Principles and institutional arrangements for better policy design:
Brazil's productivity implementation agenda: Ideas, Rent Seeking, and Institutions [1]

Roland Clarke February 26, 2018

6.1 Introduction

1. **The previous chapters have suggested that many policy-induced distortions constrain productivity and development in Brazil.** As a result, a significant number of potential policy reforms could increase competition and thereby stimulate innovation and productivity growth. These policies could also promote economic and social inclusion. Therefore, it is somewhat of a paradox that after many decades of debate on policies to promote development and a large volume of public resources spent, it appears so difficult to develop and implement successful policies. This chapter suggests that many of the currently-implemented policies failed because they have an intellectual justification rooted in distorted versions of development theory, or a misplaced vision of national security and self-sufficiency. The combination of interests with misleading intellectual justifications means that for reasons of history and political economy, adopting improved policies for productivity is very difficult. Even though the overall objective of growth is a nationally-shared aspiration, individual policy interventions have rarely had clear objectives. As a result, impact is seldom measured in relation to stated objectives and effectiveness is often unknown. This has favored a proliferation of business support policies as there is no evidence to rationalize them. Finally, there is a fundamental lack of coordination, primarily driven by a multitude of institutions that have fragmented the policy space, often in the pursuit of their own narrow agenda. Overcoming this mutually reinforcing vicious circle requires new institutional arrangements that generate policies with greater transparency, contestability linked to evidence of impact, and better coordination. These institutional features are needed to minimize rent seeking and support the policy shift required to realize Brazil's productivity promise.

2. **One of the consistent themes through the previous chapters has been that competition is necessary to stimulate learning and innovation.** However, such a view is not part of the prevailing historical vision of development in Brazil, which is loosely based on a view of a dependent Latin America requiring protection for local production, and the reduction of competition.

3. **Rather than encouraging productivity growth, the result of these activist business support policies has been to create substantial distortions from relatively closed borders, weak internal integration and poorly functioning factor markets.** Market signals have been highly muted, complicating the allocation of state support. Muted market signals have also provided justifications for additional policy interventions which offer relief to some groups while inhibiting mechanisms for innovation and learning. These additional policy interventions have created further distortions that in turn lead to further demands for policy support.

4. **This chapter suggests some principles to increase the efficacy of policy making and to avoid ineffective policies in the future.** It first addresses the question of why poor policies have been adopted and some aspects of the political economy of policy choices**.** Two key elements help explain the ineffectiveness of these policies: the dominance of the old-fashioned "developmentalist" view of

[1] This background paper draws on three background papers commissioned for this study: The Developmental State in Brazil: Politics, Ideology, and Business in the 20th Century (Schneider 2017a), The Revival of Industrial Policy in Brazil, 1990s to 2010s (Schneider 2017b), The Carwash Pandora's Box: Business-Government Relationship in Brazil (Lima-de-Oliveira 2017a). It has also benefitted from substantial contributions from Xavier Cirera as well as detailed comments and suggestions from Martin Raiser and Mark Dutz.

industrial policy as well as major institutional fragmentation. Based on this analysis, the chapter suggests how Brazil's institutional structure of policy making for productive development could be revised so that the policy making mechanisms move from a low-level equilibrium dominated by distorted ideas and interests to a higher performance equilibrium in which most businesses and policymakers have some incentive to cooperate in generating better policy. It will also suggest how new and effective institutional arrangements could be shielded from the rampant rent-seeking and fragmentation that characterizes current policy making institutions.

6.2 Understanding the ineffectiveness of recent business support policies

6.2.1 The dominance of the "historic" State Developmentalism

5. **During the 20th century policy debate was dominated by an activist state-led approach to development.** This view is loosely based on a view of a dependent Latin America requiring protection for local production, and the reduction of competition. The Brazilian 'developmentalist' approach to economic development has historical roots in the support given throughout the twentieth century (and before) to agriculture (particularly coffee production) and to incipient industrialization in the 1930s. This approach to development has been facilitated by systemic rent seeking (and particularly an assumption that producers linked to the political elite are entitled to support)[2] as well as the ideas of dependency theory (see Box 6.1 and Schneider (2017a)).

[2] Cuadros (2016) argues that the historical roots of State capitalism go back to the colonial period: José da Silva Lisboa, the Viscount of Cairú, explains in his *Princípios de Economia Política* "The sovereign of each nation must be considered the chief or head of a vast family, and thus care for all those therein like his children, cooperating for the greater good."

Box 6.1 The ideas of Brazilian developmentalism

The policy ideas of the development state originated in the early 20th century, and even before, as the government would step in to guarantee returns on private infrastructure projects (see for example Musacchio and Lazzarini (2016)). To this basic idea was added a potent mix of intellectual rationales and ideologies for state-led development to deal with severe macroeconomic and trade shocks in the early 20th century (World War I, the Great Depression and World War II).

It was in the 1930s that the Brazilian state openly ventured into a variety of sectors to coordinate industries (through import substitution industrialization (ISI)). Key measures focused on trade protection, domestic stimulus, and war-time supply. In addition, where key industries in the production chain (such as steel or oil extraction) were lacking, the government would step in to create them (Musacchio and Lazzarini 2016; Schneider 1991). By the 1950s a series of policies had created a very protected model of ISI. These policies were consistent with and reinforced by the pervasive notion of the State guaranteeing returns to the private sector. Protection served as the guarantee mechanism rather than as the means to give firms the opportunity to learn and become competitive. In this, the ISI model was very different from that of East Asia where protection was provided in exchange for the imposition of performance standards on private firms – with no guarantee of profitability (Amsden 1989).

As successive governments added new agencies, institutions and policies to Brazil's increasingly complex developmental state, motives and sources of political support also multiplied and diversified. Nationalist and populist groups, including labor unions, mobilized around some policies, while the military formulated clear strategies of economic development designed to reduce security vulnerabilities. The dictatorship (1964-1985) did not fundamentally alter the pattern of development, except to the extent that labor rights and real wages were suppressed, enabling a capital intensive and rapid although inefficient period of industrial growth.

After the return to democracy, with the opening of the economy under Collor and then the macroeconomic stabilization of Cardoso, Brazil appeared to be moving away from the active use of industrial policy. However, many components of previous industrial policy continued through the Cardoso government, and others were added in piecemeal fashion in response to pressures from business. The most important continuity was the BNDES, which continued previous policies of providing subsidized credit to a wide variety of firms as well as holding equity stakes in newly privatized enterprises. BNDES is also still the principal source of long-term and export credit for business.

Another set of legacy policies from the heyday of state-led development was numerous tax exemptions for a range of policies from regional development and informatics to R&D. Although less visible than SOEs or BNDES lending, tax incentives added up to another costly form of government subsidy for specified development goals. One of the reasons business is so active in defending many subsidies is because they viewed them as compensation for other costs that the state imposes on them, the so-called *Custo Brasil*. Over the course of more than five decades, developmentalists in government generated a raft of new policies and institutions, but the state rarely paused to monitor and evaluate any of these programs.

The pervasive idea was that problems in development could be solved by direct intervention of the State, which had a major role in guaranteeing the profitability of private enterprise without requiring any accountability for performance from the recipients of state resources or protection. These ideas were justified on the left with reference to dependency theory and on the right by considerations of national security and self-sufficiency. Groups benefitting from specific policies could point to the "harm" they would suffer if policies were withdrawn, while the private sector justified support for subsidies and protection as the only means to profitability given the *Custo Brasil* that resulted from multiple distortions because of multiple uncoordinated policy interventions, unsupported by evidence.

