Brazilian protectionism, a myopia that has deeply affected its economic development.

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Abstract

Brazil is known to be a traditionally protectionist country, its trade policies have an eminently interventionist bias, with broad restrictions on free trade, whose impact is extremely harmful to economic development and national industrial performance.
Despite the damage caused by protectionism; in Brazil, these practices remain on the agenda. Exaggerated interventionism leads the country to the opposite direction of the world trend which, over the last few years, has experienced an unprecedented advance, a consequence to a large extent of increased trade between countries. Brazil, isolated from the global integrationist spirit, does not benefit from the productivity gains associated with the global trends that have shaped the most competitive industrial production, including the integration of international trade and a fluid reallocation of resources between companies through the fragmentation of the value chains.
Based on this scenario, the objective of this work is to analyze how the protectionist position adopted by Brazil in relation to the international market impacts country's process of industrialization.

Key words: Globalization, International trade, Liberalization, Protectionism.

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Introduction

The phenomenon known today as globalization has allowed the expansion of markets and production processes. International trade has an important role on the globalization process; thus, many activities that typically used to take place within a single country or region now involve other nations. The access to products from all over the world reduces the prices for consumers by boosting the competitiveness of industries. The removal of barriers between nations fosters this integration in which businesses all over the world benefit by increasing the number of suppliers as well as economies of scale. Greater openness can also stimulate foreign investment which is a source of employment for local workforce and could bring about new technologies, thereby, fostering productivity.

Despite the positive relationship between free trade and development, it is common to conduct trade policy through protectionist strategies. There are several arguments used in favor of protectionism, both by the industrial sector and by the government. To solve the dilemma between which trade policy to pursue - liberalization vs protectionism - is a complex task for policymakers, due to the conflict of interests that it causes: on one hand the interest of the national industry, which claims for governmental protection; and on the other, consumers, who aim to have more variety of products available at lower prices. Despite the positive evidence linking free trade to economic development, several countries, such as Brazil, still have protectionist policies in place, either through tariff barriers or other subtler forms of free trade restrictions.

Introduction on International Trade Theories

Mercantilism: The political economy of the absolute state

Mercantilist was the school of thought that prevailed in the economic logic between the fifteenth and eighteenth century. For the mercantilists the maximization of exports and increase of protectionist measures were the most effective form of growth. Thomas Mun (1664) was perhaps the most influential mercantilist writer and his England's Treasure by Foreign Trade portrayed the mercantilist theory in regard of international trade.[1]

During the period, when mercantilism supported the decisions of governments, the role of the State was eminently interventionist. Measures to discourage imports, essentially high import tariffs and products entrance prohibition, were frequently used.[2] Economic activity was, therefore, reduced to a zero-sum game in which the gains of one country depended on the losses of others. At the end of the eighteenth century, the mercantilist conception had its first contestation. David Hume contradicted the former model with a theory named monetarist quantity theory of money. His essay, "On the Balance of Trade in 1758" which supported the existence of international trade laid foundation for subsequent liberal theories.[3]

Liberal theories advocated by Adam Smith and David Ricardo

Precursors of the " Absolute Advantages" and "Comparative Advantages" theories, Adam Smith and David Ricardo, represent the classical school of international economics. While the first promoted international trade by giving emphasize to the mutual gain by trade among nations in contrary to the zero-sum game highlighted during the mercantilist period, the other complemented his predecessor by bringing into light the concept of Comparative Advantages.[4] David Ricardo explained what could not be explained in the "Absolute Advantages Theory": trade can exist even if a country is more efficient in the production of all goods considered; that is, trade between two countries can occur even if one of them has an absolute advantage over all goods. What should be verified is not the existence of "absolute advantages" but rather "comparative advantages;" so each country must export goods in which it has relative advantages over the others. Both models, however, measured production costs exclusively by labor productivity.[5]

Neoclassical theories

The neoclassical theories aimed to demonstrate that not only labor determines the production advantages but also the relative presence of other factors of production: land, labor and capital. The contestation arose from the thought of Eli Heckscher (1919) and Bertil Ohlin (1933), later formalized by Paul Samuelson (1948).[6] Despite including new factors of production in the neoclassical model technologies remained constant. Consequently, Staffan Linder (1970) made his analysis considering an important feature of modern production, technology. His theory established the variation between trade of primary and industrialized goods. While the first one is explained by the Heckscher Ohlin Samuelson model, that is by the difference in the allocation of factors of production (land, labor and capital), the second is characterized by demand differentiation.[7]

Raymond Vernon (1966), in his essay, International Investment and International Trade in the Product Cycle or The Product Cycle Theory, analyzed trade of industrialized products.

