Informality and weak competition – a deadly cocktail for growth and equity in emerging Latin America

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Why is growth persistently low and so unevenly distributed in emerging Latin America compared to emerging Asia despite a huge potential? Potential growth is ranging around 2-3% in the region. Some refer to dependence on commodities, poor education, weak business environments or corruption as possible causes. But the question is deeper and more complex. A crucial factor for Latin America is low productivity, often related to a poor use of available resources. Across the region, many workers and significant amounts of capital are stuck in activities that are not efficient. The reasons for this are many, but two important forces stand out: high informality and weak competition.
High and persistent informality in the region leaves workers more vulnerable and deprives them from social protection, thus contributing to inequality. For example, old age poverty in Colombia is high as low-skilled workers spend much of their working lives in informal employment, without pension contributions (OECD, 2019[1]). In Brazil and Argentina, informal workers retire later than others for the same reason, until they eventually reach the age to benefit from a non-contributory pension (OECD, 2019[2]; OECD, 2018[3]). In Mexico, poverty and informality are highly correlated among regions (OECD, 2019[4]). Informality also tends to maintain companies small with often low productivity as growing would face high costs of formalisation. Indeed, informal-sector productivity in the average LAC country is only between 25 and 75 percent of total labour productivity, and productivity decreases as informality rises (Loayza, 2018[5]). Informality also reduces the tax base for corporate and personal income taxes, reducing the capacity of the public sector to boost productivity and reduce inequality, and requires a higher tax burden on larger formal companies.
Weak competition is a second reason behind low productivity and is often reflected in high concentration (Figure 2). Entry barriers can protect existing activities that have little future growth potential at the cost of new dynamic and productive firms. Weak competition creates rents and lowers the share of wages in value-added worsening income distribution. Higher prices for consumers reduce purchasing power, affecting disproportionally low-income households.

![Figure 2. Competition perceptions are low in LAC](image)


Reducing informality for productivity and equity

The causes of informality are multiple. Informality is often a consequence of high costs of hiring formal workers, both wage and non-wage, especially in relation to labour productivity, given low educational outcomes.

Where high informality and weak competition coincide, as is the case in many Latin American countries, the consequences for both growth and equity can be particularly severe. For emerging Latin America to grow stronger and better share the
fruits of growth, dealing with informality and competition should be priority.

Labour informality is often caused by rigid labour regulation. High firing costs of workers can discourage formal-sector hiring and promote inequality (Loayza, 2018[5]; OECD, 2018[6]; Heckman and Pages, 2000[7]). In Mexico, a labour reform in 2012 reduced hiring and firing costs, introduced different models of contracting and brought changes to the resolution of labour conflicts. Formal salaried jobs increased in the aftermath (OECD, 2019[4]). Minimum wages can be high compared to productivity or average wages keeping most workers informal. In Colombia, the minimum wage is close to the median wage and two thirds of workers earn less than that (OECD, 2019[1]). High payroll taxes can also have a detrimental effect on informality rates (Bobba, Flabbi and Levy, 2018[8]). Antón and Rastaletti (2018[9]) show how lowering employer social security contributions could lead to a substantial increase of labour formalisation. At a minimum, lower employer contributions could be offered temporarily for hiring low-skilled workers that enter the formal sector for the first time (OECD, 2017[10]). Lowering payroll taxes in Colombia helped reduce informality after the 2012 reform (Kugler et al., 2017[11]; Morales and Medina, 2016[12]; Fernández and Villar, 2016[13]; Bernal et al., 2017[14]). While incentives are crucial, better enforcement also needs to be part of any formalisation strategy.

Cumbersome administrative barriers and high taxes can keep companies informal. Latin America stands out in this respect (Figure 3). The tax burden on formal companies is also high compared to the OECD and positively associated to informality rates (Figure 4). To promote formalisation, regulatory and tax systems should be simple, with gradual increases in the tax burden as firms grow, so as not to discourage growth, and keep
marginal tax rates as low as possible (Loayza, 2018[5]). These characteristics are crucial to encourage investment and employment in growing and larger companies.