6. **The historic ideas of Brazilian developmentalism were the base for a significant revival of business support policies after 2003 following some liberal reforms introduced in the 1990s.** The underlying assumptions of the revived development state were very much those of the 20th century version: the State as a guarantor of private profitability, tax incentives, subsidies and protection without performance requirements or accountability. The results were also no better (and probably worse) than those of

previous decades, with the addition that the expansion of an industrial policy without learning mechanisms or accountability led to a deepening of the systemic exchange of favors (and outright corruption) between political actors at all levels and the private sector. The broad lines of business support policies from 2003 onwards are described in Box 6.2 and in more detail in Schneider (2017b).

Box 6.2 Business support policies from 2003 to 2016

After the government of the *Partido dos Trabalhadores* (PT) entered power in 2003, Brazil adopted a series of packages of new industrial and innovation policies. What was different in the 2000s was a higher priority given to *employment-generating* development. The new development state was a throwback to the development state of the 1960s and 1970s, but with social inclusion rather than exclusion. While the objectives now included raising employment and reducing poverty and inequality, most of the mechanisms (technology, R&D, import substitution and local content) and the instruments (subsidized credit, tax incentives and exemptions, trade protection, other subsidies, and especially SOEs) remained the same (Almeida and Schneider 2013; Hochstetler and Montero 2013). The employment priority was particularly evident in local content policies for the oil and gas sector (especially ship building) (Lima-de-Oliveira 2017b).

The conduct of industrial policy was fragmented across multiple ministries and agencies. No centralized agency comparable to the Economic Planning Board in Korea or the Commissariat du Plan in France existed to coordinate dispersed policies and their implementing agencies. Indeed, institutional fragmentation was far greater than during the authoritarian period.

Petrobras was a major instrument of industrial policy. For example, Prominp (*Programa de Mobilização da Indústria Nacional de Petróleo e Gás Natural*) was a program to increase local content in the oil industry. The shipyards and their associated suppliers also benefited from stringent local content clauses on all new gas and oil exploration concessions beginning in 2005. In addition, Petrobras pursued industrial policy through its subsidiary Transpetro. In 2004, Transpetro launched the Promef program as a classical industrial policy using public subsidies, credit and public procurement to promote domestic production. Promef's charge was to produce new ships in Brazil with a minimum of 65 percent of local content in its first phase. Promef was led by the CEO of Transpetro, a political appointee, but was also backed by the technical staff of the subsidiary (Almeida, Lima-de-Oliveira, and Schneider 2014). Transpetro was (not coincidentally) exposed in the *Lava-Jato* corruption investigation as one of the principal channels for corrupt payments to politicians. Petrobras became a major and increasing part of industrial policy in Brazil by channeling hundreds of billions of dollars to local industry.[3]

The Government also launched a series of horizontal policies to support innovation, investment and employment. The first of these was the PITCE (*Política Industrial, Tecnológica e de Comércio Exterior*), which supported innovation in many economic sectors. Politicians and business associations demanded additional policy measures to boost short-term investment in labor-intensive sectors, such as footwear, textiles, clothing and furniture. In response to these demands for a more comprehensive industrial policy (or rather a wider distribution of financial largesse), the government launched a second industrial policy in 2008, *Política de Desenvolvimento Produtivo* (PDP). The PDP was a comprehensive and ambitious industrial policy targeting many sectors and counting on the support of the BNDES to individual firms' strategy of internationalization coupled with mergers and acquisitions. The major goals of the PDP were to: raise the investment rate from 17.6 to 21 percent of GDP between 2007 and 2010; raise private spending on R&D from 0.51 to 0.65 percent of GDP by 2010; raise Brazil's share in world exports from 1.18 to 1.25 percent by 2010; and raise the number of micro and small enterprises (MSEs) that export by 10 percent. There was no logical framework connecting the targets to the PDP; they did not help in the evaluation of industrial policy, and none of the targets was met. In practice the PDP was a return to the policy of benefits for all. See for example Mendes (2014).

The next industrial policy (under President Rousseff) was *Plano Brasil Maior* (PBM or Greater Brazil Plan) which built on and expanded the PDP. In addition, the Government also promoted more *ad hoc* interventions in the economy including bank interest rates, electricity pricing and contracts, and protection for autos – all the traditional mechanisms for boosting private sector profitability without significant performance requirements on

[3] From 2004 to 2015, Petrobras invested $336 billion, almost four times its investment in the previous five decades (Lima-de-Oliveira 2017b, 216).

the recipients. The government doubled the federal excise tax on automobiles that did not have at least 65 percent domestic content, increased the import tax on cars, and increased import tariffs on about 100 products. In many respects this set of industrial policies was more defensive and designed to shield existing industry from the global economic slowdown.

The most important instrument in both PDP and the PBM was the strong role of BNDES in supplying subsidized credit. From 2008 to 2012, the Brazilian Treasury increased the debt by over US$ 150 billion to lend to BNDES for the bank to support investment in the industrial sector, finance exports, and increase infrastructure investments.

BNDES was also the driver behind the promotion of national champions that created huge, oligopolistic domestic firms. Some of these firms had a prominent engagement in politics and the corrupt financing of politicians, including the largest of the beneficiaries, JBS. This policy was not formally a part of the PDP and was only later revealed when the president of BNDES, Luciano Coutinho, said that the bank would support the creation of "world-class Brazilian companies." Beyond loans for international expansion, the BNDES often ended up participating in –and often helping to structure– M&A operations and foreign acquisitions. In the case of JBS, the reality was exposed when seven key executives of JBS confessed to payments in bribes by JBS to over 1000 politicians and civil servants, including ministers, current and ex-presidents and leaders of most of the main political parties. The extent of the illicit payments was so great that in return for leniency and full cooperation with prosecutors, the firm paid a fine of R$ 10.3 billion (of which R$ 2 billion was paid to BNDES for restitution) (O Globo 2017).

7. **These industrial policies have generated a vicious circle by which the distortions created become an integral component of a higher *Custo Brasil*.** Policies purporting to address the high costs of doing business via the creation of multiple tax exemptions and subsidies, create privileges for some firms, and more importantly, reduce competition and increase the misallocation of factors of production. These and other distortions – such as tariffs and other trade and connectivity barriers - have allowed less productive firms to remain in business, increasing the costs and lowering the quality of inputs available to more efficient firms, which in turn discourage more efficient firms from entering the market or expanding. These policies are, therefore, not a compensation to business that is orthogonal to *Custo Brasil* as some lobby groups claim, but a large component of it.

6.2.2 Excessive policy and institutional fragmentation

8. **The conduct of business support policies is fragmented across multiple ministries and agencies.** No centralized agency exists to coordinate dispersed and fragmented policies and their implementing agencies. Indeed, institutional fragmentation has become far greater in current times than during the authoritarian period. Several agencies associated with the Ministries of Science and Technology and the Ministry of Industry and Trade provide support primarily to the manufacturing and services sectors. Agencies such as ABDI, INPI, EMBRAPII, SECEX, CAMEX, APEX, FINEP, BNDES, and private public partnerships such as SEBRAE, RENAI, ANPEI, IEL ANPROTEC, in addition to line Ministries and state governments, provide services and support programs to the private sector, primarily in manufacturing[4]. This translates into a myriad of support programs that often compete for beneficiaries and overlap in

[4] See the illustrative table of innovation institutions by type of function in Limoeiro and Schneider (2017). They emphasize high levels of fragmentation and little overall coordination as a key feature of Brazil's institutions and policies, with state actors also not well connected to business and university research. However, they also argue that fragmentation and decentralization may at times yield effective outcomes, provided that it is combined with other factors including a longer-term, mission-driven focus that is sheltered from the negative aspects of coalition presidentialism; and they cite a few "islands of excellence" that have occurred in Brazil, such as Embraer, flex-fuel autos allowing flexible ethanol use, deep water oil exploration and exploitation, and the production of soybeans in tropical, semi-arid areas.

terms of objectives, and are likely to result in significant inefficiencies. Only for supporting innovation, CNI (2017) mapped 53 different instruments from different agencies either public or private with public funding. The multiplicity of agencies with overlapping objectives means that each pursues a narrow agenda, unlinked to development objectives of the country.