According to his concept innovation occurs in the most advanced and developed economies, as there is a high labor specialization in these countries. However, once the first units are produced they are transferred to countries with abundant and unskilled labor force taking advantage of production on a larger scale and with lower costs.[8] Vernon's theory was essential to comprehend the process of economies of scale, emphasized later, by the American economist, Paul Krugman. Increasing scale income motivates trade which can lead two countries, even though they are identical in terms of technologies and tastes, to benefit from international exchange of products. Thus, international trade allows countries to specialize in production in which they have comparative advantages giving them greater efficiency in large-scale production.[9]

Competitive advantage, productivity and innovation

Technical progress and the innovative capacity of countries and companies are important aspects of capitalist dynamics. Joseph Schumpeter, in 1950, was one of the first scholars to analyze the relevance of innovation to break the status quo and, therefore, boost development.[10] Schumpeter's theory analyzes the process of production and competition within capitalist economies mainly from industrial competitiveness and technological innovation: the creative destruction process.[11]

The existence of real benefits from foreign trade is a consensus among economists.[12] The theories presented here have explained the reasons for international trade and its advantages. The development of Adam Smith's "absolute advantages" and then of David Ricardo's theory of "comparative advantages" were essential to strengthen the debate about international trade and laid the foundations for multilateral trade initiatives.

International trade and competitiveness

International trade and competitiveness are complementary forces; in recent years, the world has experienced a great advance in trade between countries; there is no evidence of nations that have raised their development level without participation on international trade and integration with other markets.13 Modern economical miracles, such as: in Hong Kong, the Republic of Korea, Singapore, and Taiwan, are positive examples of the benefits of international integration, and consequently, exposure to competition, knowledge, and new technologies.

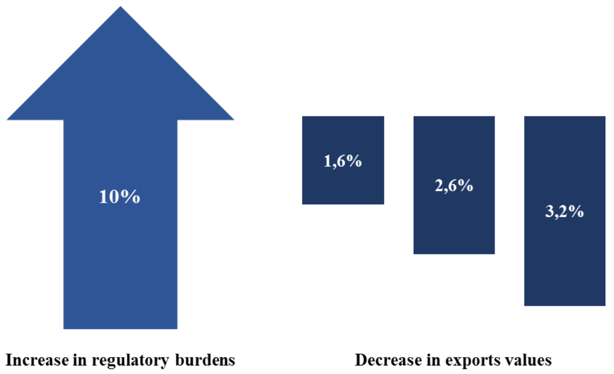
This integration among economies became even more evident in the Post-War period when the importance of international trade, both for the stabilization of economies and peace keeping, culminated in the creation of the General Agreement on Tariffs and Trade (GATT) in 1947, replaced by the World Trade Organization (WTO), in 1994. The WTO is responsible for defining trade rules that mitigate the autonomy of national states especially regarding protectionist measures.[14] Multilateral negotiations under GATT agreement were crucial to reduce tariff barriers and boost economic growth which averaged 5% a year during the first 25 years after the war.[15] Subsequently under WTO and with a 15% decrease on trade tariffs and the favorable environment for international trade the annual average economic growth was about 7%, it went from US $ 5 trillion in 1996 to US $ 19 trillion, in 2013.

Despite the reduction of barriers on trade, protectionism remains a reality; free competition undergoes various forms of restrictions.[16] The nature of barriers however has changed; tariffs decreased while non-tariff barriers increased. *Non-tariff barriers can take several forms; quotas, licenses, rules of origin, product requirement (standards, packing,* *labeling, product specifications), customs procedures and documentation requirements, local content rules and exchange rate manipulation.* (HAMILTON and WEBSTER, 2012)

The WTO allows the application of entry rules, nonetheless, these regulations should not represent unfair or discriminatory practices, thus, the abuse of restrictive rules negatively interferes the world trade dynamics.[17] The reduction of bureaucracy is an important step toward a stronger private sector because excessive regulations impede them from start, operate and expand.[18] In Brazil the regulatory system is very restrict; this hamper national business from prospering. A research conducted by the Brazilian Industry Confederation in 2013 concluded that customs bureaucracy is one of the main obstacles to the increase in Brazil's exports.

