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Economic Growth in Bahia, Brazil:
The Role of Institutions and Government

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Minerva Program

Spring 2004

Washington, DC

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1. Introduction

Economic growth, development and unemployment are in the center of the debates around the world, and they involve economists, governments, public managers, and organizations. The same as in Brazil, where the unemployment was the main subject discussed in the 2002 elections for president and governors. Currently, the sustainable growth is one of the most important federal government targets in the economic sector.

In the period between 1997 and 2002 the Brazil Gross Domestic Product (GDP) has increased 2.0%[1] in average, but in the last two years the rate was lower. Most recently, the Instituto Brasileiro de Geografia e Estatistica (IBGE), the federal agency that is responsible for measure the national accounts, announced that the GDP in Brazil decreased 0.2% in 2003. The unemployment rate in February 2004 was 12%[2]. These data show that the economic growth in Brazil is small and unsustainable, and the unemployment rate is very high.

The priority of the actual federal government in the economic agenda in the first year was the stabilization of macroeconomic issues, which includes the control of the inflation rates and the reduction of public debt. To reduce the ration debt/GDP the government has to guarantee a primary surplus of 4.25% of the GDP, according to the agreement signed with the International Monetary Fund (IMF). These surpluses are not allowing the government to apply policies that increase public investments, and the private investors are not confident enough to invest in Brazil. Both investments, public and private, are necessary to push a sustainable development of the economy.

The states governments have the same concern about the unemployment and unsustainable development in their regions. Moreover, there is a large difference among the Brazilian regions.

[1] Source: Monthly Employment Resource - Instituto Brasileiro de Geografia e Estatistica - IBGE *in* http://www.ibge.gov.br/home/estatistica/economia/contasnacionais/2002/tab05.pdf.
[2] Source: Brazil - National Account System - Instituto Brasileiro de Geografia e Estatistica - IBGE *in*

The development indexes in the South and Southeast regions are greater than the other regions of the country. These differences contribute to increase the unemployment rate and to reduce the income per capita in the Northeast, Middle West, and North.

Today, there is no clear or effective federal policy to promote the reduction of development difference among the states or regions. The policies and organizations that have been applied and used in the last years do not exist or have not reached their goals. Corruption problems have destroyed the credibility of the federal policies and the macroeconomic conditions reduced the capacity of investment in such areas.

There is a lack of microeconomic policies on the federal level for development. Due to this lack, the states of the federation created industrial policies to attract companies, including industries, commercial and services. The states are applying public policies to increase the development and reduce the unemployment in they territory. The main instrument used in these regional/local industrial policies is the tax incentive that is the development is pursued through a "fiscal war" among the states of federation. The states reduce the charge of the main state tax, state value added tax (ICMS). In some cases the states are still providing infrastructure, land, finance support and buildings to the private companies.

The efficiency of these policies is very controversy. On the one hand it can reduce the unemployment rate, but on the other hand it can increase the demand by public services, such as education, health, transportation, and electricity. Maybe, it can turn out to be a zero sum game.

So, in Brazil, the government is still playing an important role in development. There are so many kinds of macroeconomic and microeconomic policies that would increase the capacity to develop, such as the ones that regards education, infrastructure and research. Moreover, the government is the more powerful organization that could effort the change in law system and in the incentives framework. It is one of aspects that shape the institutions of a country or a

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http://www.ibge.gov.br/home/presidencia/noticias/pdf/25032004pme.pdf.

specific region.

According to some specialists, another factor that affect the sustainable growth is the institutional framework. The government policies and organizations are only two of the issues that compose the institutional framework of a country. There are the judiciary system, the constitution, and other rules that shape the human and organizational behavior. According to the New Institutional Economics, the institutions play an important role in the economic performance. They show that economies that have very similar natural conditions and labor force have presented differences in the economic performance. So, the policymaking has to consider and examine the characteristics of the institutions when discuss and debate about development.

