Promoting Sustainable Productivity Growth

A triangular key set of reforms

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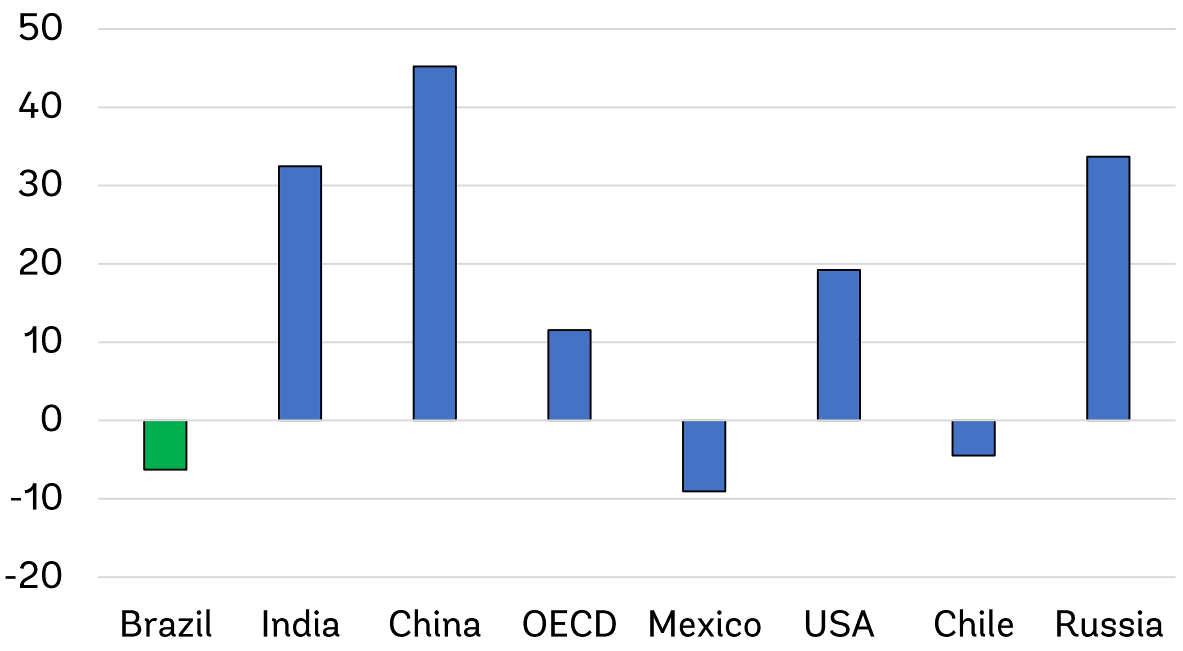
Productivity has remained stagnant over the past few decades

- TFP had a negligible contribution to GDP growth and its growth has been negative in the last decades.
- Without a significant increase in capital investments and TFP, convergence to higher income levels will be jeopardized and growth will slow down.
- TFP can complement investment, directly impacting economic growth and indirectly attracting investments to improve the capital stock and increase efficiency.

