Five priorities for Brazil’s economy

To enter the ranks of the world’s leading economies, the country must remove entrenched barriers to productivity.

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It is high time for Brazil to seize its future. The world’s fifth-most-populous nation needs a long-term vision for its economy, as well as a commitment at all levels of government to implement measures that could lead to a dramatic increase in productivity. We believe that such measures could in time lift the country’s GDP-per-capita growth from less than 1 percent a year to a sustained rate of around 7 percent.

Brazil has no time to lose. Its economic growth has stalled during the past 25 years, in stark contrast to the strong recent performance of the other three “BRIC” countries: Russia, India, and China. While macroeconomic conditions have improved substantially in Brazil during the past few years, they will not on their own be sufficient to tackle the root cause of the country's lackluster economic performance—the slow increase in labor productivity, which is the primary determinant of national wealth. In 2004 Brazil’s productivity per hour worked was only 18 percent of the US level.
When we mapped barriers to the growth of productivity in key sectors of the economy, we found that structural barriers create only about one-third of Brazil’s gap with the United States. The first structural barrier is Brazil’s modest per capita income, which favors lower-value-added products and services. The second is the low cost of labor, which is cheaper than capital and therefore discourages the use of machinery that would improve productivity. These structural limitations will fade if Brazil can achieve strong and sustained economic growth. But for this to happen, the government must tackle four nonstructural obstacles, which are responsible for the remaining two-thirds of the productivity gap: a huge informal economy (and inappropriate regulations that make it costly for companies to enter the formal economy), macroeconomic instability, inefficient public services, and an inadequate infrastructure (exhibit).

To encourage a public debate among Brazil’s leaders on how to boost economic development, we now turn our attention from analyzing the barriers to proposing ways to overcome them. The research of the McKinsey Global Institute (MGI) on productivity in 17 countries shows that appropriate social and economic policies can tear down nonstructural barriers to productivity over time. A feasible program that builds on international experience but is tailored to Brazil’s specific challenges should include five important sets of measures.

1The study was conducted in 2005 by McKinsey’s São Paulo office in collaboration with the McKinsey Global Institute (MGI). It mapped the barriers to productivity growth in eight sectors (agriculture, automotive, food retailing, government, residential construction, retail banking, steel, and telecommunications) that together make up 46 percent of Brazil’s employment. For a more detailed look at the findings, see Heinz-Peter Elstrodt, Jorge A. Fergie, and Martha A. Laboissière, “How Brazil can grow,” The McKinsey Quarterly, 2006 Number 2, pp. 12–5. The 2005 project was informed by a 1998 McKinsey study of Brazil’s productivity—see Martin N. Baily, Heinz-Peter Elstrodt, William Bebb Jones Jr., William W. Lewis, Vincent Palmade, Norbert Sack, and Eric Zitzewitz, “Will Brazil seize its future?” The McKinsey Quarterly, 1998 Number 1, pp. 74–83—and by similar MGI-supported studies in other countries. The methodology combines a detailed analysis of labor productivity in different industries with a set of transverse analyses of the economy as a whole.
Five priorities for Brazil’s economy

Our first priority deals with the informal economy, or gray market, the biggest drag on Brazil’s productivity because it stands in the way of fair competition, particularly in domestic business sectors. A second is to reduce government expenditures and so create more stable macroeconomic conditions, which are important for the international competitiveness of the economy as a whole. Such conditions would also make it possible to cut taxes and thereby decrease incentives for companies to operate informally. A third priority is to improve the efficiency of Brazil’s ill-functioning judicial system and to set a good example for reforming health, education, and other public services. A fourth priority is boosting productive infrastructure investments, which are far lower in Brazil than in many comparable developing economies. Four accompanying articles describe measures to address these priorities.) Finally, to implement the measures effectively, it is absolutely essential for any development plan to include a fifth set of measures, with two overarching elements.

The first of these elements is creating a firm commitment to a long-term vision and targets—a commitment embraced by politicians from different parties; civil servants in the federal, state, and municipal governments; and private-sector business leaders. We propose, for instance, that Brazil should embrace a vision to cut the informal economy in half—to 20 percent of GDP, from 40 percent—by 2018. We have chosen 12-year targets

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In January 2007 Brazil’s President Luiz Inácio Lula da Silva proposed a plan that seeks to boost economic growth through increased infrastructure investments and attempts to bring down government debt.
because the priority measures are politically, socially, and legally complex; time will be needed to implement them and achieve results. Moreover, 12 years is equal to three presidential terms, which would put pressure on the government and the opposition to accept a coordinated plan underpinned by a commitment to comply with previously agreed-upon contracts, norms, and regulations, so that initiatives continue even if governments change.