9. **Within this decentralized constellation, BNDES emerged as a central actor in industrial policy and other business support through its key funding role.** Given the fragmentation of policies and the multiplicity of instruments used - including subsidized credit, grants, regulations, import protection, and tax incentives - it is impossible to calculate precisely the total value of support to business. However, a lower bound estimate would suggest a very high spending in the country, within which the primary source of subsidized credit and minority shareholding was the BNDES, and the largest source of direct government investment was the SOE Petrobras.

10. **The lack of clear and effective coordination mechanisms and multiplicity of support mechanisms often results in crowding out of potentially more effective and efficient instruments, as well as unclear targeting of beneficiaries.** Agencies compete for resources and beneficiaries, and the country lacks an appropriate productivity strategy that can mobilize, coordinate and align different policy instruments. This, combined with the scarce evidence that these programs are having an impact on productivity, suggests that many resources that are used to support business could be put for better use in other public investment, including infrastructure and social protection and inclusion programs.

6.2.3 Business support policies: Costly, ineffective and institutionally damaging

11. **Brazil faces the paradox that the private sector bears the cost of ineffective policy, while the public sector pays to offset these costs.** Existing business support programs in Brazil are characterized by: (i) the major fragmentation of instruments and agencies offering support; (ii) the high volume of fiscal resources spent on private support (4.5 percent of GDP in 2015); (iii) the concentration of support in tax incentives, and to a lesser extent subsidized credit and direct grants; and (iv) the large distortions introduced with these support policies. Important objectives such as increasing domestic value added are often mandated by law or indirectly in the form of local content requirements and tax incentives, instead of addressing directly the sources and constraints to firms' competitiveness. As a result, most of these policies have been unable to resolve the key market failures that constrain productivity growth and are suggestive of major inefficiencies in the use of public resources.

12. **The available evidence shows limited effectiveness and poor efficiency of sectoral business support policy programs**. As was discussed in detail in chapters 3 and 4, the large fiscal transfers to businesses have not been accompanied by a positive change in productivity or in the critical inputs to productivity, such as innovation investments or the quality of managerial practices. Both general trends, and also evaluations of specific support programs, suggest a broad lack of impact on productivity, with a few notable exceptions; and quite often, as in the case of the *Inovar Auto* program, with a high cost on all consumers via high prices of lower quality goods. It also appears that none of these policies was designed with an explicit logical model, starting with the identification of market failures that the policy seeks to address, to the expected impacts, with a projection of expected benefits relative to costs. Consequently, policies lack transparent impact evaluation frameworks assessing their effectiveness and efficiency, and they also lack sunset clauses for terminating the policy absent rigorous evidence of cost-effective beneficial impact. This calls for a re-think of how public support to businesses is designed and implemented.

13. **Perhaps greater than any of the other costs imposed on Brazilian society was the damage that the resurgence of business support policies caused to the whole policy-making framework.** The policies evolved from attempts to stimulate business (often with little evidence or performance indicators) into a

transactional marketplace[5] in which policies and support were bought and sold for political contributions. While there were elements of such a transactional basis to policy making through the whole of the twentieth century (and before), the extent and intensity of these transactions accelerated enormously in the twenty first century because of a combination of abundant revenues from the commodity boom (particularly in Petrobras), rising costs of obtaining and maintaining political power and the proliferation of business support policies. The evidence from the *Lava-Jato* investigation provides extensive documentation of the workings of the system (see Box 6.3 and Lima de Oliveira (2017a)). The true cost of this approach to policy making is that policy making institutions in Brazil have been hollowed out, and it is the reconstitution of these institutions that will be essential for the formulation and implementation of effective policies. Good policies cannot emerge from dysfunctional institutions.

Box 6.3 The transformation of business support into the *Lava-Jato* system

Following an investigation into a possible money laundering scheme (located in a car wash – giving it the name *Lava-Jato*), in 2014 Federal Police stumbled upon an apparent bribery scheme in Petrobrás involving some of the Directors of the company colluding with construction companies. The initial investigation resulted in the detention of a director of Petrobrás who identified other directors and executives of big business groups (particularly construction groups) as being involved in a cartel for all Petrobrás construction contracts stretching back for more than a decade. The cartel members assigned the contracts and paid a standard fee of 3 percent as a bribe, which was then channeled to various political parties and individual politicians.

A much larger network of corrupt relationships between large firms and the political class was soon revealed. It involved bribes and campaign donations used to influence legislation, obtain tax breaks, circumvent public scrutiny and accountability, and overcharge other state companies, such as Eletrobrás and its subsidiaries.

The biggest player in the private sector was the Odebrecht group, which proved to have an entire department (*Setor de Operações Estruturadas*) dedicated to the organization of corrupt payments. By late December of 2016, 77 executives from Odebrecht struck a deal with prosecutors and provided testimonies about the illegal activities of the company with politicians in Brazil and abroad.

One of the main characteristics of the corrupt schemes was that they provided political financing in exchange for public contracts and public policy decisions. For example, the Odebrecht group participated in the negotiations, and made payments to politicians, on the content of 15 executive decrees (*medidas provisórias*), 4 bills, and a legislative decree. The first one was a decree to provide tax breaks for innovation. The group also lobbied for a tax break for petrochemical naphta, which would directly benefit a subsidiary of the group.

Another major enterprise involved in illicit relations with the State is the "National Champion" JBS, which became the world's biggest meat packer, using vast amounts of subsidized credit from BNDES. JBS executives confessed to systematic bribery of over 1000 politicians and civil servants, including illicit payments for issues with the competition agency CADE to be resolved in their favor. In 2009, BNDES agreed to overwrite US$2 billion in securities from JBS, later converted to equity participation, to back the group's international expansion, in exchange for a US$50 million bribe paid to senior politicians. Executives from JBS also mentioned several instances of payment to politicians to obtain favorable access to power or to obtain tax breaks.

14. **Brazilian business support policies are rooted in old ideas which have not been subject to empirical tests and have created vested interests that make effective design and implementation difficult**. Many existing business support policies have resulted in a significant capture by some large

[5] Limoeiro and Schneider (2017) argue that two features of Brazilian politics were especially consequential for the growth in illegal business-government transactional relations: appointive bureaucracy (the number of appointive positions of the executive branch increased from 18,212 to 22,961 between 2003 and 2013, versus about 5,000 positions filled in the United States by political appointment) and coalitional presidentialism (whereby the President has to build coalitions from a large number of parties through the distribution of pork and patronage). The dynamics between these two features and illegal business-government relations became aggravated with the significant increase in available resources because of the discovery of pre-salt oil in 2007 (Lima-de-Oliveira 2017b).

firms, which does little to support productivity growth in the country. This view of business support policies has also been reinforced by the perceived need to compensate national producers for the large gaps in infrastructure and complex taxation in the country (*Custo Brasil*) rather than directly addressing these underlying constraints. Few programs have clearly-stated logical frameworks, with good evaluation and best practices in design and implementation, likely contributing to the observed lack of impact of most of these support policies. Finally, this view has missed perhaps the most important justification of industrial policy, the need for coordination of public goods required for productivity growth. The policies implemented in Brazil in recent years have been accurately described as "activism without strategy" (Frischtak 2017) without a diagnosis of the problems, and without accountability for performance from the beneficiaries of incentive policies, with increasingly generalized transfer policies to the enterprise sector (on a scale far greater than social transfers to the poor and without corresponding impact).