Many countries in the region have implemented simplified schemes and reduced costs for small taxpayers with the aim of reducing informality. For example, Mexico introduced a special simplified regime for SMEs (Regimén de Incoporación Fiscal, RIF) in 2014, which induced 1.5 million informal firms to join the tax system (OECD, 2018[15]). In Brazil, a special tax regime for microenterprises (Microemprendedor Invididual, MEI) reduced the cost of formalisation and contributions to social security as of 2008. This regime helps explain the rising formalisation of the self-employed, including of women (OECD, 2012[16]). In Argentina, a simplified tax regime called Monotributo helped formalise self-employed workers. In Colombia, the tax reform in 2018 introduced a new simplified tax scheme (Simple) for small firms, and there are signs of positive impact on firm formalisation during 2019. At the same time, these regimes have to be designed carefully. When participation thresholds for special SME tax regimes are set too high, the effectiveness for formalisation declines while fiscal cost and threshold effects rise, as in the case of Brazil’s Simples Nacional (OECD, 2018[3]). At times, simplifying the general tax regime may be preferable over creating exceptions.
Education and skill levels are also linked with informality. Countries with lowest informality rates tend to have significantly higher levels of human capital (Docquier, Müller and Naval, 2017[17]). It is not a coincidence that the decrease in informality over recent decades in Latin America went hand in hand with steady progress towards universal education. Evidence shows that improvements in education have
been an important driving force behind falling informality in Colombia and Brazil (International Monetary Fund, 2018[18]; OECD, 2018[3]).

Increasing competition for productivity and equity

In Latin America, the same complex rules that discourage formal job creation often coincide with overly strict regulations that stifle competition. Competition is affected by how easily firms can enter or exit markets, by the extent of license requirements for starting or expanding a business and by competitive pressures from imports. Relatively high trade protection adds to this in a number Latin American countries, shielding domestic producers from international competition (OECD, 2018[3]). All of this tends to raise prices for consumers and keep resources in low-productivity activities where informality is widespread, for both workers and firms.

These circular relationships suggest that it is important for the public sector to take stock of burdens that even well-intended regulations and codes can impose on private activity. Disincentives for firms to go formal will inevitably preclude workers from the benefits of formal jobs, while unnecessary barriers to competition will keep more jobs in activities with limited potential for productivity and wage growth. To foster formal job creation, all parts of a country’s regulatory framework should be simple and clear, promote competition, and facilitate both market entry and exit of firms (Loayza, Oviedo and Serven, 2005[19]).

Getting there
A comprehensive strategy is needed to deal with both informality and competition. It involves simplifying labour regulations, keeping administrative burdens and license requirements for companies as easy as possible, facilitating market entry and reducing trade barriers. Bringing more workers and firms into the formal sector would bring about broader social and labour protection, fairer wages, a more even tax burden and higher potential growth. Many of these policies are politically difficult as they involve dealing with vested interests and require appropriate sequencing. But that is not an excuse for inaction. These reforms should be accompanied with training and other active labour market policies for affected workers, as the informal sector often fulfils the function of absorbing excess labour supply, especially during transitions or economic recessions. Reforms to improve quality and relevance of education to raise worker productivity and policies that can raise investment and boost firm productivity should be also part of the strategy.

References


Positive economic outlook for
The main economies in Latin America but downward risks have intensified

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The global economy is navigating rough seas. Global GDP growth is strong but it has peaked. In many countries unemployment is well below pre-crisis levels, labour shortages are biting and inflation remains tepid. Yet, global trade and investment have been slowing on the back of increases in bilateral tariffs while many emerging market economies are experiencing capital outflows and a weakening of their currencies. The global economy looks set for a soft landing, with global GDP growth projected to slow from 3.7% in 2018 to 3.5% in 2019-20. However, downside risks abound and policy makers will have to steer their economies carefully towards sustainable, albeit slower, GDP growth.

The economic recovery in the Latin American economies has become dissimilar. While in some countries, growth has been revised downwards, in others it has been revised upwards. This disparity is closely linked to how these economies have evolved in the face of the financial stress and increased financial volatility in recent months. The region’s economies with the best macroeconomic fundamentals, independent central banks, countercyclical monetary policies, sound fiscal policy framework and no major currency mismatches in corporate or sovereign debt, were better able to sail the adverse global financial conditions that led to capital outflows, weakening their currencies.
While Chile and Colombia have gained momentum, Brazil has shown lower growth and Argentina has fallen into recession. Mexico and Costa Rica have also experienced less momentum than expected. Growth in Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico, countries covering about 85% of Latin America’s GDP, is expected to be around 1.4% this year and to accelerate to 2.0% in 2019 and 2.7% in 2020 (weighted average) (see Table). However, downside risks abound while the region is vulnerable to the global context. Several indicators, such as the fiscal and current account deficits have been accentuated in the last decade in most of these economies (Figure), suggesting that the region is still vulnerable. Needs to be noted that the situation is uneven and a broader list of indicators should be analysed.