The business environment can be defined as the set of external factors that influence businesses in a country or region, such as, governmental, social, political and technological conditions. The regulatory policy that surrounds the formation of new businesses can either support companies and entrepreneurs or inhibit their ability to start new businesses. Excessively burdensome regulations often discouraged entrepreneurs from opening, maintaining or developing new business; this may increase the incidence of companies working in the informal sector and, therefore, exposed to economic shocks. This is especially true for small and middle size companies.[19]

Impact of regulatory burdens for small and middle companies



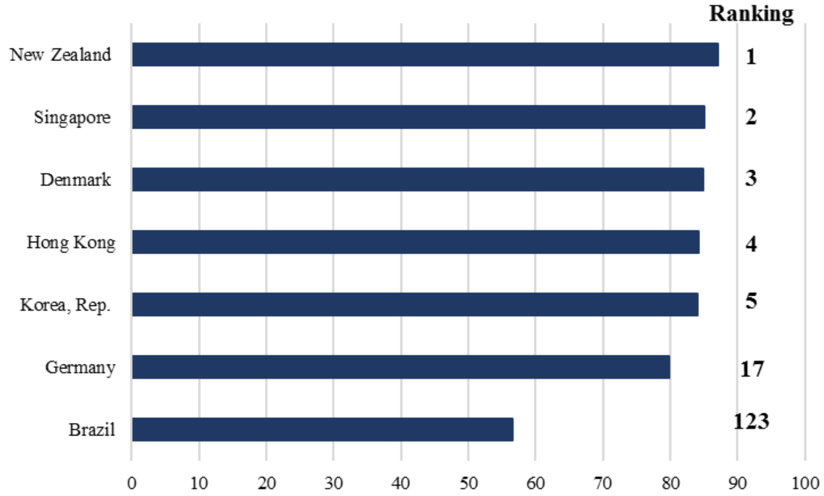
Source: International Trade Centre 2017.

Government has a crucial role in improving the regulatory environment for business activities, especially for small and middle-sized companies. Actions that simplify the regulatory surrounding; such as: transparent rules for registering a business, easy tax and credit systems, or even a faster way to register property, support not only business creation, but also, the optimization of their activities and further development.[20]

Research conducted with 172 economies identify a positive link between business regulatory reforms and economic growth. According to this research one improvement on regulation can create around 0,15% increase in GDP growth.[21] Other studies also analyze this correlation; the World Bank's Doing Business Index is one of them; it investigated the environment of doing business in 190 countries, with the main objective to provide information on business regulations in diverse central areas. The report places the best performance as a model to other countries, as "frontier"; the further away from the border (from the frontier), the worse the country's performance is in each requirement. The comparison among countries enables the analysis of well-designed regulations that foster companies' success as well the opposite: badly-design ones that hamper businesses.

The annual report is used to guide entrepreneurs in choosing the location of their investments; it enables businesses to identify opportunities and obstacles to their activities, supporting managers to more easily address challenges, and in examining the strengths and weaknesses of the company in different contexts. These indicators are also valuable benchmarking and guidance tools for policymakers, who can visualize, in a single platform, the best practices around the world and their consequences for business.

Ease of doing business distance to frontier
Index: 100 = Frontier*



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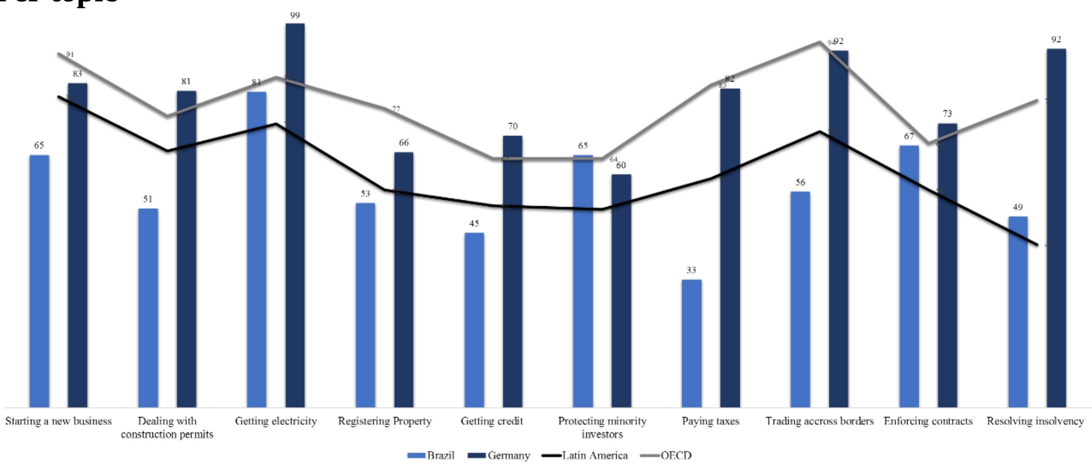
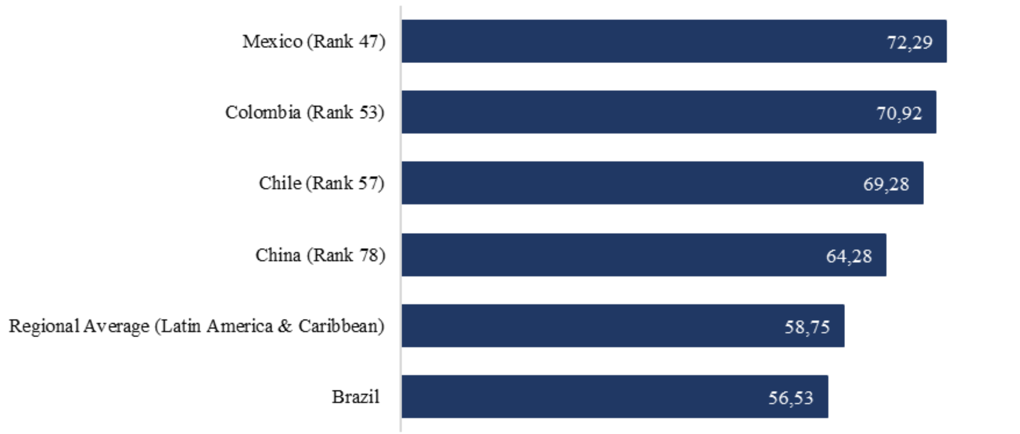