15. Accountability for performance has been displaced by accountability for reciprocal favors. The lack of accountability for performance was in part due to the historical notion that it was the role of the State to ensure the profitability of private sector ventures. However, there was a much deeper sense in which accountability for performance had been displaced by accountability for reciprocal favors. The relationship between the public and private sectors became a marketplace for buying political support, cheap credit, subsidies, and favorable legislative treatment. Offering incentives of all types, in an environment in which political activity requires enormous resources, quickly blurred the distinction between incentives for public policy purposes and incentives exchanged for private political benefits (often illegally). The distortion of industrial policy into a general incentive scheme led to the creation of the *Lava-Jato* system. Replacing this system with institutions and public policy accountability mechanisms is fundamental for effective business support policies that are needed to support increasing productivity over the coming decades in Brazil.

6.3 Designing effective productivity policies and institutions

16. **One possible (radical) conclusion from the above evidence would be to recommend the abolition of all state support mechanisms, in part to eradicate the perverse political incentives they have created.** However, this may be neither desirable nor feasible. While there can be little doubt that the forms of business support that have been adopted in Brazil have not helped growth and productivity, simply removing all support could expose uncompetitive sectors to unsustainable pressures, particularly in regions where such uncompetitive activities are located. As shown in previous chapters, factors of production, and particularly labor, are not sufficiently mobile to respond to such shocks, and the likely result would be significant unemployment in some areas. Removing all support would not only be economically inefficient and socially unjust, but also counterproductive, since it would almost certainly provoke a political reaction to reverse reforms and reinstate failed policies.

17. **Historical experience also suggests that virtually no countries have achieved high income levels without some business support policies that address existing market failures.** Dismantling the existing framework in Brazil should not mean the simple abolition of all state support, but rather the rationalization of existing policies and, more importantly, changing institutional arrangements to generate policies which facilitate competition, reduce distortions and address market failures and coordination problems. This will require some sequencing in the replacement of existing policies and require state support to facilitate economic adjustment. Precisely because the required adjustments may be large and complex, there is scope and need for the state to facilitate this adjustment.

18. **Designing a new generation of effective productivity policies requires redesigning and rationalizing existing policy-making institutions to facilitate the development of polices with three key characteristics.** New institutional arrangements are required that support: (i) greater transparency in the

objectives of, and evidence for policies and the market failure that policy seeks to address; (ii) greater contestability of policies based on rigorous evidence of impact; (iii) improving coordination of , both within government across departments, at the highest level, and between government and business.

19. **The current political conjuncture represents a unique opportunity in the history of Brazil to rewrite the rules for business support policies and institutions.** Historically Brazil has been capable of undertaking major institutional changes when faced with deep structural political and economic crises. While it is impossible to see exactly how the Lava-Jato investigation will end, Brazil has reached a moment in which there is a consensus that structural institutional changes will take place, because neither the economics nor the politics of the Lava-Jato system is sustainable. There is a consensus in both the private and public sectors that the systemic corruption cannot go on. In fact, it is the contention of this report that the *Lava-Jato* investigation and the related political crisis provide a unique opportunity to rewrite the rules for business support policies, institutions and incentives.

<u>6.3.1 Greater transparency and accountability to avoid capture</u>

20. **A central principle for new institutional arrangements is the need for accountability to be built into all policy development and implementation.** Making explicit and transparent the objective and market failure that government intervention seeks to address, together with the evidence for the policy is key for effectiveness, since it disciplines the use of instruments and facilitates the evaluation of these programs. No agent, including the State, has sufficient knowledge to make choices on sectoral priorities or national champions. This lack of knowledge implies that all policies and programs of support, even when evidence based (which was almost never the case in Brazil), will require mechanisms to ensure that they are working, adjust initially if they are not, and to cancel them if they fail to deliver adequate results. In this sense, business support policy is a learning process, and not one of predetermined recipes. Transparency and accountability are necessary to avoid or at least reduce political capture of policies and institutions.

21. **Empirical evidence suggests that competition is essential to stimulate productivity growth.** An important lesson from the experience of Brazil in the use of business support policy is consistent with that of international experience. Innovation and increases of efficiency only take place under the pressure of competition. Aghion et. al. (2015) show, on the basis of empirical data from China, that business support policy is far more effective in a competitive environment, which could consist of multiple domestic firms competing or, as in the case of Korea, "forcing firms that received targeted support to compete on global markets". The authors also note that "that the less concentrated and more competition-friendly the allocation of state aid to a sector, the less firms in that sector will lobby for that aid as they will anticipate lower profits from it. In other words, political economy considerations should reinforce the interaction between competition and the efficiency of sectoral state aid" (Aghion et al. 2015, 24) This does not imply that there is no role for business support policy, just that a business support policy that isolates firms from competition is likely to be ineffective and prey to political economy distortions in the search for rents without accountability.

<u>6.3.2 Designing evidence-based contestable policies: Addressing market failures while avoiding government failures</u>

22. **Correct and effective policies can only be designed and implemented by appropriate institutions.** The policy challenge is not just to identify the correct policies, but also to establish institutional arrangements that can develop good policies and identify and reject bad policies, make sure that these are aligned and coordinated these and generate incentives for entrepreneurs to invest and innovate and

use solid design and implementation processes that minimize capture and maximize effectiveness. Below are some core principles to make these policies more effective.

23. **Effective policies to support productivity need to be evaluated for their impact on the business environment and competition, and to this end, employ market-compatible incentives.** The large number of exemptions, sector choice and combination of instruments used in existing business support policies translated into a significant number of distortions and the erosion of the level playing field for the private sector. For example, programs that provide subsidized finance in some sectors, almost inevitably introduce an uneven playing field between those in the receiving subsidized finance and those not receiving it. It is, therefore, critical that existing and newly designed polies are evaluated not only on the basis of their potential to have the expected impact, but also on making sure that distortions to competition are minimized.

24. **Problems are better addressed by incentives that are aligned with the market.** Where government is required to redress a market failure, for instance lack of firm upgrading or training, due to asymmetric information or coordination, employing market-compatible incentives is likely to lead to better allocation of resources. For example, it is important to make sure that although subsidized, the marginal costs of training or extension policies should be paid by the beneficiaries, so costs fall on the beneficiaries if they do not subscribe. In the case of the training program, the evaluation of PRONATEC (O'Connell et al. 2017) suggest that when the private sector is involved in designing the training priorities, the program shows better outcomes.

Correctly identifying market failures

25. A second principle for effectiveness is a shift towards evidence-based contestable policies based on rigorous evaluation, which make explicit the market or systemic failure that is being addressed. Business support policies in Brazil rarely make explicit what market or more systemic failure they are trying to address. Instead, the "developmentalist" objective focuses primarily on supporting specific activities by providing generic subsidies or reserving markets. This policy "engineering" omits a key element of any logical framework of a policy intervention, the mechanism through which the intervention is expected to generate change. For example, subsidized loans to facilitate firm productivity upgrading projects may work if the underlying market failure that constrains upgrading is primarily a financial market imperfection; i.e. firms are financially constrained to upgrade and adopt new technology, and when trying to access the banking sector to finance some necessary investments they are excluded or cannot afford a very high interest rate. However, the failure to upgrade is often related to information asymmetries or the fact that firms have difficulties in the design and execution of innovation projects. Even in the case that a financial imperfection undermines upgrading, the problem may not be the cost of credit, given the expected high returns, but the overall access to credit. These examples would suggest a different set of appropriate instruments to support upgrading; in the former case some technical assistance with a matching grant or direct extension services, and in the latter case a credit guarantee would suffice. Thus, any effective institution for designing business support policies must include rigorous processes to identify the specific market failures being addressed, and use this as a basic criterion or disciplining device for the development of policy proposals.