| OECD Economic Outlook for some Latin American countries |
|-----------------|--------|--------|--------|--------|
|                  | 2017   | 2018   | 2019   | 2020   |
| Argentina        | 2.9    | -2.8   | -1.9   | 2.3    |
| Brazil           | 1.0    | 1.2    | 2.1    | 2.4    |
| Chile            | 1.6    | 4.1    | 3.7    | 3.4    |
| Colombia         | 1.8    | 2.8    | 3.3    | 3.4    |
| Costa Rica       | 3.3    | 2.9    | 3.0    | 3.3    |
| Mexico           | 2.3    | 2.2    | 2.5    | 2.8    |

Source: OECD Economic Outlook 104.

Note: Contains data for Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico in the region. In addition, it contains data for China, India, Indonesia, Russia, South Africa and Turkey.
Source: OECD Economic Outlook 104 and IMF.
An accumulation of risks could create the conditions for a harder-than-expected landing. First, further trade tensions would take a toll on trade and GDP growth, generating even more uncertainty for business plans and investment. Second, tightening financial conditions could accelerate capital outflows from the region and depress demand further. Third, a sharp slowdown in China would hit Latin America and other emerging economies, but also advanced economies if the demand shock in China triggered a significant decline in global equity prices and higher global risk premia.

Looking ahead, it will be necessary to strengthen the macroeconomic policy framework to reduce vulnerabilities where necessary. Most of the region’s economies are starting, or will start in the near future, more restrictive monetary policies, while also undertaking fiscal consolidation. Depending on each country, it will be important to find a balance between the needs for social spending and public investment, with the need to put debt on a sustainable path. In Chile, Colombia and Mexico, this consolidation can be done gradually, but Argentina, Brazil and Costa Rica need to do it more urgently. Pension or tax reforms will be necessary in this regard.

Given the limited scope for countercyclical policies, in the face of external risks and a more pronounced slowdown, the time to promote the necessary structural reforms is now to guarantee a future with a sustained increase in productivity and greater inclusion. Many countries in the region have scope to reform the tax system and make it more effective in improving investment incentives and raising more resources. Depending on the characteristics of each country, possible measures may include limiting the use of tax exemptions and reduced rates, particularly in VAT, but also in corporate taxes, extending the tax base by including more people in personal income taxes, reducing evasion or making greater use of property, inheritance or environmental taxes. Other
priorities should focus on export promotion and diversification, which would help reduce current account deficits. Investing in quality and innovative human capital, closing infrastructure and logistical gaps, and curbing corruption would support exports and their diversification, strengthening growth. Encouraging women’s participation in the labour force, reducing precariousness and informality in the labour market, as well as pension reforms are also urgent in several countries of the region and necessary to increase productivity and reduce inequalities.

**Argentina**: A combination of massive fiscal and monetary tightening will keep the economy in recession during 2018 and 2019. Private consumption and investment will remain depressed due to lower real incomes and high interest rates, and unemployment will rise. However, a better harvest and a lower real exchange rate will support stronger exports.

**Brazil**: Growth will gain momentum during 2019 and 2020 as private consumption, supported by improvements in the labour market, will increase. Recovering credit and greater policy certainty as a new administration takes office will buttress the recovery. Political uncertainty around the implementation of reforms remains significant and could derail the recovery, but if uncertainty fades and reforms advance as assumed, investment will become stronger.

**Chile**: Growth is projected to remain strong over the next two years. With an uncertain external environment, solid domestic demand will underpin growth, aided by a stable inflation environment, public infrastructure projects and a tax reform. Inequality, though decreasing, remains high, as informality and unemployment remain high and social transfers low.

**Colombia**: Growth is projected to pick up as infrastructure projects, lower corporate taxes and higher oil prices will boost investment. Improving confidence and financing conditions will support consumption. As growth gains traction,
unemployment will edge down. Social indicators are improving but informality and inequality remain high.

**Costa Rica**: Growth is projected to recover to around 3¼ per cent in 2020 and be broad-based, underpinned by both domestic and external demand. However, uncertainty, particularly surrounding the planned fiscal reforms, is weighing on growth in the near term. The projections are based on the assumption that the fiscal reforms will be implemented from 2019, with modest fiscal tightening holding back growth in 2019 and 2020.