In this context, this paper's main objectives are to analyze the role of the government and institutions for economic growth. In particular, the discussion will be concerned about the economic growth in the Brazil Northeast region and in Bahia.

In chapter two the paper will present the definition of development and the difference between this definition and economic growth concept. The different aspects and objectives of development (economic growth, inequality reduction, and poverty eradication) are going to be discussed.

Chapter three contains a theoretical discussion about institutions. The ideas of the Prize Nobel Douglass North, based on the theory of Transaction Cost Economics, will be used to define institutions and to present the important role they play in development. This chapter will analyze the relation between institutions and economic performance too.

Chapter four presents the role of the government for the development and which policies are necessary for economic growth. The way in which the central government and local governments play a role in economic performance will be discussed.

In chapter five the role of regional industrial policies are discussed. The main institutions and organizations in Brazil and in State of Bahia that affect economic growth will be described. The incentives that the State of Bahia government and the Federal government apply will be listed and they results will be discussed.

Chapter six will present an initial review of development-policy formulation and presents some issues for develop an institutional framework for the economic growth in Northeast and Bahia. Because the results of the policies applied by the federal government level did not reach their targets, therefore the great difference of the GNP per capita among the Brazilians regions still exists, there is a need for new model. This chapter will suggest some adjustment in the Bahia industrial policy too, despite the results that were reached in the last years.

Chapter seven will present the conclusions about the policies that have been applied in the Northeast and in Bahia. The new challengers and targets that have to be defined to implement an industrial policy that could improve the growth and development in Bahia are going to be presented.

2. Development and Economic Growth

To discuss the development it is important to present the differences between the means of development and economic growth.

Economic growth is the increase in the output (goods and services). The measure is the change in GDP or Gross National Product (GNP), which indicate the total wealth, or the GDP per capita, which is total wealth divide per population amount. This was the subject of The Theory of Economic Growth. Lewis (1955, p. 9) presents that

> … It is possible that output may be growing, and yet that the mass of the people may be becoming poorer. We shall have to consider the relationship between the growth and the distribution of output.

According to Todaro and Smith (2003, p. 16)

> … Prior to the 1970s at least, development was nearly always seen as an economic phenomenon in which rapid gain in overall and per capita GNP growth would either 'trickle down' to the masses in the form of jobs and other economical opportunities or create the necessary conditions for the wider distribution of the economic and social benefits of growth. Problem of poverty, discrimination, unemployment, and income distribution were secondary importance to 'getting the growth job done'.

Lewis (1955, p. 420 to 424) presents some advantages from economic growth: it increases human choice, increases freedom, and permits to have more services, goods and leisure.

Some experiences in countries which had economic growth but the welfare of the population decreased, show that only economic growth on its own is not sufficient to guarantee the welfare and the quality of life of the people. Todaro and Smith (2003, p. 25 to 29) present the Brazil as an example where the industry is developed but the level of poverty is high.

Todaro and Smith (2003, p. 17) argue that

> Development must therefore be conceived of as a multidimensional process involving major changes in social structures, popular attitudes, and national institutions, as well as the acceleration of economic growth, the reduction of inequality, and the eradication of poverty. Development, in its essence, must represent the whole gamut of change by which an entire social system, turned to the diverse basic needs and desires of individuals and social groups within that system, moves away from a condition of life widely perceived as unsatisfactory toward a situation or condition of life regarded as materially and spiritually better.

Three aspects in the above argument can be emphasized: acceleration of economic growth, the reduction of inequality, and the eradication of poverty.

According to Bartik (1991, p. 1) for politicians development means job creation. The creation of jobs "bring many benefits: lower employment, higher wages, greater property values, increased profits for local business, more tax revenues, and reelection for the politician who take credit for these boons".

As discussed, there are differences between development and economic growth. The former is a wider definition. In this paper the discussions are going to be more detailed in the subjects that concern economic growth. Some analyses and suggestion include the development as widely defined.