Box 6.4: Types of market failures

Effective business support policies aim at addressing existing market or system failures. Some of the justifications for these policies include:

a. Well-known externalities that private entrepreneurs cannot capture, such as the benefits from innovating in products or processes that may diffuse in specific industries or clusters, breaking into new export markets or pioneering new economic activities.

b. Existing information asymmetries that can generate important financial imperfections that discourage banks from lending to productive but risky innovation and upgrading activities due to adverse selection or moral hazard.
c. Information asymmetries that generate capabilities failures in companies – that firms don't know what they don't know – such as how to achieve quality standards, upgrading new technologies or accessing export markets.
d. Coordination failures that prevent the provision of adequate infrastructure, support services and adequate legislation.

26. **Two important elements are critical to avoid policy failures: a solid diagnostic and strong public-private dialogue mechanisms.** Business support policies are often designed based on false premises due to an incomplete identification of existing problems, false assumptions about the underlying problem or simply mimicking existing policy instruments in other countries. For example, the use of local content requirements to induce downstream linkages is often based on a false premise: reserving part of the market to local SMEs will allow enough scale for these to become suppliers of larger buyers. However, the reason why large buyers, often MNEs, do not source locally is primarily due to quality and cost considerations. While scale may help to reduce costs, local SMEs face significant constraints due to their inability to upgrade their operations and produce the quality required. The best policy in this case is to address the quality problem directly and work with suppliers through, for example, supplier linkage programs. This, in addition to addressing the quality problem directly, via the adoption of ISO certification and other MNEs standards, has the advantage of allowing SMEs to improve their competitiveness and, in some cases, to access export markets.

Box: 6.5 Learning from incorrect diagnostics: The Inovar Auto program

Brazil has invested very heavily in creating a vibrant automotive sector. In 2011, the Inovar Auto program combined high tariffs to protect the sector with substantial incentives to perform innovation activities in the country and to source local content to local providers. Protection combined with the size of the market and very large subsidies attracted major producers to locate in the Brazilian market. However, this came at a huge cost to consumers, who have to pay much higher prices for automobiles than neighboring countries. Furthermore, the programs have been challenged in the WTO and ruled as non-WTO compatible, which resulted in the end of the program in 2017.

The basic problem of the program is that of having a bad diagnostic of the sector. There is a mismatch between Brazil's automotive policy stance and current global realities in the industry. Brazil's automotive policy is based on the idea of capturing — or replicating — the entire value chain for automobile production in Brazil. However, no country except Japan and South Korea has been able to achieve this since the dawn of the industry. Since the 1990s, the global industry has moved rapidly and decisively toward a global value chain (GVC) structure populated by global lead firms (automakers) and global suppliers that collaborate on new model/platform design and development in traditional industry clusters (e.g. Detroit, Southern Germany, and Tokyo/Osaka) and then produce in or close to large end markets. Because GVCs fragment value chains geographically into innovation and production, Brazil will not capture high value-added functions or make significant contributions to the evolution of the global industry using its current approach.

A second problem - related to the first – is the use of policy instruments. While countries like the Czech and the Slovak Republic effectively used supplier linkage programs to build links with large German car manufacturers, Brazil tried to induce these linkages by providing incentives to car manufacturers. However, the main outcome has been a high trade deficit in automotive parts and components with little or no exports of second and third tier suppliers. More importantly labor productivity in the sector has been decreasing in recent years, making it more difficult to achieve a high competitiveness that would allow Brazil to dominate exports in the region.

Source: Adapted from Sturgeon et al. (2017)

27. **An accurate diagnostic demands strong public-private dialogue mechanisms.** In addition to a solid diagnostic, identifying the key market failure requires the participation of the private sector in policy design beyond the usual complaints about the business environment or access to finance. Policymakers need to understand the problems producers face in order to identify the key binding constraints and decide what support is needed or what public infrastructure should be prioritized (Ghezzi and Utterwulghe 2017). Similarly, the private sector needs to be able to communicate their needs to the government to adapt policies and prioritize public infrastructure that is constraining their competitiveness. This dialogue is effective when it has mechanisms to avoid capture as shown in Box 6.6, as well as a basic agreement on the overall rules for business support policies (see subsequent sections), including particularly accountability for performance.

Box 6.6: Some Lessons from the "Executive Working Groups" in Peru

The experience of the "Mesas Ejecutivas" (MEs) in Peru highlight the following lessons for public-private sector dialogue:

1. More important than having long periods of consultation and studies with the private sector is to start solving problems from the beginning. This enables "positive momentum" that encourages continuous participation which, in turn, increases the probability of solving more problems.

2. MEs need to be demand-driven. A crucial ingredient of a successful ME is to have a capable and committed group of private sector participants; their continuous participation can be used as a metric of success when it is still too soon to show tangible results. The existence of private sector champions will help in gaining overall public attention for the sector.

3. The key differentiating factor between the MEs that can "hit the ground running" and those that cannot appears to be how proactive and well organized the private sector is while participating in the ME and how feasible it is to remove the bottlenecks limiting the sector's productivity. Experience shows that a successful ME requires perseverance and the ability to show results and get things done.

4. Experience shows that because the private sector is so interested in the success of the ME, and because misleading information can eventually be detected, private sector participants have an incentive to provide truthful information to the public sector during ME sessions and inter-sessional meetings.

5. The MEs require solving coordination problems within the public sector; this is difficult to achieve. Beyond other incentives (or punishments) to secure cooperation, public sector participants should not feel overshadowed by the team that coordinates the ME. This coordinating team needs to be an honest broker between private and public stakeholders.

6. The focus on productivity of MEs is a useful disciplinary device. The private sector, when asked for the solution to their problems, will automatically prefer a subsidy or a tax exemption over the more "time-consuming" solutions aimed at increasing productivity. This makes sense for the private sector to ask, but it does not necessarily make sense for the ME to focus on that. For a subsidy one does not need a ME. The objective should be to increase productivity, not to compensate low productivity with a subsidy.

7. Transparency is an intrinsic part of a ME by virtue of the way it is constructed. Transparency is crucial due to the traditional mistrust that exists in society regarding public-private dialogue. It will reduce the risk of capture (because of manipulation of private information or outright corruption).

8. MEs must receive support from the very top of the government. Otherwise, they will sooner or later hit a wall.

9. In policymaking there is a tendency to build institutions for delivering. However, MEs start delivering using a relatively simple institutional set up and capabilities already present at the Ministry of Production. The positive momentum generated by delivering helped "within- government-institutionalization" of MEs as a tool. More than writing into law, continuous commitment from the private sector is likely to be the best guarantee that the ME will survive the necessary political cycles. It also strengthens learning in public sector institutions.

Source: Ministerio de la Producción del Perú (2016)

Avoiding government failure

28. **An important principle for effective policies is to minimize the risk of government failure.** Agencies and ministries executing business support policies have limited capabilities, human and financial, which constrains the types and complexity of policies support measures that can be designed and implemented effectively. For example, the use of many tax exemptions to support R&D or local content requires various capabilities such as: knowledge of what expenses can be deducted, monitoring of these expenses, integration of tax databases, monitoring of local content contracts. In this regard, designing policies that minimize the need for high bureaucratic capabilities may lead to second-best design, but better outcomes. A good diagnostic and identification of market failure is, therefore, a necessary but not sufficient condition for effective policies, and agencies and line ministries need to weigh their capabilities and the relative strengths of governments agencies and private providers in delivery. In this regard, using partnerships with the private sector can help clarify the roles and specializations when designing policies.

29. **Accumulating government capabilities requires investing in good processes in design, implementation and coordination.** Business support agencies need to invest in adopting robust processes, training their staff and making sure that the required resources and necessary checks and balances are in place. Box 6.7 below shows a checklist of elements needed for good policy design. In addition to the rationale and diagnostic of the problem discussed above, it is critical to have a good intervention model that enables a monitoring and evaluation (M&E) system, which will determine the indicators that project managers need to choose to evaluate the implementation and effectiveness of their policies. Of fundamental importance during this process of policy formulation is to evaluate the interaction between existing policies and the new policy proposed, with the objective of avoiding unnecessary overlaps, inconsistencies, or competition for beneficiaries, as well as improving inter-agency coordination and more broadly increasing the efficiency of public resources.