**Mexico**: Growth is projected to pick up to 2¾ per cent in 2020. Low unemployment, strong remittances and the recovery of real wages will support household consumption. Investment, which has been persistently low, will strengthen on the back of announced public investment plans and increased confidence associated with the US-Mexico-Canada trade agreement. Exports will decelerate owing to less favourable global conditions, especially in the United States. Inflation has been pushed up by rising energy prices, but expectations and core inflation remain anchored and within the central bank’s target band. Informality is slowly declining but remains elevated, contributing to persistently high inequalities and low productivity.

To read more about the Economic Outlook and the main structural challenges visit the [english and spanish/portuguese version](https://doi.org/10.1787/eco_outlook-v2018-2-en) (it includes OECD forecasts and a chapter on decoupling of wages and productivity and the implications for public policy).

**References:**

Las perspectivas económicas son positivas en los principales países de América Latina pero los riesgos a la baja se han acentuado

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La economía mundial está navegando mares agitados. El crecimiento del PIB mundial es fuerte, pero ha alcanzado su punto máximo. En muchos países, el desempleo está por debajo de los niveles anteriores a la crisis de 2008, la escasez de mano de obra se empieza a sentir, aunque la inflación sigue siendo templada. Sin embargo, el comercio y la inversión mundiales se han desacelerado como consecuencia del incremento de aranceles bilaterales y de mayor incertidumbre política, mientras que varias economías emergentes están experimentando salidas de capitales y un debilitamiento de sus monedas. La recuperación del crecimiento global comenzará a desacelerarse, mientras que los riesgos a la baja se han acentuado. Se prevé que el crecimiento del PIB mundial disminuya del 3,7% en 2018 a 3,5% en 2019-2020. Sin embargo, abundan los riesgos de recesión y los responsables políticos tendrán que orientar cuidadosamente sus economías hacia un crecimiento sostenible, aunque más modesto, del PIB.

En las principales economías de América Latina, la recuperación económica se ha vuelto despareja. Mientras que en
algunas, el crecimiento se ha revisado a la baja, en otras se ha revisado al alza. Esta disparidad está estrechamente ligada a cómo estas economías han evolucionado frente al estrés financiero e incremento de volatilidad financiera de los pasados meses. Las economías de la región con mejores fundamentos macroeconómicos, bancos centrales independientes, políticas monetarias contracíclicas, un marco de política fiscal sólido y sin grande descalle de monedas en la deuda corporativa o soberana, fueron los que sortearon mejor las condiciones financieras globales adversas que sometieron a varios países a una repentina salida de capitales y debilitamiento de sus monedas.

**Perspectivas Económicas de la OCDE para algunos países de América Latina**

<table>
<thead>
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<th>País</th>
<th>2017</th>
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<td>Chile</td>
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Fuente: Perspectivas Económicas 104 de la OCDE.

Mientras que Chile y Colombia han ganado ímpetu, Brasil ha mostrado menor crecimiento y Argentina ha caído en recesión. México y Costa Rica también han experimentado menor ímpetu al esperado. Se espera que el crecimiento en Argentina, Brasil, Chile, Colombia, Costa Rica y México, países que cubren alrededor del 85% del PIB de América Latina, se sitúe en torno al 1.4% este año y se acelere a 2.0% en 2019 y 2.7% en 2020 (promedio ponderado) (Tabla). Sin embargo, abundan los riesgos a la baja, mientras que la región se encuentra vulnerable al contexto global. Algunos indicadores, como los déficits fiscales y de cuenta corriente (Figura) se han acentuado en la mayoría de estas economías en la última década, sugiriendo que la región es aún vulnerable. Debe notarse que la situación es dispar y se debe mirarse una lista más amplia de indicadores.

Una acumulación de riesgos podría crear las condiciones para
una desaceleración de crecimiento más acentuada de la esperada. En primer lugar, nuevas tensiones comerciales afectarían al comercio y al crecimiento del PIB, generando aún más incertidumbre para las empresas y la inversión. En segundo lugar, el endurecimiento de las condiciones financieras globales podría acelerar las salidas de capitales y deprimir aún más las monedas de la región. En tercer lugar, una fuerte desaceleración en China afectaría a la región y otras economías emergentes, pero también a las economías avanzadas si el shock de la demanda en China provocara un descenso significativo de los precios mundiales de las acciones y un aumento de las primas de riesgo mundiales.