Authors indicate different causes for economic growth. Lewis (1955, p. 10) indicates "the growth of output per head depends on the one hand on the natural resources available, and on the other hand on human behavior". He agues that regions or countries that have roughly equal natural resources, but that the human behavior causes differences in its economic growth. Lewis (1955, p. 11) indicates that economic activity, knowledge, and capital support economic growth. Finally, Lewis indicates that some institutions can or cannot encourage these three factors that affects the economic growth.

For Todaro and Smith (2003, p. 79), the main components of economic growth are the capital accumulation, technological progress, and growth in population and in the labor force.

The capital accumulation includes investment in factories, machinery, equipment and materials, which can cause an increase in the output, as investments in infrastructure. The capital accumulation can be used to improve the human capital through investment in education and training programs. It is useful to increase production and productivity. The increase in the labor force means an increase in the potential domestic market and force an increase in labor productivity. For Todaro and Smith "… technological progress results from new and improved ways of accomplishing traditional tasks". It can induce an increase in the output or a reduction in the amount of capital or labor necessary, which reduce the costs involved in the production of goods and services.

Todaro and Smith (2003, p. 84) indicate that economic progress can be carried out by so many factors, but the most important are the "… investments that improve the quality of existing physical and human resources, that increase the quantity of these same productive resources, and that raise the productivity of all or specific resources through invention, innovation, and technological progress…".

The concept of development includes economic growth. The economic growth is the aspect of development more easy to evaluate, so is broadly used. It is important to say that other issues of developme nt, such as reduction of inequality and eradication of the poverty can affect directly a high and sustainable economic growth.

3. The Role of Institutions

3.1. What is on institution?

So many authors defend the relation between institutions and development. According to Lewis, the willingness of people to make effort required for economic growth is related to institutions. "Institutions promote or restrict growth according to the protection they accord to effort, according to the opportunities they provide for specialization, and according to the freedom of manoeuvre they permit" (1955, p. 56).

There are different definitions of institutions presented by some authors. According to Hamalainen (2003, p. 153)

> The word 'institution' has different meanings for different persons. In his *Economic Institutions of Capitalism*, Oliver Williamson defined institutions as alternative organizational mechanism: markets, hybrids and hierarchies (Williamson 1985). John R. Common viewed institutions as established societal organizations, or 'going concerns', which included *inter alia* universities, labor unions, churches, political parties and government (Commons 1970, p. 129). Hechter, in turn, used a more indirect definition by arguing that 'the existence of social institutions …[is]…revealed by appearance of some regularity in collective behavior' (Hechter 1990).

Douglass North did a very detailed study about the relation between institutions and economic performance. North (1990, p. 3) defines institutions, as "the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic". North's concept is used in this paper to describe institutions.

Institutions reduce uncertainty shaping the human interaction and applying many forms of constraints. For North, "Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake some activities" (1990, p. 4). So, the institutional framework shapes the interactions among the humans that take place under some rules. This institutional framework provides the cost and consequences for certain conducts, and establishes the punishment when the rules are violated.

The institutions can be formal or informal. The informal institutions are defined by codes of conduct, norms of behavior, conventions, taboos, customs, and traditions. They are unwritten rules. These constraints are present "In our daily interaction with others, whether within the family, in external social relations, or in business activities" (North 1990, p. 36).

About formal institutions North (1990, p. 47) wrote that

> Formal rules include political (and judicial) rules, economic rules, and contracts. The hierarchy of such rules, from constitutions, to statute and common laws, to specific bylaws, and finally to individual contracts defines constraints, from general rules to particular specifications. … Political rules broadly define the hierarchical structure of the polity, its basic decision structure, and the explicit characteristics of agenda control. Economic rules define property rights that are the bundle of rights over the use and the income to be derived from property and the ability to alienate an asset or a resource. Contracts contain the provisions specific to a particular agreement in exchange.