Box 6.7 Designing policies, a checklist of good practice to consider during the design stages

1. **Rationale and diagnostic**
   - Is there a documented market or system failure to be addressed?
   - Is there a clear statement of goals, beneficiaries, and measurable outcomes?
   - How will the proposed solution interact with the rest of the policy mix?
   - Does the proposed solution take into account how local context may make an alternative policy more efficient?
   - Does the measure consider the relative strengths of the public and private sectors?
   - Has the proposed solution anticipated potential capture in its design?
2. **Intervention model:**
   - Is there a logical model integrating theory, assumptions, and how inputs lead to outcomes?
3. **Monitoring and evaluation methods:**
   - Are there monitoring and evaluation (M&E) approaches and systems set up at the design stage?
   - Are there clear procedures for M&E feedback to inform the evolution of policy?

Source: Cirera and Maloney (2017) based on Rogers (2017); Wu and Ramesh (2014).

30. **Equally important in developing these government capabilities for business support policies is the adoption of good implementation practices.** Very often evaluations of business support policies that do not show positive impacts are unable to identify what the problem is, and the question remains

whether the policy was badly designed based on false premises or, alternatively, whether lack of impact is due to poor implementation.

31. **Evaluation and learning play a critical role in ensuring evidence-based policies, but often agencies are not well equipped to implement both processes.** The previous discussion showed that very few business support policies are evaluated, even though around 3-4.5% of GDP is annually spent in a sub-set of these interventions at the federal level. Without proper measurement of results, it is not possible to learn and adapt existing policies. For example, after decades of using tariffs as an instrument for industrialization, there has been no analysis of their effectiveness, and the same occurs in more targeted programs such as the *Lei de Informática*. Collecting such data and evaluating these programs is critical, but this also requires (i) clarity of when impact evaluations need to be implemented; (ii) dedicated departments with trained staff to coordinate these evaluation exercises; (iii) learning mechanisms to discuss and adapt existing programs, and; iv) mid-term reviews of existing policies with clear mechanisms to close programs deemed as ineffective.

32. **Good implementation needs also agile processes and good management practices.** A key part of implementation is the way in which the processes for application and delivery of support and services are organized. Very often the application process can be very cumbersome or is designed in a way that the same set of enterprises repeatedly benefit from different support schemes. This is an element that has been raised by smaller firms in Brazil, suggesting that a lot of existing schemes are captured by larger firms. In addition, a new empirical literature suggests that similarly to what is observed in the private sector, managerial practices also matter for productivity in the public sector. Rasul and Rogger (2017) show how infrastructure projects in Nigeria that are implemented with better managerial practices in terms of monitoring, setting of targets and managers incentives, have also better outcomes. Improving the capabilities of government to implement these policies, require, therefore, the adoption of modern public management practices.

Coherence and consistency of existing policies

33. **One key problem of existing support policies is that they are not coherent with an objective of productivity growth**. As the previous chapter shows, despite the large amount of public resources committed directly or indirectly to support the private sector, only a small share of resources go directly to the objective of supporting productivity. This is not surprising given that productivity growth is not a central objective of business development support in Brazil, which focus primarily on industrialization objectives. Therefore, a first necessary condition for having coherent policies for productivity, is to establish productivity growth as the central objective of business support policies.

34. **Focusing on productivity growth as the central objective of business support policy is the first step to rebalance policies and ensure better coordination across agencies and institutions.** It is difficult to have coordinated policies if fragmented agencies have different objectives that often compete or contradict each other. While some policies such as "Brasil mais produtivo" have at the center the objective of facilitating productivity growth, other policies that provide support to specific sectors regardless of their productivity capabilities can be undermining the productivity growth objective by subsidizing inefficient firms and undermining the Schumpeterian allocation mechanism. As a result, it is key that all policies are designed with the objective of productivity growth. While this is a necessary condition to start rebalancing expenditure to be coherence with the productivity growth, it is not sufficient, and clear coordination institutional mechanisms are needed as suggested in the next section.

35. **Productivity growth requires long-term commitment and predictability over time**. Business support policies have had a very strong business support policy bias in the last decades. Overcoming this bias to transform it in productivity growth policies requires long-term commitment. Reversal in the

liberalization process in the previous decade, suggest that the “developmentalist” views of business support policies are deeply entrenched in society. But the evidence is clear: productivity is the most important predictor of differences in standard of living, and there is no evidence that existing policies have had an impact on the industrialization objectives originally formulated. Furthermore, there is no evidence that some industrialization could be achieved without the direct objective of improving the level playing field and supporting the private sector via upgrading and innovation policies. These policies, however, require strong investments by the private sector that need predictability over time.

6.3.3 Reducing fragmentation and embedding evidence-based policy and systematic evaluation in institutional arrangements

36. **A central question is how to modify existing institutions and incentives to reduce the risks of a public-private relationship based on transactional rent seeking and promote competition and good policy making.** What the *Lava-Jato* scandal showed was that the transactional nature of policy had permeated the business community and the political class to the extent that meaningful policy making has become impossible. Creating institutional arrangements to confront this problem is the basic challenge for policy-makers who want effective business support policies.

37. **The absence of effective policy making institutions is compounded by major institutional fragmentation.** The fragmentation of institutions within the Federal Government, and across levels of government, as well as the fragmentation of instruments, means that even in the absence of systemic corruption, developing coherent evidence-based policies would be almost impossible. Programs overlap and contradict each other, and in such a fragmented environment there are neither the resources nor the incentives to develop evidence and evaluate policies, including their interactions with policies of other agencies. Thus, the reconstruction of effective policy institutions needs to deal directly with the problem of fragmentation. It also requires building a dedicated focus on evaluation. This is much more than a passive technical activity. It requires gathering evidence to support policies and then evaluating their impact, and changing or removing them as a result of the evaluation.

38. **In several countries institutions to support productivity growth have been developed to address the fragmentation problems and enhance the coordination, coherence and effectiveness of productivity policies.** Perhaps the most well-known and longest established example is that the Australian Productivity Commission, which was established in 1998 as a public sector body with a remit to provide evidence on policies and issues related to productivity, in a transparent and independent manner (Banks 2015; Renda and Dougherty 2017). Although an advisory body, its findings carry weight with the Government, because of its independence and expertise. Policies derived from its recommendations are also more likely to attract a consensus, as they will not be seen to favor any particular interest group. Similar institutions have also been established in countries such as Chile, Denmark, Mexico, New Zealand and Norway, although much more recently.

39. **A recent study of productivity institutions identified several general lessons for these institutions to be successful.** Among these were[6]:

a. Pro-productivity institutions should be part of a wider effort to embrace good governance and evidence-based policymaking. The effectiveness of a pro-productivity institution can significantly depend on the extent to which good governance and better regulation principles are embedded in the legal system. Pro-productivity institutions can issue as many policy recommendations as they wish, but the uptake of such recommendations in the administration will largely depend on the

[6] The points below are summarized from Renda and Dougherty (2017)

administration's capacity to absorb and implement them, on the political commitment towards following up on these recommendations.

b. Political commitment is essential. Without a strong political commitment, pro-productivity institutions are unlikely to flourish or become prominent in the overall political landscape. They will have little impact on policy and will have little credibility.

c. Independence is important, and is a key asset, which contributes extensively to the legitimacy of the institution's output.

d. Budget and human resources must be sufficient to allow for high-quality research and quality control. The need for autonomy and independence is also reflected in the need for sufficient budget and resources to organize the institution's research work, as well as to adequately engage with stakeholders, e.g., through extensive public consultation.

e. Institutions should engage with stakeholders. Openness and transparency and independence of stakeholders interests are increasingly important for institutions.

f. It is important to combine short- and long-term thinking in the institution to preserve legitimacy and salience. All pro-productivity institutions consider long-term thinking to be their core business, although some have a stronger focus on shorter- or longer-term problems.

g. Pro-productivity institutions should be "plugged into" the policy process. Pro-productivity institutions can represent a great complement to regulatory oversight bodies in securing that the economics backing legislation and regulation is sound, and that the "long-term" is adequately accounted for when designing or evaluating new policy interventions.