La región sigue siendo vulnerable diez años después

Nota: Contiene datos para Argentina, Brasil, Chile, Colombia, Costa Rica y México en la región. Además, contiene datos para China, India, Indonesia, Rusia, Sudáfrica y Turquía.
Fuente: Base de datos de Perspectivas Económicas 104 y FMI.

De cara al futuro, será necesario reforzar el marco de las políticas macroeconómicas para reducir vulnerabilidades donde sea necesario. La mayor parte de las economías de la región están comenzando, o lo harán en el futuro próximo, políticas monetarias más restrictivas, al tiempo que también deben llevar a cabo una consolidación fiscal. Dependiendo de las holguras de cada país, será importante encontrar un ritmo que balancee las necesidades de gasto social y de inversión
pública, con la necesidad de poner la deuda en una senda sustentable. En Chile, Colombia y México, esta consolidación se puede llevar a cabo de manera gradual, pero Argentina, Brasil y Costa Rica necesitan hacerlo de manera más urgente. Reformas pensionales o tributarias serán necesarias en este sentido.

Dado el escaso margen para hacer políticas contracíclicas ante la realización de riesgos externos y una deceleración más acentuada, el momento de impulsar reformas estructurales necesarias es ahora, para garantizar un futuro con incremento sostenido de la productividad y mayor inclusión. Muchos países de la región tienen margen para reformar el sistema tributario y hacerlo más eficaz para mejorar los incentivos a la inversión y recaudar más recursos. Según las características de cada país, posibles medidas pueden incluir limitar el uso de exenciones tributarias y tasas reducidas, en particular en el IVA, pero también en los corporativos, extender las bases de imposición incluyendo más personas en los impuestos a los ingresos personales, reducir la evasión o hacer mayor uso de impuestos a la propiedad, a la herencia o impuestos ambientales. Otras prioridades deberían focalizarse en fomentar las exportaciones, y diversificarlas, lo que ayudaría a reducir los déficits de cuenta corriente. Invertir en capital humano de calidad e innovación, cerrar las brechas de infraestructura y logística y frenar la corrupción apoyarían a las exportaciones y su diversificación, fortaleciendo el crecimiento. Alentar la participación de la mujer en la fuerza laboral, reducir la precariedad e informalidad del mercado laboral, así como reformas al sistema de pensiones son también urgentes en varios países de la región y necesarios para aumentar la productividad y bajar las desigualdades.

**Argentina:** La economía seguirá en recesión en 2018 y 2019 debido a un endurecimiento fuerte y simultáneo de políticas monetarias y fiscales. El consumo privado y la inversión seguirán siendo bajos a causa del descenso de los ingresos
reales y de los elevados tipos de interés, y aumentará el desempleo. Sin embargo, una mejor cosecha y un tipo de cambio real más competitivo contribuirán al aumento de las exportaciones.

**Brasil**: El crecimiento cobrará impulso en 2019 y 2020 gracias al aumento del consumo privado, respaldado por mejoras en el mercado laboral. La reactivación del crédito y el descenso de la incertidumbre política una vez que el nuevo gobierno tome posesión apuntalarán la recuperación económica. La incertidumbre política sobre la implementación de reformas sigue siendo importante y podría frenar la recuperación pero, si desaparece y las reformas siguen adelante como se supone que deberían hacerlo, aumentará la inversión.

**Chile**: Según las proyecciones, el crecimiento seguirá aumentando en los próximos dos años. Ante una incierta coyuntura externa, el crecimiento estará respaldado por la sólida demanda interna con ayuda de un entorno de inflación estable, proyectos de infraestructuras públicas y una reforma fiscal. A pesar que las desigualdades han disminuido, permanecen altas, debido a que la informalidad y el desempleo siguen siendo elevados y las transferencias sociales escasas.

**Colombia**: Las proyecciones indican que el crecimiento repuntará, ya que los proyectos de infraestructuras, el descenso del impuesto de sociedades y la subida de los precios del petróleo potenciarán la inversión. La mejora de la confianza y de las condiciones de financiamiento respaldará el consumo. A medida que el crecimiento se vaya afianzando, el desempleo descenderá. Los indicadores sociales están mejorando, aunque la informalidad y la desigualdad se mantendrán en niveles elevados.

**Costa Rica**: Según las proyecciones, el crecimiento se recuperará hasta el $\frac{3}{4}$ aproximadamente en 2020 y será generalizado, sostenido tanto por la demanda interna como externa. Sin embargo, la incertidumbre, particularmente
respecto a las reformas fiscales planificadas está lastrando el crecimiento a corto plazo. Las proyecciones parten del supuesto de que las reformas fiscales se aplicarán a partir de 2019, con un modesto ajuste fiscal que frenará el crecimiento en 2019 y 2020.