Each country or region has particular formal and informal rules that constitute their institutional framework. They affects the cost to produce and can limit the potential economic growth in different ways.

3.2. The Transaction Cost of Exchange

The neoclassical economic theory characterizes the market as a world of perfect information and with an enormous number of competitors. There are no differences among goods and the changes occur immediately. But in the real economy, there is no limited rationality; there is opportunist behavior and uncertainty. It involves a cost to produce and exchange.

The total cost of goods or services is the sum of the cost of transformation and transactions cost. For North the cost of transformation "…consist of the resource inputs of land, labor, and capital involved … in transforming the physical attributes of a good" (1990, p. 28), that is to say: raw materials, energy, wages, equipments, installations, buildings, and others.

The transaction costs are the costs not directly related to production. There are the costs involved in negotiating, establishing and enforcing a contract. These costs exist because the market is not perfect. For North, "The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the cost of protecting rights and policing and enforcing agreements" (1990, p. 27).

In order to reduce the cost of transaction the humans use institutions to regulate their behavior. They set the rules and the limits under which the parties involved can contract and exchange. For North,

> How well institutions solve the problems of coordination and production is determined by the motivation of the players (their utility function), the complexity of the environment, and the ability of the players to decipher and order the environment (measurement and enforcement) (1990, p. 27).

Institutions, as governmental organizations, reduce the cost to obtain information. Laws and the judiciary system reduce the cost involved to solve the contests and to apply enforcement in case of disagreement. Institutions set the level of protection of properties rights and they may or may not stimulate the development of new technologies or new products.

According to Hamalainen, the institutions "… facilitate efficient transactions and production in real economic systems" (2003, p. 153). So, the transaction cost theory of exchange is very important to support the idea that institutions shape human interaction in order to reduce the transaction cost.

3.3. Institutions and Economic Performance

It is clear that institutions influence economic growth. They explain why countries with similar natural resources and populations present different wealth and economic growth. Economic growth rate was high and sustainable in some regions and low and weak in others. North asserts that institutions "are the underlying determinant of the long-run performance of economies" (1990, p. 107). He reinforces his claims when he explains "in the Third World countries are poor because the institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity" (North 1990, p. 110).

According to Hamalainen (2003, p. 156)

> The institutional framework influences economic competitiveness and growth by shaping the individual and organizational incentives… These incentives shape the process of resource accumulation and upgrading; technology development and diffusion; resource (re) allocation, utilization and coordination; the interaction of buyers and sellers in the product markets; and the internalization of business activities.

Lewis (1955) analyzed what institutions can offer to people to make the effort required for economic growth. Institutions affect and influence the right to reward, trade and specialization, and economic freedom.

The first aspect that Lewis analyzes is the concept of the right to reward. For him, the "men will not make effort unless the fruit of that effort is assured to themselves or to those whose claims they recognize" (1955, p. 57). This assertion applies to the protection of intellectual property rights also. If the institutions are not sufficient to protect property rights and assure that the owner will receive part of the gain that the innovation brings to society, then scientists, organizations, and companies will have no incentives to create and conduct research. If the protection laws are weak, probably, the economy will be weak in the research and technological sectors.

All kinds of properties have to be well protected. Lewis (1955, p. 60-61) analyzed the influence of the property protection system in economic growth:

> Capital formation is one of the conditions of economic growth, and the existence of a law of property is one of the conditions of capital formation… If it is necessary to protect public property from private abuse, it is just as necessary to protect private property from public abuse. The maintenance of law and order is one of the primary conditions of economic growth, and many communities have declined because the state was unwilling or too weak to protect the owners of property against the actions of bandits or of mobs… The fundamental requirement, from the angle of economic growth, is that potential investor must believe that he is in a position to get 'his money back', plus some compensation for the act of making the investment instead of consume his substance.