Figure 1: TFP Growth during 1995-2014



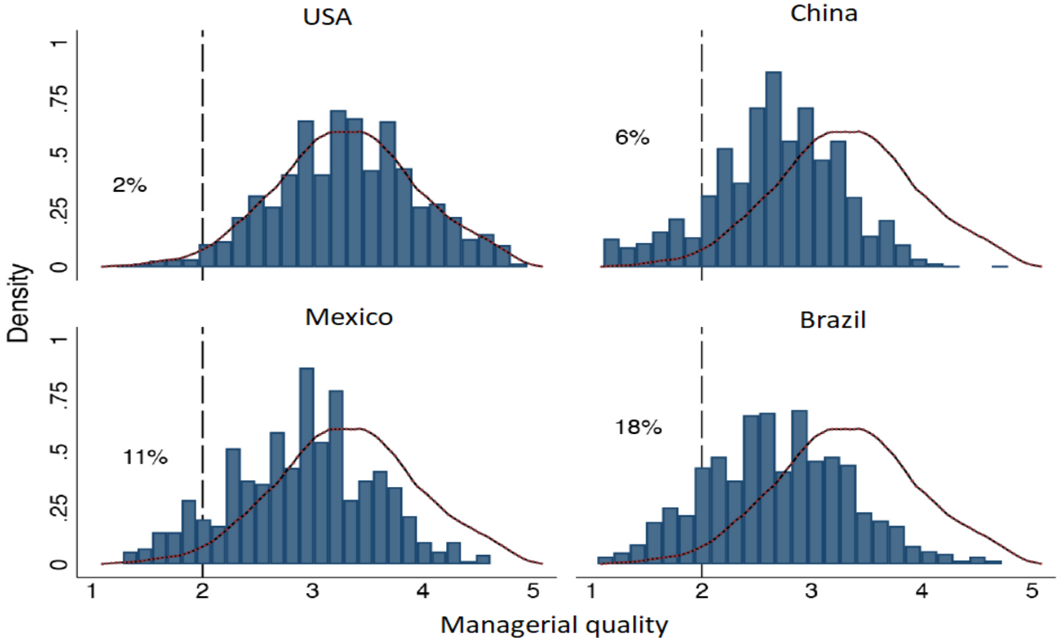
Source: World Bank calculations using Penn World Tables (2016).

I. Key Sectoral Challenges

There are several dimensions to Brazil's productivity problem

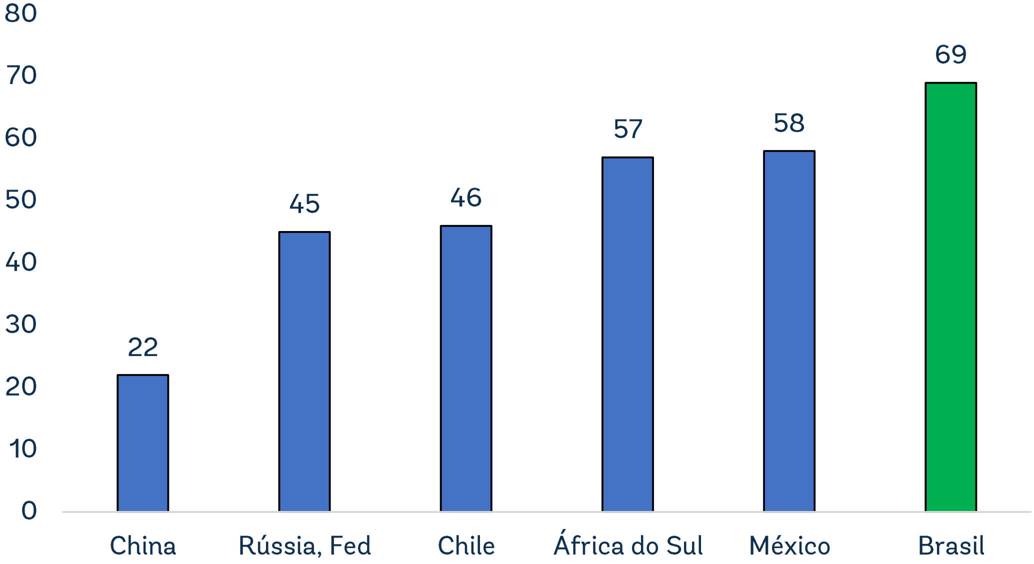
- Brazil's productivity problem is ubiquitous and is explained by underperformance in all components of productivity exhibiting a disappointing performance: entry and exit of firms, reallocation across sectors and firms, and within-firm productivity growth.
- Internal to the firm:
  - Poor managerial practices and underinvestment in innovation, result in lower productivity.

Figure 2: Distribution of firms managerial quality compared to the USA



Source: World Management Survey; World Bank staff elaboration.