**México:** Está previsto que el crecimiento repunte hasta el 2¾ por ciento hacia 2020. El bajo nivel de desempleo, fuertes remesas y la recuperación de los salarios reales reforzarán el consumo de los hogares. La inversión, que ha sido persistentemente baja, se reforzará a consecuencia de los planes de inversión públicos anunciados y del aumento de la confianza vinculado al acuerdo comercial entre Estados Unidos, México y Canadá. El crecimiento de las exportaciones se reducirá debido a unas condiciones internacionales menos favorables, en especial en Estados Unidos. La subida de los precios de la energía ha empujado la inflación al alza, pero las expectativas y la inflación subyacente siguen ancladas y dentro del rango meta del banco central. El alto nivel de informalidad contribuye a que haya una gran desigualdad y una escasa productividad.

Para leer en más detalle sobre las proyecciones macroeconómicas, así como los principales desafíos estructurales ir al reporte en la versión español/portugués o inglés (que incluye proyecciones para países de la OECD, principales desafíos y un capítulo especial sobre la desvinculación de los salarios y la productividad y las implicancias en términos de políticas públicas).
Towards a more prosperous and inclusive Brazil

By Jens Arnold and Alberto González Pandiella

Over the past two decades, strong growth combined with remarkable social progress has made Brazil one of the world’s leading economies. However, Brazil remains a highly unequal country, recent corruption allegations have revealed significant challenges in economic governance and the situation of its fiscal accounts is challenging with high and rising public debt (OECD, 2018). This calls for wide-ranging reforms to sustain and continue progress on inclusive growth. The government has started to put in place significant reforms, including a fiscal rule and a financial market reform that aligns directed lending rates with market rates. The long and deep recession is over and growth is projected to accelerate significantly this year. But more needs to be done to improve the living standards of all Brazilians.

The overall budget deficit is close to 8% of GDP driven by rising expenditures. Gross public debt has increased by approximately 20 percentage points of GDP over the last 3 years and stands around 75% of GDP. Implementing the planned fiscal adjustment and achieving fiscal targets is crucial for restoring the credibility of fiscal policy and avoiding a fiscal crisis. A comprehensive social security reform has become the most urgent element of the fiscal adjustment, as much of the worsening of the deficits is due to rising pension spending. A pension reform is also an opportunity to make growth more inclusive through better targeting of benefits. Aligning Brazil’s pension rules with those practiced in OECD countries could be done in a way to preserve the purchasing power of pensioners while significantly improving the sustainability of the pension system. For example, in OECD countries people retire on average when they become 66 years
old, while the effective retirement age in Brazil is 56 years for men and 53 for women. Establishing a formal minimum retirement age would help, in addition to rethinking the current benefit indexation mechanisms. Without reform, pension expenditure will more than double by 2060 (OECD, 2017), which would lead to unsustainable fiscal dynamics (Figure 1).

![Brazil’s public debt trajectory under various scenarios, 2007-2030](image)

Note: See OECD (2018) for a definition of the different scenarios. The ambitious reforms scenario assumes structural reforms boosting productivity growth, such as lowering trade barriers or reducing barriers to entrepreneurship. See table 1 in OECD (2018) for additional details. The no pension reform scenario assumes the absence of any noticeable parametric reform to the pension system.

Source: OECD Economic Surveys: Brazil 2018

Improving the effectiveness of public spending, and in particular public transfers, will also be crucial for further social progress. At present a large and rising share of social benefits is paid to households that are not poor, which reduces their impact on inequality and poverty. Already, poverty is more than three times higher among children and
youths than among those aged above 65 (Figure 2). Limiting future increases in those social benefits that do not reach the poor would be a first step. That would instead allow shifting more resources towards transfers that do reach the poor, such as Bolsa Família, which is highly regarded across the world and reaches the poor like hardly any other social programme in Brazil. This would help particularly children and youths. Currently Bolsa Família only represents 0.5% of GDP out of the 15% of GDP that Brazil spends on social transfers (OECD, 2018). There is also scope to reduce transfers to the corporate sector, which have increased markedly over recent years. These transfers, often granted in the form of tax exemptions or subsidised lending, have not been associated with visible improvements in productivity or investment, but they benefitted primarily the more affluent, besides creating fertile ground for corruption and political kick-backs.
Further advances in living standards will also hinge on finding a new inclusive growth strategy, ensuring that the benefits of growth will be broadly shared across the population. Productivity will have to become the principal engine of growth in the future, because the demographic bonus that has supported growth in Brazil is reversing. But raising productivity will require significantly higher investment and trade. Brazil has one of the lowest investment rates among OECD and emerging market economies and it is also less integrated into global trade. Boosting investment and trade would raise productivity, helping Brazilians to access higher
Reforming Brazil’s old-age pension system to ensure its sustainability