Another important aspect is the opportunities that institutions bring to trade and specialization. Lewis sets these aspects as a vital part of economic growth. If an economy increases trade, it can "[stimulate] the demand, by introducing new goods to a community, and in doing so it may stimulate the desire to work more, or more effectively" (1955, p. 70). Continuing this thought, Lewis says that "trade also [brings] new ideas - new patterns of consumption, new techniques, or new ideas of social relationships".

Institutions affect freedom, both personal and economic. Freedom is an important aspect in all markets, but it is relevant and important in the labor force market and in the competition between firms. In the labor market, some economic institutions or labor laws can increase the cost to contract in the cause of "protecting" the workers. For Lewis, some institutions "reduce the mobility of labour, and make it less easy for new firms or new industries to establish themselves and grow" (1955, p. 93). Of course, institutions have an obligation to prevent the occurrence of abusive labor practices, where the health and the physical and moral integrity of the individuals are not protected.

The level of freedom that firms have to contract in the market has an impact on economic growth. Numerous of restrictions and rules can reduce the efficiency and the performance of companies and economies. But it is unanimous that of a good and clear system of antitrust and regulation is important to guarantee the rights of the consumers. It can also increase or reduce the investment in some sectors, such as infrastructure, and avoid the formation of some practices that can reduce the gain to all society, as monopoly, oligopoly, and cartel.

Is important to point out that institutions are not the only factor that affects economic growth. In Lewis' opinion, institutions play an important role but "economic change does not result exclusively from changes in institutions. Economic growth may occur because of an increase in capital formation, or because new technological knowledge becomes available, or for other reasons not originating in institutional change" (1955, p. 142).

4. Policies for Economic Growth

4.1. The Role of Government

In the nineties the economic policies applied in developing countries followed the Washington Consensus, the list of policies that the US economic officials, the International Monetary Fund (IMF), and the World Bank supported for this countries. According to Stiglitz (1998, p. 31) "the Washington Consensus advocated use of a small set of instruments (including macroeconomic stability, liberated trade, and privatization) to achieve a relatively narrow goal (economic growth)". Brazil improved in these three aspects of the consensus, but economic growth was not higher. Stiglitz recognized that a broader list of instruments and policies are necessary to increase economic development.

So, the government's role is not being restricted in applying macroeconomic policies. These policies are a necessary condition for the development, but not sufficient. Some other policies could be requested.

Michael Porter in his book The Competitive Advantage of Nations analyzes how competitiveness differs among countries. He explains why a specific industry of a nation can achieve international success. It occurs due to four factors that he called Determinants of National Advantage (Porter 1990, p. 71):

> 1. *Factor conditions*. The nation's position in factors of production, such as skilled labor or infrastructure, necessary to compete in a given industry.
>
> 2. *Demand conditions*. The nature of home demand for the industry's product or service.
>
> 3. *Related and supporting industries*. The presence or absence in the nation of supplier industries and related industries[3] that are internationally competitive.

[3] According to Porter (1990, p. 782) "related industries are those where firms can share activities in the value chain across industries (for example, distribution channels, technology development) or transfer proprietary

> 4. *Firm strategy, structure, and rivalry.* The conditions in the nation governing how companies are created, organized, and managed, and the nature of domestic rivalry.

According to Porter "government can influence (and be influenced by) each of the four determinants either positively or negatively". He continues, saying, "the factor conditions are affected through subsidies, policies toward the capital markets, policies toward education, and the like". The government can be one of the largest buyers or suppliers and affect demand conditions. "Government policies also influences firm strategy, structure, and rivalry, through such devices as capital market regulation, tax policy, and antitrust law" Porter says (1990, p. 127). Therefore, the government can directly or indirectly affects the competitiveness.

According to Lewis, "the behavior of governments plays as important role in stimulating or discouraging economic activity as does the behavior of entrepreneurs, or parents, or scientists, or priests" (1955, p. 376). He lists the main activities that are relevant to economic growth and that the government should operate with:

> Maintaining public services, influencing attitudes, shaping economic institutions, influencing the use of resources, influencing the distribution of income, controlling the quantity of money, controlling fluctuations, ensuring full employment, and influencing the level of investment (1955, p. 376-7).