As for the second overarching element, it will be necessary to coordinate the program and to assign clear responsibility for its implementation to relevant ministries and agencies. We propose the establishment of a central coordinating body, similar to the Prime Minister’s Delivery Unit, which works closely with government ministries to support and monitor the reform of public services in the United Kingdom. The unit, whose leaders are appointed by the prime minister, has served as a model for similar organizations in Australia and Canada.

A Brazilian equivalent could be configured in many different ways. The most important thing, perhaps, is to provide for the institutional continuity of reform regardless of the dominant political party at any given time. Therefore, the senior people should be highly regarded across sectors and come from a range of political and other backgrounds. The unit could report directly to the president of Brazil and be advised by independent academics, international experts, and prominent businesspeople. It could coordinate the work of special liaison subunits tackling the areas singled out for reform; a subunit battling informality, for instance, might support efforts across business sectors, ministries, and states, as well as the legislative and judicial branches. Finally, it could propose targets, define how to track progress, monitor results, and provide methodologies and solutions to ministries and agencies responsible for implementing specific measures.

Overcoming the obstacles to increased productivity in Brazil will require political will and endurance. But if Brazil takes the right steps now, this land of promise can finally begin to fulfill its potential for growth and prosperity.

The authors would like to thank Igal Neiman for his contribution to this article.

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Brazil has every reason to make the battle against its huge informal economy the top priority of any economic-development program. The gray market accounts for 40 percent of Brazil’s GDP and for 50 percent of nonrural employment—a much larger share than it claims in China and India. Moreover, informality and inappropriate regulations are responsible for 60 percent of Brazil’s nonstructural productivity gap with the United States.

In Brazil, as in most other developing economies, large numbers of gray-market companies in many sectors evade taxes and social obligations to their workers, ignore quality and safety regulations, or infringe upon copyrights. By doing so, they gain cost advantages that allow them to compete successfully against more efficient, law-abiding businesses. Honest companies lose profits and market share and thus have less money to invest in technology and other productivity-enhancing measures.

The experience of countries that are successfully reducing their informal economies suggests a need for a three-pronged approach: reducing the burden of formality by reforming the tax system and labor laws, improving the enforcement of laws and regulations, and creating a culture of formality by raising popular awareness about the gray market’s harmful effects on economic development. Some measures should be implemented across sectors to address structural problems; others should target specific sectors.

Brazil has already implemented several cross-sector and sector-specific initiatives. By reducing the burden of formality, the Simples system, a simplified tax scheme with fewer and lower tax brackets for small and midsize enterprises, has increased tax collections from them by an average of 13 percent annually since its introduction, in 1997. On the sector level, the cross-checking of production and sales data and the mandatory use of leak-measurement devices in the beer and soft-drinks sector increased tax revenues from it by 26 percent in a five-month period. Experts predict that such auditing and enforcement measures will all but eliminate high levels of formalita in the beverage industry.

These and other isolated cases are encouraging, but Brazil’s tax burden as a percentage of GDP has grown to 36 percent, from 28, during the past ten years while tax rules have become increasingly complex. Furthermore, it still takes more than 150 days—three times the global average—to open a new business in Brazil. Informal employment is actually growing in some industries, such as residential construction, where small traditional builders that evade social-security payments compete successfully against modern companies that are twice as productive.

That’s why Brazil needs a comprehensive approach to tackling informality, with full coordination among municipalities, states, and the federal government and with initiatives sequenced according to their ease of implementation and potential impact. The first wave of measures should include a few important cross-sector initiatives, as well as a pilot program in a sector with high informality—for instance, construction or domestic services—to demonstrate the potential impact and to provide lessons for the subsequent waves of initiatives in other sectors.

One possible cross-sector initiative would be to link electronic payments to small
and midsize retailers, restaurants, and hotels to the federal tax collection agency’s computer system, thus forcing these businesses to declare their electronic revenues. To heighten the impact, consumers should be encouraged to increase their use of credit and debit cards—perhaps by giving them a partial rebate on the value-added tax (VAT) on such purchases. Another effective initiative would be to implement Redesim: a proposal that Brazil’s government is considering to create a simplified and unified system for registering businesses.

The potential impact of interconnected cross-sector reform has been demonstrated by Spain, which in the 1990s simplified its taxation system, introduced more flexible labor regulations, and created a new agency to fight tax evasion. The program, amply publicized in the media, helped to increase the amount of taxes collected from small and midsize companies by 75 percent and to reduce the unemployment rate by 40 percent in only six years.