Source: Doing Business Index, 2017
* The best performance is considered the "frontier"

Brazil is in the 123rd position, with 65 points, it is considered one of the most difficult countries to do business in. Several economic, bureaucratic, and structural problems compose the so-called Brazilian risk/ Brazil cost, which represents an excessive amount of time and resources required to overcome bureaucratic barriers. The extent of bureaucracy faced by companies can be illustrated by the results of the most recent World Economic Forum (2015) study: in terms of "easy compliance of regulatory and administrative requirements" Brazil was ranked in one of the last positions among 140 countries analyzed.

Brazil in comparison with other countries on the ease of doing business



Source: Doing Business Index, 2017.

This is a phenomenon not only present in Brazil but in many countries in Latin America. Diverse factors contribute to Latin America's low productivity; however, one of the biggest hindrances is the unfavorable business environment. The region is behind developed economies in all analyzed aspects, of the Doing Business Index. Stringent regulation is an obstacle to companies' performance. Brazil and other countries, such as Mexico and Argentina, have international competitive industries, such as EMBRAER and Alfa Group, from Mexico, however, they are exemptions. Most small enterprises in the region struggle to compete internally and internationally, they lose competitiveness because of state bureaucracy, restrictive labor rules and other sector specific regulations.

Nevertheless, not only businesses suffer from this situation; evidence from a study conducted at George Mason University reveals that economies with severe entry regulations frequently have higher levels of income inequality.[22] The governmental role in Latin America should be reduced, and public policies designed to eliminate obstacles to business and to produce a favorable environment for competition, innovation, and economic growth.

BRAZIL'S ECONOMIC BACKGROUND AND INTERNATIONAL TRADE.

Industrial activities in Brazil started before the Great Depression in 1929. Nonetheless, only after the crises that the national industry began its development. The international economy slump resulted in a reduction of commodities' demand alongside the volume of Brazilian primary products exportation. The lower inflow of foreign exchange weakened Brazil's ability to import industrialized products and thus, the need to produce internally what no longer could be imported stimulated the domestic industry.[23] This period known as the "inward" industrialization was an important stimulus to the national industry, which became after the Second World War one of the most important sectors of the Brazilian economy.[24] Despite this great achievement this economic development was always destined to failure due to its protectionist bias.

The process of Brazilian industrialization occurred on a protectionist basis; however, it was only from the 1960s onwards that protectionism became a State Policy supported by the "Import Substitution Industrialization" (ISI). A development model formulated by the Economic Commission for Latin America and the Caribbean (ECLAC) within the framework of the United Nations (UN).[25] As Raul Prebisch, ECLAC's idealizer said: *Formerly, before the great depression, development in the Latin-American countries was stimulated from abroad by the constant increase of exports. There is no reason to suppose, at least at present, that this will again occur to the same extent, except under very exceptional circumstances. These countries no longer have an alternative between vigorous growth along those lines and internal expansion through industrialization. Industrialization has become the most important means of expansion.* (PREBISCH,1950).[26]

According to ECLAC's theory, less developed countries, exporters of primary products, have relative disadvantages in terms of trade. Low value-added products, with inelastic demand, are worth less in international markets, while high value-added products, with higher elasticity of demand, are worth more.[27] Developing nations would, therefore, be stuck in a continuous cycle of underdevelopment which could only end through the progress of their industries.[28] However, the continuity entry of imported products impede industry to emerge, it would be necessary, as Friedrich List's (1856) theory: "Infant Industry Protection" states, to isolate national industry during its early stages of development.[29]

