed, private-sector waged workers earned the minimum wage as did 16.1 percent of informally employed waged workers. The minimum wage helps disadvantaged groups, e.g., women, blacks, youths, earn higher salaries. The increase in the minimum wage has also played a critical role in the reduction in income inequality that took place over the past decade. Although still extremely high, the Gini index in Brazil fell from 0.59 in 1999 to 0.54 in 2008. Indeed, an analysis by Saboia (2007) of the impact of the minimum wage on the reduction in inequality during 1995-2005, found that 64 percent of the improvement in income inequality at the household level was due to increases in the minimum wage. In addition, the minimum wage is the reference value for a number of social programmes, including pension, disability and unemployment insurance benefits. Its increase during the 2000s significantly improved the living standards of low-waged workers while boosting aggregate demand in the economy.

Another important feature that characterized the 2000s was the development of a strong welfare state. With one of the highest levels of income inequality in the world and a PPP US$1.25 poverty rate of 14 percent in 1999, the government took important steps to lower poverty and reduce inequality through the creation and expansion of a variety of social programmes. Though many of the programmes had been set forth in the 1988 Constitution, their implementation had been slow. It wasn’t until the 2000s that the programmes underwent a notable expansion in coverage and an increase in the value of the benefits. The programmes include the rural pension, the BPC (Prestação de Benefício Continuada) and the Bolsa Família conditional-cash-transfer programme (Box 1).
Box 1: Social programmes in Brazil

**Rural pension:** The rural pension accounts for thirty percent of the benefits paid under the general pension system (RGPS - Regime Geral de Previdência Social). The programme provides a pension to rural workers upon meeting the retirement age, who can provide evidence of fifteen years of rural activity. The number of beneficiaries has expanded significantly since the early 1990s, from 4.1 million in 1992 to 6.4 million in 2000 and 8.2 million in the first half of 2010 (MPS, 2010). For 2010, this amounts to a transfer of approximately R$50 billion (1.6 percent of GDP) to rural areas of the country that are typically the neediest.

**BPC (Prestação de Benefício Continuada):** The BPC is a social assistance programme that provides benefits equivalent to the monthly minimum wage to persons aged 65 or older, or to persons who are unable to work due to disability of any age, whose per capita household income is less than one-fourth of the minimum wage (the extreme poverty line). The BPC was the first social assistance programme started in the country on a national scale, beginning in 1996. In 2010, 1.6 million elderly and 1.8 million disabled households received benefits through the BPC. Total spending amounted to R$20 billion, equivalent to .06 percent of GDP. The existence of the BPC and the rural pension has ensured a high level of pension coverage in the country – 85 percent for persons aged 65–approaching the level of Canada, at 90 percent coverage, and exceeding that of the United States, at 74 percent coverage (ILO, 2010).

**Bolsa Família:** The Bolsa Família conditional-cash-transfer programme started in 2003 with the merger of four existing conditional and unconditional cash transfer programmes of the federal government. The aim of Bolsa Família is to reduce poverty and hunger and improve social development, by means of a direct income transfer to poor and extremely poor families. It also aims to break the cycle of intergenerational poverty by improving the well-being and skills of children so they can overcome the social and economic barriers faced by their parents. Parents are required to maintain school-age children in school, have children vaccinated, and for women who are pregnant or breast-feeding, accept pre-natal and post-natal care. The programme has expanded rapidly from 3.6 million families in 2003 to 11.1 million in 2008 and 12.8 million in December of 2010, over one-quarter of the country’s population. The value of the benefit varies according to the number of children in the family, and averaged R$97 per month (approximately US$60) at the end of 2010. The total programme cost in 2010 was R$14.4 billion, roughly 0.4 percent of GDP.