By Jens Arnold, Head of Brazil Desk at the OECD Economics Department and Hervé Boulhol, Head of Pensions and Population Ageing at the OECD’s Directorate for Employment, Labour and Social Affairs

Pensions have been successful in reducing old-age poverty well below the population-wide average, and below the OECD average (Figure 1). At present, all pension recipients – and this includes around 90% of those aged 65 and above – receive at least the minimum wage, which is more than 5 times as much as the poverty line of BRL 170 (equivalent to USD 55).

However, Brazil’s old-age pension system already costs more than 10% of GDP, despite the country’s young – but rapidly ageing – population. The combined annual shortfall of the pension schemes is close to 4.5% of GDP, contributing substantially to the budget deficit. If the current parameters

References:


of the system remain unchanged, spending on pensions for private-sector workers alone would increase by almost 3% of GDP by 2030, and by almost 5% of GDP by 2040. Taking into account the public sector amplifies imbalances, which will make the system financially unsustainable. An in-depth reform is necessary and inevitable.

Several policy measures could contribute to containing pension expenditures. Raising Brazil’s low average retirement ages of 56 years for men and 53 years for women appears urgent, by introducing a binding minimum retirement age. Many OECD countries are now gradually moving their normal retirement ages beyond 65 years for men and women. In contrast to Brazil’s pension system, all public pension schemes in OECD countries include a minimum retirement age.

Brazil also stands out for high pension benefits relative to working-age incomes, in particular for low-wage earners, paid at low retirement ages (Figure 2). In the OECD, an average-wage full-career worker will get a pension paying 53% of pre-retirement earnings at the age of 65.5 years, compared to 70% for men and 53% for women in Brazil at age 55 and 50, respectively. Moreover, the minimum pension benefit is equal to the minimum wage, which has led to real increases in the
minimum pension of almost 90% over the last 10 years. The minimum pension is available after 35 years of contribution or from age 65 after only 15 years of contribution.

Figure 2. Net replacement rate for full-career worker having entered the labour market in 2014

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Untying the knots strangling Brazil’s competitiveness

by Sónia Araújo
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There is strong international evidence that trade
liberalisation and increased international integration are key elements of a successful growth strategy. Exposure to international competition, sourcing internationally and learning by exporting accelerates technological upgrading and fosters productivity growth. This column explains how three policy instruments are holding back competitiveness by limiting Brazil's ability to tap into the global pool of knowledge.

Despite a constitutional amendment in 2003 intended to exempt exports from indirect taxes, Brazilian exporters face tremendous hurdles in claiming back indirect taxes paid on intermediate inputs. Poultry exporters, for instance, estimate that the government owes them around 7% of the value of their exports on account of the several indirect taxes paid on inputs. After attempting to claim these credits for years, companies simply prefer to write off these amounts.

The competitiveness of industrial exports is suffering even more than that of raw and semi-processed goods on two accounts: higher rates are applied to products requiring more transformation and indirect taxes are cumulative. Indirect taxes on inputs embodied in exports put Brazilian producers at a disadvantage vis-à-vis foreign competitors who do not pay such taxes.

Brazilian exporters are also penalised by Brazil’s high import tariffs, which are the highest among the BRICS countries for non-agricultural products (see previous post on Brazil: A tale of two industries or how openness to trade matters, March 22, 2016). Together with local content requirements that expand into an increasing number of sectors (oil, chemicals, motor vehicles, telecoms, health, etc.), they prevent Brazilian companies from sourcing at the lowest cost.

Advocates of trade protection often claim that protection raises the performance of domestic industry over time. Brazil’s own experience in this area is sobering. There is no
evidence that high levels of protection have spurred Brazil’s exports, which have remained flat relative to GDP (Figure 1).