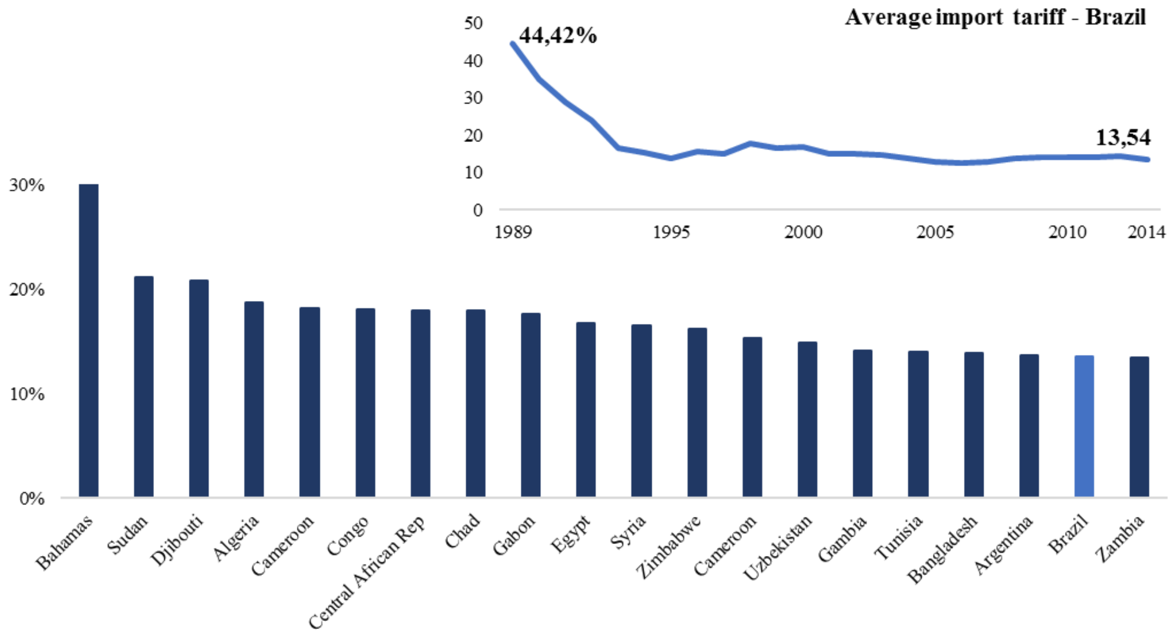
This policy aimed to encourage the industrialization of developing countries and prevent the deterioration of their economies.[30] A characteristic of this concept is, however, that isolation is only beneficial during the early stages of industrial development, exclusively in the effort to encourage industrial production, and should not serve as a continuous policy. It becomes unsuitable when protection remains for several years, and the industry, no longer nascent and unable to modernize itself, uses resources that could be destined to other relatively more efficient sectors.[31] Raul Prebisch himself recognized the distortions created by excessive protection. *The closed Industrialization by excess of protectionism, as well as excessive tariffs on certain important agricultural products, have created a cost structure that makes it difficult to export manufactured goods to the rest of the world*. (PREBISCH, 1963 – author's translation)

In Brazil, the ISI failed to guarantee full industrial development and to reduce the national dependence on foreign products. The obsolescence of the strategy fostered a highly protectionist, nationalist, dependent industrial sector.[32] Excessive protection was the main reason for the low competitiveness of domestic industry and directly affected the country's growth in the 1980s. To revive the economy in 1988 economic reforms were made; among them, the reduction of import tariffs.

The Brazilian market opening process was short lived and did not follow the world trade liberalization trend. Several countries, such as the Asian Tigers and Chile that, like Brazil, began their industrialization through the import substitution, changed the dynamics of their economic strategies, abandoning a protectionist model in favor of a market-orientated approach, and reached relatively higher levels of economic development. In the 1960s, while Brazil continued focused on protectionist strategies for its industrialization, South Korea - which at the time, had a lower per capita income than Brazil - initiated a process of export promotion, and, today, its export rate is 3.9 times higher than in 1970 (58.5% of GDP). The Brazilian coefficient, in the other hand, still very low, 11.5% of its GDP.[33] According to World Bank data, South Korea has now a per capita income of US$ 27, 221, three times higher than the Brazilian one (US$ 8,538).