Figure 3: Global Innovation Index



Source: Global Innovation Index rank, 2017 report;
Nota: Ranking between 127 countries, 1 = top ranked

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There are several dimensions to Brazil's productivity problem

- External to the firm:
  - High tariffs and NTBs, and pervasive local content requirements reduce competition and distort access to inputs and technologies.
  - Brazil is a very closed country: average trade as percentage of GDP between 2010 and 2017 is 25%, the lowest ratio in a series with more than 200 countries and with higher import taxes.
  - High cost of doing business: Brazil ranked 125th in the Doing Business ranking.
  - Complex and distortive federal policies amounting to 4.5% of GDP (and more from tax exemptions and subsidies at subnational level) often without clear objective to address market failures and undermining competition.

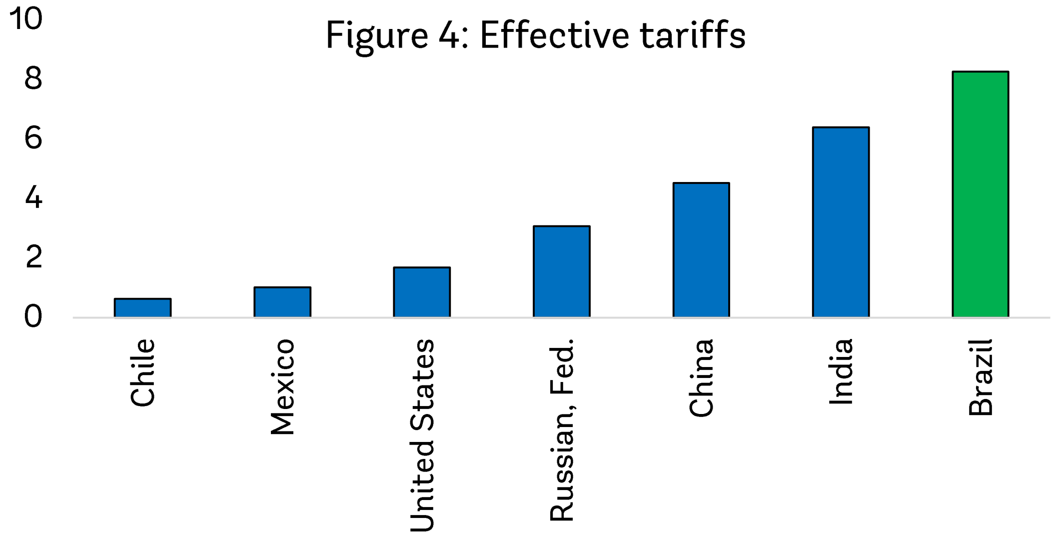
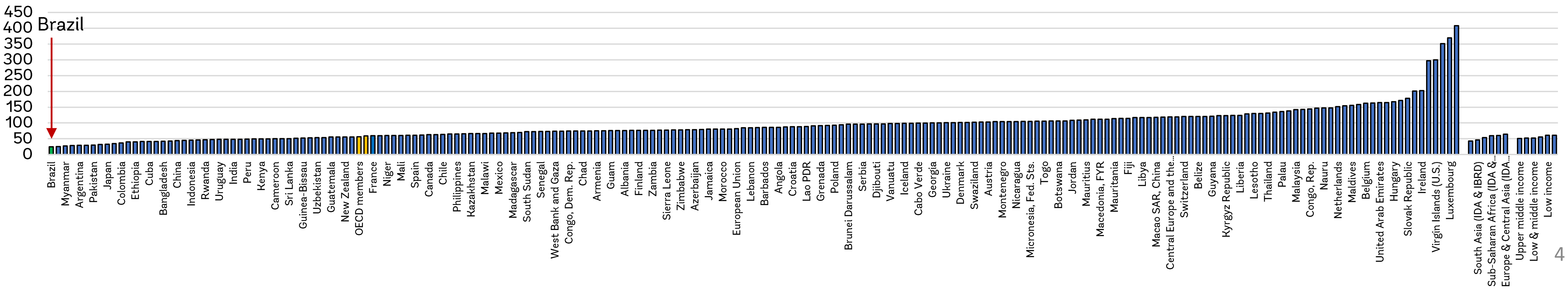