Chile’s reform of domestic services is an encouraging example of what a full set of sector-specific initiatives can achieve. Only 17 percent of Chile’s domestic-services market remains gray, for example, while Brazil struggles with a 70 percent informality rate in this sector, which is one of the country’s biggest sources of employment. Chile has reduced the burden of formality by simplifying the required employment contract, setting a lower minimum wage for domestic services than for other categories of work, and developing an Internet-based “one-click” payroll system integrated with social-security obligations, such as pensions, health care, and unemployment insurance. The one-click system cuts red tape, since the employer doesn’t have to visit three different offices to pay. Chile also enforces high penalties on employers shown to use domestic-service workers who don’t have contracts.

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Reducing government consumption

William B. Jones Jr.

Brazil’s macroeconomic indicators are in better shape than they have been for years, yet fiscal imbalances are inhibiting economic growth. Rising social expenditures and other forms of government consumption, financed by high and increasing taxes, have discouraged business investments, crowded out much-needed improvements to public infrastructure, and undermined attempts to generate budget surpluses or to reduce the high cost of servicing the country’s large domestic debt. As a result, Brazil’s economy is still perceived as vulnerable to internal and external shocks, and real interest rates remain high. We believe that the remedy is to reduce government spending as a share of GDP.

Brazil can look back ruefully on 25 years of macroeconomic instability, marked by hyperinflation, debt crises, and stock market crashes, all of which made the cost of capital quite high. That in turn discouraged long-term investment in productivity-enhancing improvements such as automation. Since 1985 the private-business sector’s stock of machinery and equipment has grown by only 2 to 3 percent annually, compared with about 10 percent a year from 1950 to 1985. Macroeconomic instability has also hurt productivity by creating a high degree of uncertainty about future demand for products and services, as well as future prices, exchange rates, and interest rates. We estimate that 20 percent of Brazil’s nonstructural productivity gap with the United States results from this kind of instability and uncertainty.

While Brazil’s inflation rate, like its nominal public-sector budget deficit, is now in the single digits, the economy still suffers from high real interest rates (around 10 percent, compared with just 2 percent in the United States) and a country risk premium of 200 basis points. Brazil’s bonds do not have an investment-grade credit rating, and only recently has the government begun to test the market’s appetite for long-term debt denominated in the local currency.

The fiscal imbalances at the heart of Brazil’s remaining macroeconomic vulnerabilities indirectly underpin two other barriers to productivity: an inadequate infrastructure and a huge informal economy (because high taxes are one reason companies choose to operate in the gray market). Brazil’s government expenditures can be placed in three main categories: consumption, such as welfare spending and public-sector wages; investments; and debt servicing. They constitute more than 40 percent of GDP—a share much higher than in other developing economies—because social-welfare spending has increased dramatically in recent years. Brazil also spends a comparatively high share of GDP on servicing its debt, which mostly has relatively short maturities and is indexed to inflation and interest rates, thus making the country vulnerable to shocks. Meanwhile, government investments in the infrastructure, which have declined from 3.6 percent a year of GDP in the early 1980s to around 1 percent today, are considerably lower than those of many countries at a comparable stage of development.

By substantially reducing the share of GDP that the government consumes, Brazil could create a virtuous cycle. Lower public spending would allow the government to reduce taxes and the public sector’s debt burden. Lower tax rates could help make
informality less common, and reduced debt could help bring down real interest rates. Lower interest rates, in turn, are crucial to encourage higher investment, whether in automation, new technologies, or additional capacity. With higher investment and productivity, the economy will grow faster, and tax revenues may rise even as tax rates fall. This would make room for further public investment in infrastructure, which would help boost productivity in many sectors, leading to further economic growth and the possibility of reducing the country’s debt and tax burdens even more (exhibit).

The growth rate of public-sector consumption could fall not only through the ongoing effort to cut the public payroll’s share of Brazil’s GDP but also if the government took advantage of opportunities to reduce the growth of social-security spending—for example, by raising the retirement age and disaggregating pension adjustments from minimum-wage adjustments.

Another way forward would be introducing measures to improve the productivity of Brazil’s public sector, so that it can provide services at lower cost. Of course, these measures must be adapted to the specific problems and opportunities of each public-service area.