As the government can stimulate economic growth, it can also retard growth

> By failing to maintain order, by plundering the citizens, by promoting the exploitation of one class by another, by placing obstacles in the way of foreign intercourse, by neglecting the public services, by excessive *laissez-faire*, by excessive control, by excessive spending, and by embarking upon costly wars" (Lewis 1955, p. 408).

The difficulty for the policy-making is to determine the level of intervention of the government,

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skills from one industry to another.

using public policies toward economic growth. To handle it Hamalainen purposed a new macro-organizational role of the government for development. It has to take account the reduction of the market imperfections, the influence on competitiveness, the mediation and reduction of conflicts of interest, and the maximization of the public sector. The government should continuously monitor industry performance. To do this is necessary that

> Sufficient knowledge about the strengths and weaknesses of all relevant private, public and third sector organizational alternatives in particular socio-economic contexts. Without such knowledge public policy makers cannot make rational decisions about appropriate policy interventions or regulatory reforms" (Hamalaine 2003, p. 247-9).

Hamalaine (2003, p. 248) proposed the use of the flow chart below to deciding on government intervention:

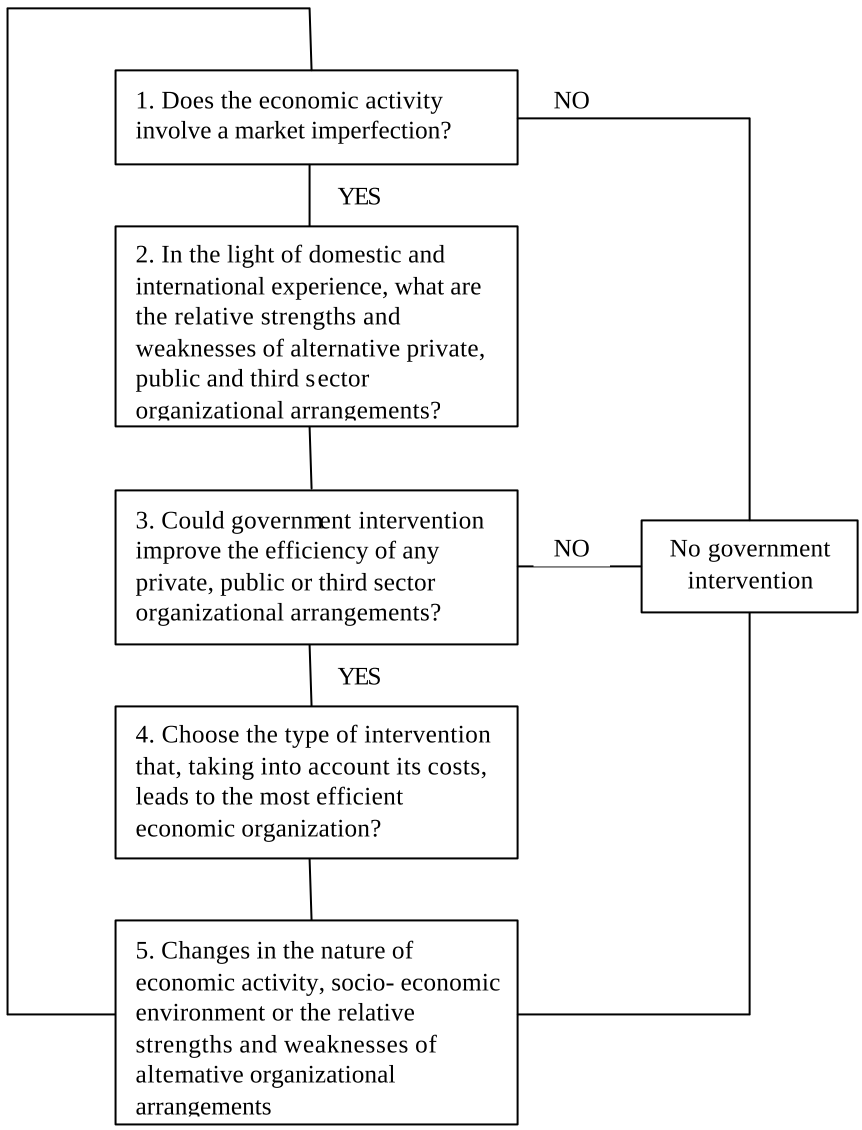

Figure 01: Deciding on Government Intervention

There is no doubt that the government can influence and affect a large number of economic sectors. To carry out the economic growth, macroeconomic aspects, such as inflation and debt control, and balance debt account and budget, have to run efficiently. But to increase economic growth in some cases it is necessary that the government apply some specific policies, including the industrial policy.

4.2. Industrial Policy

As presented in the introduction, the subject of this paper is to analyze the industrial policy in Bahia and in Northeast region of Brazil. The industrial policy can directly affect the acceleration of economic growth. This is a regular instrument that countries, regions, states or cities are applying is public policies for increase economic growth. The quantity of money spent in subsidies and the support that governments offer to entrepreneurs is increasing. Bartik (1991, p. 3) describes economic development policy as "those that provide *direct* assistance to business".

Not everyone agrees to apply these policies. Some are concerned about it because the money from the public budget is supporting private companies and is giving too much profit to businesses. Others argue that these policies give too much power to governments and politicians. According to World Bank (1997, p. 74) experiences in some countries