40. **However, a pro-productivity institution, would, on its own, be unlikely to address the problems of productivity in Brazil.** Until the issue of the transaction-focused relationship between the private and public sector is addressed, other institutional interventions are likely to have little effect. It is likely that the post *Lava-Jato* settlement will include new rules and stronger enforcement of rules regarding public and private sector interactions. While an important step forward, new laws and their enforcement would need to be supported by other formal and informal institutions to offset decades of a transactional approach to productive development policies.

41. **To deal with these problems, new institutional arrangements are required.** Institutional arrangements that embody the principles of transparency and accountability, evidence-based policy contestability and coordination, whether through modifications to existing or new institutions, include: i) a political concertation mechanism between the Government, business, labor and others involved in production to agree on a new framework for productive development, including particularly new rules of the game for support to specific sectors and firms; ii) a rationalization of business development agencies to reduce and better determine the roles of the multiplicity of line ministries and existing institutions, such as BNDES, EMBRAPA (Empresa Brasileira de Pesquisa Agropecuária), FINEP (Financiadora de Estudos e Projetos), (ABDI) Agência Brasileira de Desenvolvimento Industrial and Embrapii (Empresa Brasileira de Pesquisa e Inovação Industrial); and, iii) an institutional focus on developing, monitoring and evaluating policy interventions, with a mandate to review and pronounce upon all executive and legislative measures to support productive enterprises. The final goal of these changes is to be able to embed the principles of transparency and accountability, policy contestability and coordination into the policy-making institutions.

A new political concertation mechanism for business support policies

42. **A concertation mechanism between government, business and labor would be necessary to establish the basic rules of the game for business support policies**. A pro-productivity institution could not be effective without a prior agreement that all future policies would be based on evidence, subject to rigorous evaluation, and that benefits derived from future policies would be conditional upon performance (accountability). The concertation mechanism would provide a mechanism for a coordinated reduction in sector and firm specific benefits, and their replacement by coherent evidence based policies, thus changing the current dynamics of public-private sector dialogue. There are many possible institutional forms of the concertation mechanism. The main point is that it would include representatives of business (agricultural, manufacturing and services), labor and government, first to agree on a new set of principles to underlie all productive development policies, and second, to provide a forum for the identification of issues and problems impeding development for analysis and recommendations by an evidence-based productivity institution. The first stage of agreeing the new principles (or rules of the game) for development policies would be the most critical, in that it would provide a mechanism, supported by a credible commitment from all parties, to dramatically reduce the scope for rent seeking behavior and resulting policy distortions. To be successful it would almost certainly need to be supported by a simultaneous political reform process aimed at reducing the dependence of the political system on illicit financing.

43. **The concertation mechanism would establish the new principles for the conduct of productive development policies.** The principles would likely include that all future productivity policies (including external trade restrictions) be subject to performance criteria, time bound, and with specific monitorable objectives, subject to performance review by the productivity institution, with regular publication of results of the reviews, and a withdrawal of incentives or benefits from non-performing firms. Second, the ultimate objective of the discussions should be anchored on increasing productivity in the private sector as a disciplining device, where bottle necks and coordination issues are discussed

44. **The principles agreed upon would provide a basis for reducing rent seeking, by ensuring that fewer public policies generate pure appropriable rents**. Any rents or transfers from the public sector would be highly conditional and subject to public external review. This would allow a movement towards focusing on obtaining support to generate quasi-rents from future investment and innovation. One question that might be raised is what incentives there would be for traditional rent-seeking groups to agree to such principles. There are several reasons to believe that such an approach might be successful. The first is that the situation created in the post Lava-Jato environment will have convinced many agents that some things must change. There is also a consensus among most producers that the market for policy incentives, and the resulting increase in complexity of the business environment, are ultimately affecting all concerned. Historically the problem has always been one of coordination. There is no incentive for any sector or enterprise to reduce resources dedicated to seeking public resources and protection. The principles agreed in the concertation commission provide a means of a coordinated effort to reallocate entrepreneurial resources to innovation and investment rather than rent-seeking.

A productivity institution

45. **The establishment of a productivity institution or adding this mandate (with appropriate resources) to an existing institution is key to ensuring coordination and evaluation of existing policies.** The institution would provide a means to evaluate policy proposals, and policies in the process of implementation, as a technical body with deep understanding of productive sectors and the capacity for unbiased analysis. The historical problem described throughout this study is that ineffective policies are launched and then become permanent, not only failing to solve the problems that they were intended to solve, but also creating additional problems, throughout the economy, and providing incentives for

entrepreneurs to dedicate their most valuable and creative resources into seeking support and protection rather than innovation and investment. The mandate of this type of institutional arrangement should include a specific commitment to developing policies that increase productivity, keeping in mind the inclusion focus as also a key objective for the country.

46. **To be effective, the productivity institution would need to be clearly and transparently connected into the policy making process.** This could be achieved by it having a mandate to initiate policy reviews in any area of the economy, and make public recommendations, which the Government would be obliged to consider, and to provide an explanation if the recommendations are rejected. In addition, proposals for developmental policies emanating from congress would also be required to be submitted to the institution for an evaluation of their likely implications, and a summary of the evaluation published prior to the congress voting on the legislation. The evaluation would at a minimum seek to answer the following questions: What is the problem being addressed by the policy? What is the market failure that has been diagnosed to justify the policy? Is the alleged policy remedy—whether it entails alleviating the failure or redressing its impact—a good match for the diagnosis? Are institutional capabilities sufficiently strong to design and carry out policy as intended?[7] What are the likely unintended consequences of the policy? and finally what is the expected overall impact of the policy proposal? This type of evaluation would also take place on policy proposals emanating from the executive, before they are submitted to Congress for approval.

47. **The institution should also be able to accept requests for evaluations of policy questions from the Government, Congress, the concertation institution and other relevant bodies.** While both the legislature and the executive could ignore the recommendations of the productivity institution, the effect of making public policy evaluations would be to make it politically more difficult to adopt obviously mistaken policies, or policies that are simply to benefit specific individuals, enterprises or sectors at the expense of the wider society. If the policy evaluations of the institution show how reforms may hurt some groups but benefit society, this would help in building the political consensus for such reforms.

48. **The productivity institution would be central for developing the policy agenda for business support, identification of priorities and evaluation.** The evidence presented throughout this report suggests a complex reform agenda going forward, which needs careful sequencing of policies (see chapter 6). That demands a clear mandate to coordinate existing efforts across line ministries and agencies to avoid overlaps and re-focus policies when ineffective. It also requires some foresight work in identifying where new problems may arise, which in turn affects the sequencing of policies. However, better policies cannot simply be imposed if the institutional system is dysfunctional. The institutional structures suggested in this chapter would provide a basis for validating and developing the necessary business support policies for increasing productivity with inclusion.