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1 Excluding the impact of inflation.
2 Including interest payments on debt.
3 The difference between the yields on Brazilian bonds denominated in US dollars and on US treasury bonds of equivalent maturity.
4 Many investors, raters, analysts, and policy makers predict that Brazil’s bonds could reach investment-grade status by 2009.
5 Because of the index link and the short-term maturities of these loans, an external shock (such as an oil crisis, a sharp increase in US interest rates, or a “hard landing” in China) could significantly raise interest rates on the whole debt stock and create concern about Brazil’s ability to repay its loans.
Improving the judicial system

Thiago Arruda and Stefan Matzinger

Brazil’s executives tend to be frustrated by the inefficiency of their country’s judicial system, and for good reason. One electrical utility went to court in 1992 to question increased monthly sales taxes called Cofins. The lower court took more than three years to make its ruling, in the company’s favor, but the story doesn’t end there. In July 2003, after overcoming all process obstacles (including appeals by the federal government), the company received a letter from the authorities explaining that the amount the state owed to it would be paid back by 2014—22 years after the case first went to court.

This company’s experience was extreme, but nobody doubts that Brazil’s judicial system is overwhelmed. The number of cases brought before the courts increased by 90 percent during the past ten years, mainly because economic and social policies have changed so often, with complex legal implications for tax collections, consumer rights, and social-security and pension payments. Indeed, such cases make up almost half of the new cases entering the court system. A high rate of appeals adds to the congestion. We estimate that the volume of cases pending in Brazil’s courts will double during the next ten years if nothing happens to improve the situation.

A slow and unpredictable judicial process, with high rates of appeal and many reversed rulings, is bad for business, since an uncertain legal environment can make executives shelve investments they would otherwise have made. Likewise, the slow resolution of a dispute over a contract can diminish a company’s value because of missed opportunities or the effects of inflation, to name just two possibilities. A debt recovery case takes an average of 546 days to resolve in Brazil, compared with 305 days in Chile, and the costs are prohibitive (exhibit).

Improving the judicial system would be a prime opportunity to set a good example for the reform of public services, whose inefficiency accounts for 12 percent of Brazil’s nonstructural productivity gap with the United States. More judges are not the answer. Brazil already spends roughly five times more per inhabitant on its justice system than Mexico does, for example—mainly because it pays judges three times the global average and gives them large support staffs. But surveys suggest that the money isn’t well spent: partly as a result of inefficient administrative processes, Brazil’s judges spend only 35 percent of their time reviewing cases.

To alleviate the court system’s problems, Brazil’s government is implementing a number of initiatives, such as establishing a secretariat for justice reform and offering incentives to encourage the courts to use new technologies that would help them administer their caseloads more efficiently. Increasing the productivity of the courts has been the focal point of these initiatives. The government should complement them by acting on the demand side to control the flood of new cases. Since the swelling caseload results mainly from the complexity of the tax, social-security, and pension
In 2004 alone the federal government, states, and municipalities adopted some 8,800 new tax rules. Simplifying the tax system, perhaps by implementing a nationwide value-added tax (VAT), should be a priority. Allowing people with the same complaints to receive a collective ruling might also reduce demand. Another set of possible measures to limit the use of the court system would involve collaboration between financial and social authorities in order to establish administrative norms determining when they should (and should not) go to court. Today, for instance, the government often appeals rulings even when it has clearly lost its case. Likewise, there should be incentives to settle simple cases out of court when precedents suggest what the outcome would be.

Over the next 12 years, Brazil should set a goal of cutting by half the number of new cases entering the system and the average time to resolve them. The experience of other countries suggests that this goal is quite feasible. In 1995, for example, Australia started a comprehensive program that cut its caseloads to 25 percent of their original volume and reduced, to 8 months, the average time needed to resolve cases in lower courts. The global average is 18 months.

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4 Setlement (eg, payment from debtor to bank). Source: Banco Central do Brasil

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<th>The high cost of collecting</th>
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<td>Cost to recover a debt in Brazil, by phase in collection process</td>
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<td><strong>Extrajudicial</strong> <em>(before going to court)</em></td>
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<td>Awareness phase <em>(in court but before judge’s decision)</em></td>
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<td>Execution phase <em>(between final decision and settlement)</em></td>
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<td><strong>Total</strong></td>
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Exhibit 1 of 1

Glance: The cost of recovering a debt through Brazil’s judicial system is prohibitively high.

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<th>Phase in collection process</th>
<th>Cost as % of debt</th>
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<tr>
<td>Extrajudicial <em>(before going to court)</em></td>
<td>17</td>
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<tr>
<td>Judicial <em>(after going to court)</em></td>
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<tr>
<td>Awareness phase <em>(in court but before judge’s decision)</em></td>
<td>39</td>
</tr>
<tr>
<td>Execution phase <em>(between final decision and settlement)</em></td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>76</td>
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Extrajudicial (before going to court) 17
Judicial (after going to court)
Awareness phase *(in court but before judge’s decision)* 39
Execution phase *(between final decision and settlement)* 20
Total 76

1 Settlement (eg, payment from debtor to bank). Source: Banco Central do Brasil

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1 This case, concerning Companhia de Eletricidade do Estado da Bahia (Coelba) was reported in the Brazilian business daily Valor Econômico, January 5, 2006.
Developing an adequate infrastructure

Iris Yan

The infrastructure investments of Brazil’s government have declined from 3.6 percent a year of GDP in the early 1980s to around 1 percent now. Inadequate roads, ports, power plants, and sanitation are the result. In fact, the country must increase these investments dramatically to lift its infrastructure to the level of many other developing economies (exhibit). To that end, Brazil must create an attractive environment for private investments in infrastructure.