In addition to social policies, there was growing recognition by the middle of the 2000s of the need to address bottlenecks arising from poor infrastructure, as well as the need to stimulate domestic investment, which had been hovering at the low rate of 17 percent of GDP for more than a decade. As a result, in 2007, the government launched the Growth Acceleration Programme (PAC – Programa de Aceleração do Crescimento), with the aim of investing R$420 billion during 2007-2010 in the areas of energy, logistics and social and urban infrastructure. Although initial evaluations of the PAC during 2007-2010 estimate that only about half of the planned investments took place. Nevertheless, the PAC represents a substantial sum of funds dedicated to investment but more importantly, is indicative of a paradigm shift in favour of a more active role of the State in investment. This paradigm shift can also be witnessed in the renewed interest given to industrial policy in the country. In 2004, the government created the Brazilian Agency for Industrial Development (ABDI – Agencia Brasileira de Desenvolvimento Industrial), a semi-autonomous agency tasked with working with the private sector to support and develop leading sectors through productive investments.

### 3. The crisis and Brazil

Before the onset of the economic crisis in September 2008, Brazil’s economic growth had been robust, averaging 4.4 percent annually in real terms in 2004-2007 and 6.4 percent (in accumulated growth) for the first three quarters of 2008. But the collapse of Lehman Brothers in September 2008 reverberated quickly across the globe, leading to a restriction in credit among private Brazilian banks and a sharp fall in the country’s exports. As a result, fourth quarter GDP growth
fell by 4.4 percentage points over the preceding quarter (seasonally adjusted) and there was a net loss of 634,000 formal jobs in the quarter, compared with a net gain of 10,400 formal jobs in the fourth quarter of 2007. The industrial sector was hit hard: production fell by 8 percent in the fourth quarter of 2008 and between the months of November 2009 and March 2010, half a million manufacturing jobs were lost in the country.

The Government responded quickly to the crisis by injecting liquidity into the economy, through the establishment of credit lines for sectors experiencing difficulty and by increasing the resources of the National Economic and Social Development Bank (BNDES). It also guaranteed maintenance of existing social programmes as well as the six percent real minimum wage increase that had previously been negotiated. Although with delay, the Central Bank initiated a series of interest rate reductions in January 2009 that lowered the base interest rate, the SELIC, by five percentage points from 13.75 percent to 8.75 percent in September 2009. To directly mitigate the crisis, the government also developed a fiscal stimulus package.

The stimulus package amounted to a US$20 billion injection into the economy in 2009, equivalent to 1.2 percent of Brazil’s GDP, among the lowest amounts spent by G20 countries. As a result, the fiscal impact was limited, with the deficit estimated at 3.2 percent of GDP in 2009. The main elements of the stimulus package were infrastructure investment (41 percent) and tax cuts (35 percent), followed by interest-rate subsidies to BNDES and the agricultural sector (15 percent), extraordinary budget transfers to municipalities (5 percent), extension of the Bolsa Familia conditional-cash-transfer programme (2 percent) and extension of unemployment insurance benefits (1 percent) (Table 1). Infrastructure investments included an expansion of the PAC and a new housing programme, Minha Casa, Minha Vida, targeted at low and middle-income households.

<table>
<thead>
<tr>
<th>Stimulus package</th>
<th>US$ billion</th>
<th>percent of GDP</th>
<th>Share of stimulus package (%)</th>
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</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td></td>
<td></td>
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<tr>
<td>Increase in Growth Acceleration</td>
<td>8.3</td>
<td>0.51</td>
<td>40.3</td>
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<tr>
<td>Programme (PAC)</td>
<td>5.0</td>
<td>0.31</td>
<td>24.3</td>
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<tr>
<td>Minha Casa, Minha Vida</td>
<td>3.3</td>
<td>0.20</td>
<td>16.0</td>
</tr>
<tr>
<td>Tax cuts</td>
<td>7.6</td>
<td>0.40</td>
<td>36.9</td>
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<td>Subsidies</td>
<td></td>
<td></td>
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<tr>
<td>Agriculture</td>
<td>3.1</td>
<td>0.20</td>
<td>15.0</td>
</tr>
<tr>
<td>BNDES</td>
<td>0.9</td>
<td>0.06</td>
<td>4.4</td>
</tr>
<tr>
<td>Transfers to municipalities</td>
<td>1.1</td>
<td>0.07</td>
<td>5.3</td>
</tr>
<tr>
<td>Social protection</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expansion of Bolsa Familia</td>
<td>0.5</td>
<td>0.03</td>
<td>2.4</td>
</tr>
<tr>
<td>Extension of unemployment insurance benefits</td>
<td>0.3</td>
<td>0.02</td>
<td>1.5</td>
</tr>
<tr>
<td></td>
<td>0.2</td>
<td>0.01</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>20.6</strong></td>
<td><strong>1.21</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: ILO, based on information from the Ministry of Finance, Brasil. Calculated at exchange rate of US$1 = R$1.8.