Redefining and rationalizing existing business development agencies

49. **Improving the institutional framework for business development support requires less agencies and a clear mission orientation towards problem solving.** There is a multiplicity of agencies, public and public-private, operating in the same space, including BNDES, EMBRAPA, ABDI, AMEX, FINEP, EMBRAPII, SEBRAE and SENAI. They often compete for resources and beneficiaries. These drain significantly public resources – given that each agency has significant fixed costs - and fragments policy. This fragmentation is even more challenging given the subnational dimensions of policy in Brazil and the need to keep active access in all the states of the country. Regrouping these agencies into a much smaller number that can be defined under broad themes of SMEs – including export support – or innovation would facilitate

[7] The previous three questions are posed as the central questions for industrial policy in (Crespi, Fernández-Arias, and Stein 2014)

coordination as well as access to the different states in the country via sub-national offices (which already exist forcefully in some of the agencies). Numerous international models for such support exist (see Box 6.8 below).

Box 6.8 Institutional features that increase the effectiveness of business development support

A review of the designs of different business development support institutions suggest that different institutions follow different models to allow them to operate with more efficiency and efficacy. For example, an agency that has accomplished transparency and accountability, with strong mission orientation in supporting innovation, is Malaysia's MTDC (Malaysian Technology Development Corporation). This is an agency owned by the government but with a relative degree of autonomy and flexibility to derive its funding from multiple government sources. It is owned by Malaysia's Sovereign Investment Fund, but serves as a platform for multiple government ministries to advance innovation. In support of this mission, it has a governing board comprised of leaders from multiple agencies and receives funding from multiple government sources. This serves to make sure that its policies are aligned with industry as well as addressing the coordination problem.

Another agency that has been very successful in accomplishing effectiveness in their policies is SPRING (the Standards, Productivity and Innovation Board) Singapore. More importantly, its well-articulated entrepreneurship support role within Singapore's innovation ecosystem evolved from basic productivity support to more complex technological support in a process of learning that was facilitated by their mission orientation. In the 1980s, Singapore had become disappointed with the productivity gains arising from its growth model. In particular, the country had been successful in attracting multinational enterprises (MNEs), but local firms had not yet been able to link into these value chains. Their ability to be accountable and avoid capture played a key role in its success, as well as the ability to identify the key market failures and find solutions, often learning from elsewhere. SPRING Singapore enhances coordination in business development support by working closely with other agencies, such as the Economic Development Board, which focuses on economic development planning, attracting foreign direct investment, and facilitating industrial development.

Another key capability that business support agencies must have is the ability to understand strengths and weaknesses of their activities. In some countries, this role may be fulfilled via a partnership between the institutions and academia to monitor and deliver timely evidence to policy makers to justify, scale, and especially abandon policies and programming. A good example is the independent external impact evaluation of the Serbia IF's pilot enterprise innovation programs that met with strong opposition from the scientific research community and even policy makers. Eventually the impact evaluations demonstrated additionality of these pilot programs, garnering support for these programs in times of economic distress and continued funding from the donor community with the backing of the government. The Serbian IF also engages with an independent financial auditor, which periodically performs ex-post program evaluations, while its in-house systems are collecting long term data for impact evaluations.

Source: Adapted from Kapil and Aridi (2017) and Cirera and Maloney (2017)

50. **These regrouped agencies should have a clear mission orientation related to problem solving.** The idea behind such agencies is that policy makers invariably make mistakes. They therefore need to shift the focus from choosing winners (sectors, industries, national champions) to the process of detecting and correcting errors (with careful attention to governance). They also explicitly confront the problem of obstacles to informed choices such as the influence of entrenched interests, insufficient public- sector capabilities, and the like) which require particular attention. Another issue is the insufficient capability of governments and other economic agents to undertake business support policy tasks, as has been described previously in this chapter. Public support to establish connections with the world economy, may not be effective if the capabilities to make these connections do not exist. The issue is how to generate the capability (Kuznetsov and Sabel 2014, 36). Given the sophisticated capabilities needed to design and implement projects, these can be arranged in portfolios managed by such an agency. The agency should

be an autonomous entity with a mandate to experiment by assembling a portfolio of projects and carefully monitoring the portfolio, yet remaining accountable for the results of the experimentation.[8]

51. **A key objective of such agencies is to address systemic failures.** For example, in Ireland the IDA focused on collaboration with groups of firms to address systemic problems. The IDA's attention to the systemic or economy-wide implications of its collaboration with groups of firms can be illustrated by two examples: the way it tracked and reacted to indications of possible skill shortages, and the effort directed at supplier development. Thus, between 1977 and 1979 the agency negotiated agreements with electronics firms that, together, would create demand for some 600 electrical engineers per year, about four times the number that Irish universities and regional colleges were then graduating. The short-term solution was to convert science graduates to electronics qualifications via one-year courses; the longer-term solution was to expand existing courses and add new ones. The rapid response of the Higher Education Authority provided reassurance to subsequent investors that Ireland could provide the skills needed and contributed to a renewal of the university and technical training systems (Kuznetsov and Sabel 2014, 37).

52. **These development agencies use diagnostic monitoring and learning as a central tool.** It involves the systematic evaluation of a portfolio of projects or programs to detect and correct errors as each project evolves (including the weeding out of inefficient ones) in light of experience and new information.[9] The learning takes place through diagnostic monitoring. Diagnostic monitoring is essentially about identifying obstacles and overcoming them, not ensuring compliance with a pre-determined plan. Instead of protection through fiscal and consumer transfers, such agencies help directly solve productivity bottlenecks through public-private framework programs, which promote entrepreneurship and allow coordination-related problem solving between government and businesses.

6.4. Concluding remarks

53. **The analysis suggested that any new institutional arrangements would embodying certain principles**: (i) greater transparency and accountability to avoid capture, (ii) greater contestability of policies based on evidence and the market failure to be addressed, (iii) improving coordination of policies across sectors and departments. These principles are critical to address some of the key existing problems, with required actions including: i) Ensuring a good diagnostics, evaluation and learning within institutions for policy design and implementation; ii) Ensuring that the recipients of business support policies are accountable and subject to performance requirements; iii) Eradicating the false, but long-held belief that sustained business profitability can be obtained by transfers, cheap credit or protection, and the resulting tendency to capture policies and politicians; and iv) Building a political and popular consensus around these actions. These problems have their roots in history and in entrenched ideas. It may therefore seem very optimistic to suggest that these problems can be overcome simply through new institutional arrangements. It will undoubtedly take time, but if ever there were a moment in the history of Brazil when such an approach would be feasible, that moment will come in the very near future as the final institutional implications of the current political and economic crisis become apparent.

54. **The types of institutional arrangements proposed here attempt to address the problems noted above.** The concertation mechanism is designed to focus on changing the political economy of what development policy needs to be. It also sets a framework for establishing accountability mechanisms for recipients of assistance in the future. The productivity institution addresses the issue of policy

[8] Examples of such agencies exist in Taiwan (China), Ireland, Chile, Finland and Israel see (Kuznetsov and Sabel 2014).
[9] The use of this tool is illustrated by Kuznetsov and Sabel (2014, 43) in CORFO (Corporación de Fomento de la Producción de Chile) which manages the the Fundación Chile program.

coordination as well as the absence of prior analysis and evaluation of productive development policies. The rationalization and mission orientation of existing agencies addresses directly the question of learning and problem solving. What is clear is that these institutional changes would have to function in ways that create synergies and complement each other.

55. **Finally, lasting success in developing effective business support policies will also depend on wider institutional changes taking place within Brazil's political system.** The most important measure to strengthen Brazil's development prospects and to ensure sustained productivity growth and shared prosperity will be the generation of the political consensus to support a reform program and the establishment of institutional mechanisms to ensure that future policy choices are subject to scrutiny for effectiveness and abandoned if found wanting. The political crisis generated by the *Lava-Jato* investigation and the urgent need for long-term structural reforms makes it possible that such changes will be possible. The current crisis is thus an opportunity to build new institutional arrangements, reduce the privileges and protection granted to a select few, and to realize the Brazil's productivity promise.

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