**Figure 1. Brazil’s share of world trade is low relative to its GDP**

Share of exports and imports on world’s total exports and imports, respectively

![Chart showing Brazil's share of world trade](chart)

*Source: Secretaria de Comércio Exterior (SECEX) do Ministério do Desenvolvimento, Indústria e Comércio Exterior (MDIC), World Bank Development Indicators.*

In fact, the share of manufacturing output in GDP has been declining for a decade and manufacturing productivity is low and stagnant (Figure 2).

**Figure 2. Manufacturing productivity is low and stagnant**

Labour productivity in thousands of constant 2005 USD per employee
By international comparison, Brazil’s industrial sector is small for a middle income country (Figure 3; OECD, 2015).

**Figure 3. Brazil’s industrial sector is small for an upper middle income country**

*Share of industry in total value added in middle income countries, in per cent, 2012*


In a recent study, we attempt to quantify the effects of lifting these barriers to trade using the OECD Metro model, a computable general equilibrium model of the world economy. The simulation results suggest that reducing import tariffs and local content rules, and effectively exempting intermediate
inputs from indirect taxes would boost Brazilian exports, production and jobs substantially. The largest gains would accrue in manufacturing, where exports of leather products, electronic and transport equipment, motor vehicles and non-ferrous metals would all increase by more than 40% (Figure 4). Job creation would be higher in lower skilled occupations, benefiting those at the lower end of the income distribution.

**Figure 4. Largest Gains in Exports**
Sectors with an increase in exports of at least 20%

The simulation results also suggest that these tax and trade policy reforms would bring clear efficiency gains to the economy: firms would be able to use a higher share of foreign intermediate goods and final goods would in turn be sold at lower prices, enhancing export competitiveness and benefiting Brazilian households.

Another result from our simulations is that it pays to go for a big push. The benefits of a wide-ranging trade liberalisation would far exceed those of partial reforms. Overall, getting rid of these barriers would enable Brazil to develop a stronger manufacturing sector and become much more integrated into the global economy.
Brazil: A tale of two industries or how openness to trade matters

by Jens Arnold
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Brazil has a large and diversified industrial sector, but while parts of it are thriving, others are facing hard times, in part because they are weakly integrated into the world economy. The automotive and the aircraft sectors are two opposite examples of Brazilian industries – one inward-focused and one fully integrated into global trade.

Brazil is the world’s seventh largest automobile producer, but its automotive industry is currently facing severe challenges and production is declining (Figure 1). The industry is heavily protected from foreign competition and Brazil’s car manufacturers have a strong focus on the domestic market and on local content. Only 15% of the production is exported. Despite being the 8th largest producer of cars in the world,
Brazil ranks only 24th in automotive exports. Brazilian vehicle exports have the third-lowest foreign value added content among the 62 countries in the OECD-WTO Trade in Value Added database (OECD, 2015a).

**Figure 1. Production of motor vehicles, in million units, accumulated over 12 months**

![Graph showing production of motor vehicles from 2005 to 2015](http://www.anfavea.com.br/tabelasnovorev.html)


While many foreign producers have set up production plants in Brazil in light of the attractive long-term potential of Brazil’s consumer market, most of them have not integrated their Brazilian plants into global value chains (OECD, 2015b). Possibly due to the low exposure to foreign competition, productivity has fallen sharply behind Mexican car manufacturers, who are fully integrated into global production chains and have achieved remarkable gains in global market share. For example, Mexican plants produce 53 cars per worker and year, as opposed to 27 in Brazil, although the cars produced in Mexico are on average smaller models.

A very different story can be told about Brazil’s aircraft industry. Given that production volumes of airplanes are much smaller than for automobiles, economies of scale mandate that firms in this industry focus on the global market. Embraer, originally created in 1969 as a state-owned company, was privatized in the 1990s and has become one of the top global players in the industry since then. Its initial strategy was
largely based on buying almost all components internationally for a final assembly in Brazil, although over time it has started to produce parts itself. As a result of its roots, Embraer has always been strongly integrated into global production chains, and imports still account for 70% of its value added. At the same time, exports have grown steadily, performing significantly stronger than motor vehicle exports (Figure 2). By now, Embraer has become the world’s third largest aircraft producer, and it is the global leader in the 70-130 seat aircraft segment, where it accounts for 60% of global deliveries.

**Figure 2. Brazil: Exports of motor vehicles and aircraft, 2005=100, in USD**

![Figure 2. Brazil: Exports of motor vehicles and aircraft, 2005=100, in USD](image)

*Source: Ministry of Development, Industry and Foreign Trade, Brazil.*

**References**