6 Calculated at the exchange rate of US$1 = R$1.8.
The stimulus package reflected the development agenda of the Lula government with its emphasis on consumption and investment as the drivers of economic growth. Consumption would be boosted by the reduction in the personal income tax rates of middle-income households as well as the reduction in the industrial products tax (IPI) on motor vehicles and appliances. To stimulate investment and counter the tightening of credit of the private banks, the government capitalized BNDES, providing subsidies on loans and developing special lines of credit for specific sectors, some of which were also made available through the two other public banks, the Banco de Brasil and the Caixa Econômica Federal. In addition, the government directed additional funds to the construction of public infrastructure, which served to ease transport bottlenecks, provide social goods such as housing, and create jobs.

As Brazil had managed to establish an extensive social protection system during the 2000s, further investments in social protection did not figure prominently in the package. Nevertheless, the government went ahead with its previously planned extension of the Bolsa Família programme by raising the eligibility ceiling to include an additional 1.3 million households and adjusting the benefit value to account for cost-of-living increases. The government also enacted a limited, two-month extension of unemployment insurance benefits to workers whose sector of economic activity was severely affected by the recession. This measure benefited approximately 310,000 people.

The decision to maintain the increase in the monthly minimum wage to R$ 465 in February 2009 and again in January 2010 (to R$510 per month) increased the incomes of wage-earners at the bottom of the pay scale, and also raised the incomes of pension and BPC beneficiaries. According to Jaccoud (2009), 64 percent of pension benefits equalled the minimum wage, such that an increase in the minimum wage translates directly into an increase in pension benefits. Similarly, benefits paid under the BPC are also tied to the minimum wage. As a result of its impact on wages and social benefits, the February 2009 minimum wage increase led to a direct injection of R$21 billion (0.7 percent GDP) into the economy in 2009. The indirect effects of this measure were also considerable. Based on the 2006 Social Accounting Matrix constructed by IPEA, each additional R$1 spent on the RGPS has a multiplier effect of 2.1 on family income and of 1.23 on GDP. The BPC programme, which is limited to families in extreme poverty, has a multiplier effect of 2.2 on family income and 1.38 on GDP, whereas Bolsa Família has a multiplier effect of 1.44 on GDP and 2.25 on household income (IPEA, 2010).

The strategy to boost consumption through wage increases, social transfers and tax cuts proved successful. Private consumption, which accounts for more than 60 percent of GDP, dipped slightly in the fourth quarter of 2008, remained flat in the first quarter of 2009, and by the second quarter had begun to climb again. Throughout the crisis, total retail sales remained positive. Sales of non-durable consumer good grew robustly as a result of the increased purchasing power of the poorer segments of the population; sales of consumer durables, which depend on the middle class, fell at the beginning of 2009, but then recovered strongly by the middle of the year (Figure 2).

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8 In 2006, the government, following consultation with representatives from workers’ and employers’ organizations as well as representatives of retirees, set out the terms of yearly minimum wage increases through 2011.