We estimate that the inadequate infrastructure accounts for 8 percent of Brazil’s nonstructural productivity gap with the United States. Energy shortages have halted production and generated losses in many industries; more blackouts may follow unless sufficient investments in power generation take place in the next five years. In agriculture, bad roads, storage facilities, and port infrastructures lead to the spoilage of 3 to 12 percent of Brazil’s grain production (depending on the crop) before it reaches the country’s consumers.

The World Bank estimates that to promote sustained economic growth and catch up in 20 years with the infrastructure levels of, for example, South Korea and the developed parts of China, Brazil must increase its combined public and private investment in infrastructure, currently around 2.4 percent of GDP annually, to 5 to 7 percent of GDP. That would mean an additional $20 billion to $36 billion of infrastructure investments a year.1 Covering this gap with public funds alone is virtually impossible, as the sum required is roughly equal to the entire allocation for health or education in already-strained government finances. Yet we believe that Brazil should aspire to reach and sustain this level of investment over the next 12 years—and can do so by drawing on successful international experience to complement public direct investment with private investment and public-private partnerships to finance and develop infrastructure projects.

Chile’s highly successful program to improve its road infrastructure, now in its 30th year, was founded on a long-term vision accepted by both public- and private-sector stakeholders. A strong political commitment underpinned the country’s success as it built a reputation for institutional stability, respect for contracts, effective mechanisms for resolving conflicts, and rules that protect creditors and allay fears of expropriation.

Brazil has yet to develop an integrated plan for land, air, and water transport. In the energy sector, it isn’t clear that the present regulatory framework can create sufficient incentives for new capacity; the current outlook indicates a growing risk of shortages and increasing prices over the next five years. The government must find ways to develop viable partnerships with the private sector for large hydroelectric power projects and to improve the coordination among the environmental agencies that have an important say in decisions to award operating licenses for power plants.

Sound, stable, and well-defined regulation that promotes fair competition in each sector is important for overcoming infrastructure-related productivity barriers. It is also a prerequisite for attracting...
funds from private investors, whose returns will be determined in part by their projects’ operating income. Brazil’s regulation of infrastructure has on the whole been fairly restrictive, complex, and unstable. Nonetheless, good progress has been made in telecommunications and in the transmission and distribution of electricity, two areas that enjoy a stable regulatory environment. The recently approved regulations for water and sanitation (as well as the natural-gas framework now being discussed in Congress) have yet to be implemented and put to the test.

Clear and fair regulation of public-private partnerships is equally important. Such rules were crucial to the success of the new mass-transit bus system in Colombia’s capital, Bogotá, which has reduced fatal accidents by 90 percent and pollution by 43 percent while creating 18,000 new jobs.2 The approach taken there was to make the system sustainable in the long run by avoiding subsidies, giving the private sector responsibility for operations, managing revenues through a trust administered by Lloyds Bank, and leaving little room for government interference.

As for Chile, since 1994 its government has engaged the private sector in 36 partnerships, with a total value of $5.5 billion. Chile leaves ample room for adapting contracts to the needs of each project, awards contracts in competitive auctions open to both domestic and foreign companies, and guarantees the winner an exchange rate band and a minimum revenue. In return, the private company holding the concession shares its revenues with the government once they exceed a certain ceiling.

Brazil has passed legislation aiming to encourage public-private partnerships, but so far no major undertakings have been launched. Federal railway and highway projects and a subway line in São Paulo, now in the pipeline, must be managed carefully to start building a good reputation among investors, much as Chile did. Brazil’s government should also consider
public-private partnerships in the energy sector and for airports and ports.

Countries such as China and Singapore offer various forms of incentives and preferential treatment to woo international investors that are quickly building global infrastructure portfolios worth tens of billions of dollars. In this highly competitive world of international infrastructure investments, Brazil’s success in attracting funds will ultimately depend on the perceived risk of regulation, the judicial system, and macroeconomic and institutional stability.

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1 President Lula da Silva has called for the government, state companies, and the private sector to spend $240 billion on infrastructure investments through 2010.