Figure 4: Effective tariffs

Figure 5: Trade as percentage of GDP (Average 2010-2017)



II. Policy Recommendations

Pursue a three-pronged reform process

- The reform agenda needs to be triangular with clear commitments and milestones focused on:
- Trade policies: increasing competition and enhancing access to inputs, technologies and markets.
  - Liberalization of capital and IT goods to facilitate the diffusion of technologies in addition to the conclusion of the Mercosul-EU trade agreement or wide Mercosul liberalization; and
  - Creation and implementation of a national trade assistance program with re-skilling and cash transfers to support the losers, such as the workers in affected regions and industries.
- Tax reform: advancing tax reform and simplification, followed by the consolidation of indirect taxes in one to reduce the burden and costs on the private sector (see note on tax reform).
- New industrial policies: Redesign private sector support programs to support competitiveness by addressing market failures and eliminating distortions. These include:
  - Rationalization of local content requirements by shifting from exemptions and content requirements to supplier linkages programs and quality upgrading;
  - Expansion and unification of programs that directly targets productivity and quality improvement, such as the Brasil Mais Produtivo, SEBRAE and SENAI programs;
  - Consolidate programs that support technology adoption (at SEBRAI, SENAI, EMBRAPII, ABDI, BNDES or FINNEP) under one umbrella; and
  - Replicate the demand-driven design of PRONATEC-MDIC in the other PRONATEC programs.

Risks and challenges of the reform process

- **Where to start and what to watch out for?**
  - There are several ongoing/unfinished reforms, such as tax simplification or trade protection to protect domestic industry (e.g., Desoneração da folha, Lei de Informática)
  - Large uncompetitive groups reduce competition and are heavily distortionary: They can halt the reform process and impact the nature of support policies that become compensatory instead of building competitiveness..
  - Large institutional fragmentation increase the number of ministries and implementing agencies with different agendas that often compete among themselves and create inefficiencies.
- **Who leads the reform?**
  - Solve the coordination problem by creating an inter-ministerial productivity commission (see Australia, New Zealand and Mexico) with an empowered secretariat to ensure coordination and leadership of the reform process.
  - The main tasks of the secretariat would be to: (i) propose specific productivity related reforms, (ii) supervise the effective implementation of these reforms, (iii) coordinate different ministries and agencies around the productivity agenda, and (iv) monitor productivity growth and its key constraints.

An three-pronged reform effort

Reform Area	Short-term	Medium-term
Trade reform	• Liberalization of capital and IT goods • Design of the national trade assistance program	• Coordinated trade reform within Mercosul—reduction of tariffs by 50 percent with respect to non-Mercosul countries
Tax reform	• Implementation of tax simplification process (see tax policy note)	• Introduction of the VAT system (see other policy note)
Reformulation of business support policies	• Rationalization of local content requirements • Rationalization of tax incentives based on evidence of impact • Diffusion of PRONATEC-MDIC model to other PRONATEC programs	• Expansion and integration of programs that directly targets productivity and quality improvement • Expansion and integration of programs that directly support technology adoption

III. Main Messages

1. **Brazil economic growth prospects and transition to high-income country largely depends on its ability to accelerate productivity growth, which has been flat in the last 20 years.**

2. **The productivity problem in Brazil is multidimensional: It requires a number of reforms to be accomplished simultaneously, ideally with a nation-wide agreement.**

3. **Specifically, we propose to start with a triangular key set of reforms:**
    1. Unilateral reduction of tariffs for capital and ICT goods, followed by a more ambitious reform of the Mercosur CET, to increase competition and facilitate access to inputs and technology;
    2. Implementation of tax processes simplification, followed by the consolidation of indirect taxes in one to reduce the burden and costs on the private sector; and
    3. Rethink and reform of industrial policies to address market failures, eliminate bottlenecks and distortions in order to support competitiveness.

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