After the opening shock from the 90's, protection policies have taken a prominent place in Brazil. Regarding import tariffs, after been reduced, they stabilized and were no longer changed. At present, in accordance to the WTO, the average tariff in Brazil is around 13%, relatively high, not only in comparison to other members, but also in relation to its peers, in Mexico, for example, the average tariff is 7%.

The 20 Countries with the highest rates for trade



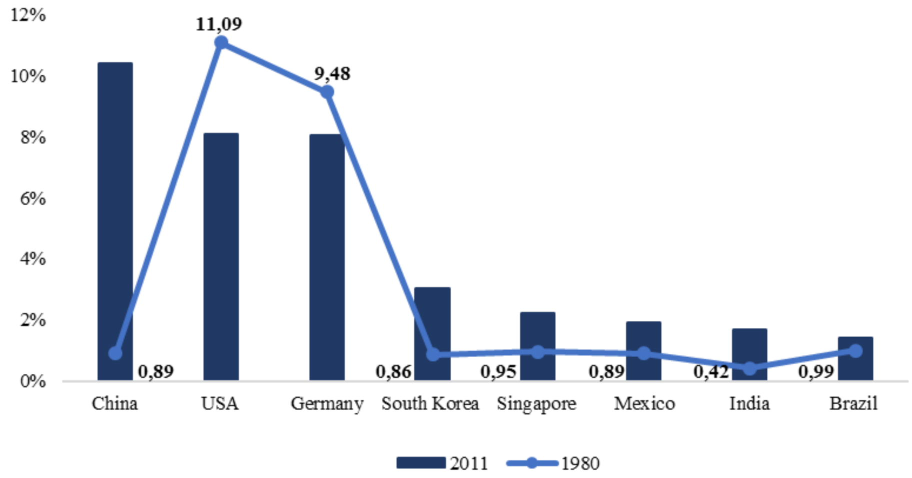
Source: WTO, 2014 and IndexMundi, 2015.

For six decades until the 90's Brazilian trade policy was characterized by a low integration into the world's economy, state discretionary generalized intervention, and the prevalence of state control at the expense of market competition. The 90's, were marked by a short process of trade liberalization, which shifted from state-led industrialization (based on the import substitution) to a more open market-oriented economy. Since the 2000s, however, trade policy has again used protectionist practices, not only in the form of tariff barriers, but predominantly non-tariff barriers (trade defense, local content policies and import quotas).

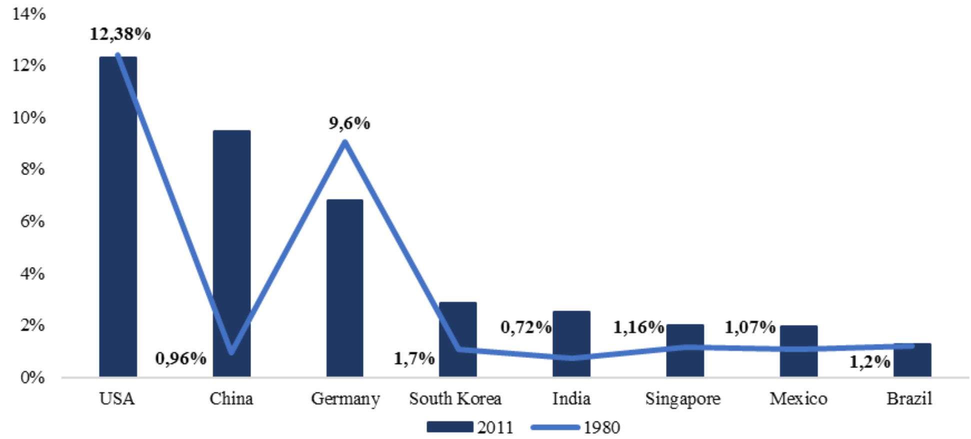
Inward-looking strategies slowly led the country away from more dynamic international trade chains. Despite the domestic purchase power, national companies are not able to profit from economies of scale. In this view, full global integration, alongside with an effective export promotion, are the path to increase productivity and competitiveness.

Brazil is one of the larger economies in the world; even so, the percentage of its exports in relation to its GDP remains low.[34]

World merchandise exporters, 1980-2011



World merchandise importers, 1980-2011



Source: WTO, 2013.