9 Pensioners who receive benefits that are above the minimum wage also benefited from the increase but at a lower rate. The increase was not automatic and had to be approved by Congress, though the increase was given retroactively to the date of the increase of the minimum wage.
Thus, despite a 0.6 percent drop in GDP in 2009, private consumption continued to rise due to the fiscal policies implemented to respond to the crisis as well as the wage and social policies that were already in place and further enhanced. As Schettini et al (2010) demonstrate in their empirical analysis of fiscal multipliers and consumption during 1995-2009, a one percent reduction in taxes or a one percent increase in social transfers is associated with a 0.46 percent increase in family consumption. The strategy was therefore important for increasing aggregate demand through its largest component—private consumption.

By shifting policy towards consumption, the government mitigated the effects of the fall in exports and investment associated with the international crisis, over which the country had little control. In the first quarter of 2009, for example, imports, exports and investment suffered a fall of roughly 15 percent compared with the same quarter of the previous year. In contrast, private and government consumption—which account for over 80 percent of GDP—remained relatively stable over the period of the crisis (Figure 3).

**Figure 2: Retail Sales: Year-over-year change (percent), September 2008-March 2010**

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**Figure 3: GDP by component (1995=100), Q2 2008 – Q3 2010**

Source: Central Bank of Brasil.
Most importantly, the ability to harness consumption for the benefit of the economy lay in the survival and continued presence of an important domestic manufacturing base. Although Brazil experienced some de-industrialization as a result of trade liberalization in the 1990s, there remains a sizeable manufacturing sector that accounts for the production and sale of most consumer goods, especially those aimed at the lower and middle class segments of the population. For example, in 2007, the average Brazilian owned 11.6 kilos of clothing, nine kilos of which were produced domestically. Imports have grown steadily since liberalization and there is a negative trade balance in the sector, yet sales continue to be largely domestic (da Costa and da Rocha, 2009). Moreover, automobiles, appliances and computers, though dependent on imported inputs, are primarily domestically produced. This differs radically from other Latin American countries whose manufacturing sectors were dismembered with trade opening, as in the case of Chile for example.

The existence of an important manufacturing base meant that the increase in income was directed primarily towards the purchase of domestically produced goods, as opposed to leaking out of the economy for the purchase of imports. Indeed, policies to boost income and consumption had important multiplier effects on the economy, boosting employment and incomes. For example, a study by IPEA (2009) calculated that each R$1.00 spent on cars has a multiplier effect of R$3.76 on aggregate output. With an estimated 25 million jobs (direct and indirect) reliant on car manufacturing, in the first half of 2009 the IPI cut is estimated to have contributed to maintaining between 50,000 and 60,000 direct and indirect jobs in the Brazilian economy (IPEA, 2009).

4. Conclusion

In responding to the economic crisis, the Brazilian government intensified the shift in its economic model that been slowly coming to fruition during the 2000s. The crisis made apparent that the Brazil could not rely on exports, especially of commodities, for its economic development. Development, rather, lied within its own borders, through income policies that boosted the purchasing power of the lower and middle classes and created a demand for goods and services, coupled with investment policies to improve physical infrastructure, synergizing business and advancing the progress of leading sectors. Such a response also took into consideration important multiplier effects, especially as regards job creation. 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 (Mostafa, forthcoming).

This strategy shift was facilitated by the existence of several key pre-crisis institutions. These include an extensive social safety net – especially when compared with other middle-income countries – that combines traditional social security programmes with social assistance, and which was able to be ratcheted up to mitigate the effects of the crisis, as well as the existence of three important public banks, including the BNDES, which promote investment by issuing government loans to the private and semi-public sector and which were able to counter the fall-off in liquidity from Brazilian private banks at the beginning of the crisis.

Brazil’s success in using income policies to mitigate the effects of the international crisis demonstrates that a trade-off does not exist between economic and social goals; on the contrary, income policies promote economic growth while improving the living standards of the population.
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