These graphics show the prominence of Asian economies such as China, India, and the Republic of Korea in world trade. In Latin America, Mexico showed a considerable advance in its international trade participation, while Brazil remained at the same level for the past 30 years.[35] The consulting company McKinsey measures the connective flows of 131 countries by analyzing the level of integration in the global network. Brazil is in the 44th position far behind its peer's countries: China, Russia, and India, which occupy the 7th, 14th and 30th places respectively.[36]

Brazil's position in the "Connectiveness Index", in addition to the high national value added (90%) on country's exports, are evidence of its isolation from international trade flows. The OECD and WTO study, titled Trade in Value Added (2015), concluded that Brazil in 2011 was the country with the highest domestic value-added not only among the BRICS but also the Group of Seven - G7. From 1995 to 2011 the percentage of imported inputs in Brazilian exports rose from 9% to 11%; in China, it increased from 10% to 35% and in India from 9% to 24%.[37]

In a world where industrial production is fragmented and geographically dispersed, the Brazilian government has a protectionist vision, that all industrial processes should be done internally. While other countries follow the “made in the world” tendency; Brazil focus on the “made in Brazil” approach, even if it means the preservation of inefficient industries. Brazilian domestic industry remains reliant on internal inputs and deprived of access to products and technologies available in the world. Protectionism affects negatively country’s participation in Global Value Chains; it hampers efficiency by limiting the access to more varieties and high-quality intermediates inputs and, therefore, increases production costs.

In the case of many developing countries high tariff and non-tariff barriers to import act as a large absolute subsidy and therefore relative incentive to produce import substitute products for the domestic market. The subsidy to import substitute activities is directly observable in absolute terms from the price-raising effects of import restrictions. The anti-export bias generated by these import restrictions is less direct as a result is often less evident. (MILNER, 1990)

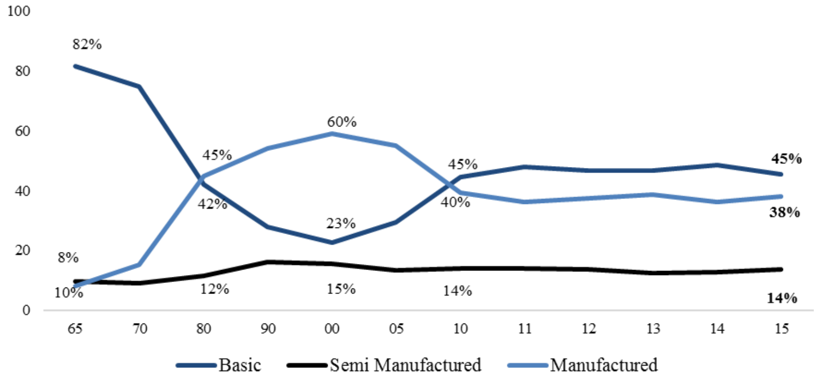
A study conducted by Oslo University analyzed trade policy during the 90’s known as the Great Liberalization period and its correlation with the intensification of patent applications, innovation, and research and development. The study estimates that, 6% of global knowledge had been created because of trade policies’ impact on patent application. It suggests, therefore, that trade liberalization has significant economic effect on innovation.[38]

Brazilian Exports
Commodities x Manufactured Goods

The share of Brazilian exports is low, 13% of country’s GDP, 1,2% of global trade share and when manufactured goods are considered, the percentage decrease to 0.7%.[39] The country has returned to the position of eminently agricultural exporter with low value added in the production processes.

The past few years Brazil has experienced a small "economic miracle," driven by the increase in demand for commodities mainly from China. This period of wealth creation has run out, and the country now faces the current economic reality which demands greater productivity and investment to reach higher levels of economic growth. The industrial productivity plays a fundamental role in the growth and development of any society. In Brazil, however this importance seems to have been neglected. Evidence shows a significant reduction on industry competitiveness; its share of national GDP reached 10.9% in 2014, the lowest level since 1947: 11.9%.[40] According to the World Fact Book, in 2015, industrial production growth in Brazil was negative (-5%), far below the world average growth, which was 1.8%.[41] This period was also marked by the shift of Brazilian exports from manufactured to primary goods; from 2007 on commodities returned to being the main item on the Brazilian export agenda.

Brazilian exports by aggregate factor: 1964-2015
(Share of total exports)



Source: SECEX/MDIC, 2015.

Evaluations made by the atlas of economic complexity, created by the Harvard Kennedy School – which analyses the level of value added in the products of each country - showed that Brazil has a low level of economic complexity not only in relation to its peers - but also in relation to Brazil itself decades ago. In 1995, its index was 0.67693 and the country ranked 29th out of 125 countries analyzed; currently, however, the country ranks 54th (index of 0.244) among 124 countries.[42]

There are several causes that explain the relevance decrease of Brazilian manufactured products in foreign markets. According to a survey conducted by the IPEA (Brazilian Institute of Applied Economic Research), in 2012, the negative effect of the exchange rate overvaluation could be one of the reasons for this phenomenon since the increase of commodities exports would lead to an appreciation of the exchange rate and, consequently, a reduction of the competitiveness of Brazilian manufactured products abroad.

Variation of the exchange rate
(Dollar Parity, average per period)

Source: World Bank Data, 2016.

The appreciated exchange rate may, in fact, represent an obstacle to industrial exports; however, analyzing the process - of Brazilian low competitiveness - only under this prism is at the very least simplistic and reductionist. Poor infrastructure, high production costs, poor labor qualification, hostile business environment, and high trade barriers are fundamental characteristics that hamper Brazil's access to the international market. Industrialization combined with active participation in foreign trade proved to be a successful recipe for several countries. WTO data shows that, China, the United States, and Germany managed to reach 30% of world trade in 2014: 12.3%, 8.5% and 7.9%, respectively. While Brazil has only 1.2% of the global export share. According to World Bank Data the percentage of manufactured exports, among the total exports of goods from the three countries, between 2010 and 2015 was 93%, 64% and 84%; in Brazil, this percentage is 35% with a reduction of 18% in comparison to the 1990s.

The export of high-tech products is also low. A survey conducted, in 2015, by the United Nations Industrial Development Organization (UNIDO) showed that 4% of Brazilian exported products were high technological, ahead only of Russia, 2%, and South Africa, 3%. In Mexico, on the other hand, 73% of the export is concentrated in low, medium and high technological products; the amount of manufactured exports from Mexico is greater than that of all Latin America together. Among the reasons that explain Mexican success is the shift in the country's trade strategy which from 1994 onwards went from import-substitution industrialization to an export-oriented strategy. Its degree of commercial openness is high and includes free trade agreements with more than 45 countries.[43] Through these changes, the World Bank estimated a growth in Mexico GDP of 2.5% in 2015; in Brazil in the same period the variation was 3.8% negative.

While, in general, economic development is ruled by commercial freedom, in Brazil the view that complete manufacturing industries are needed; that is centralized domestic production exclusively focused on the domestic market, or at most, within the MERCOSUR, remains. A study conducted annually by the Heritage Foundation that analyzes the level of openness of different economies positioned Brazil as one of the most closed economies in the world, occupying position 122 out of 178 nations. By imposing tariff reservations, exacerbated trade defense measures and local content policies, the government immobilizes the operations of Brazilian companies. With exclusive focus on the domestic market, national firms cannot rely on the process optimization, available only in the international environment that combines the supply of domestic and foreign inputs as well as machinery and equipment.[44]

Summary

Relevant international trade theories have been covered in this article. Starting with Adam Smith who analyzed the gains from the nations absolute advantages. Followed by David Ricardo who in his study of comparative advantages broadened the scope of Adam Smith's theory; and Heckscher and Ohlin, whose work emphasized the relevance of factors of production for international trade. Afterwards, Schumpeter analyzed the process of creative destruction and the importance of innovation to the capitalist system.

The multilateral trade system has made progress in reducing barriers to trade which has allowed the specialization of production. However, protectionist practices remain in the forefront, especially in developing countries. Brazil is by tradition a protectionist country with a defensive trade strategy. The country maintains the model of import substitution and base its actions on instruments and policies that have made sense for many years but that are disconnected with the present productive scenario. As a result, an obsolete industry has been shaped in Brazil, with no capacity to compete internally or internationally and with little or no technological creativity. This retrograde vision of international trade as a zero-sum game limits Brazil’s participation in the global production scenario. Changes in public industrial policies have no effect if not combined with a commercial policy appropriate to the current international productive reality. In this sense, public policies, even the most ambitious one, do not substitute for the benefits of free competition.

Brazil is one of world's most closed nations. According to data from the World Trade Organization, it is among the 20 countries with the highest tariff restrictions in international trade. Brazilian participation in world trade is low, almost insignificant vis-a-vis the size of its economy, about 1%. The state intervention in the economy indicates the continuity of an interventionist agenda, initiated by the outmoded model of import substitution industrialization currently consolidated into counterproductive commercial and industrial strategies strongly based on the protection of domestic production in the detriment of interaction with external markets. With the objective to increase industry competitiveness, these plans use protection measures that include tariff and non-tariff barriers, preventing Brazil from boosting innovation and development trough international competition.

This retrograde vision of international trade as a zero-sum game limits the participation of the country and its industries in global production. Industrial policy changes have no effect, if not combined with a commercial policy in accordance to the international productive reality. Growth in Brazil comes from external demand for commodities and from the increase in labor supply. By adopting strategies that are not complementary, the national economy will always depend on primary products exports, demanded by waves of external growth and can hardly reach higher levels of development. A stable development will only be possible by growing productivity. Brazil needs commercial policies that foster integration into international trade and global value chains.

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