> Highlight why the debate over industrial policy has been unusually heated: industrial policy is combustible. Economy theory and evidence suggest that the possibility of successful, market-enhancing activism cannot be dismissed out of hand. But institutional theory and evidence suggest that, implemented badly activist industrial policy can be a recipe for disaster.

When the discussion concerns policies for development, two questions come: what is industrial policy? Is it really necessary?

According to Markunsen, industrial policies are used "to create capacity in key industries, to develop domestic markets, and to reduce imports and build export capacity" (1995, p. 279). Bartik writes, "direct economic development policies assist businesses with cash, such as subsidies, for example, or with services, such as training individuals in how to develop a business plan for a new enterprise" (1991, p. 3). It can include the provision of land, financial assistance, and infrastructure.

Todaro and Smith (2003, p. 679) argue that experiences in the East Asia shows that the government planning helped the development, but in other parts of the world (Africa, Latin America and Caribbean) the same did not happened. For the authors, the application of public policies to increase development can be justified by some reasons as followed: market failure, resource mobilization and allocation, attitudinal or psychological impact, and foreign aid. The government planning in case of a market failures is important because "the market cannot function properly or no market exists; the market exists but implies an inefficient allocation of resources; and the market produce undesirable results as measured by social objectives other than allocation of resources" (Todaro and Smith 2003, p. 683). The resource mobilization argument defends that the limited resources cannot be used without an economic planning. Other argument is that the economic planning can promote a mobilization in the society. The fourth argument is that these planning are necessary to justify and to receive foreign aid from the international agencies.

Todaro and Smith (2003, 695) present the main reasons of planning failure: deficiencies in plans and their implementation; insufficient and unreliable data; unanticipated economic disturbances, external and internal; institutional weakness; and lack of political will[4]. The institutional weakness in planning failure is presented by the authors: the distance of the planning agency from the day-to-day decision machinery of government; the lack of dialogue inside the government about goals and strategies; use of inappropriate practices to the local conditions; unqualified public servants; excess of bureaucratic procedures; intergovernmental rivalries; differences between the national and regional goals; and corruption.

As showed, in developing countries industrial policies are necessary, and can result in increase in the economic activity. But, if not applied correctly, they can cause damages or aggravate the

[4] For details about planning failure see TODARO, Michael P. and SMITH, Stephen C. *Economic Development*. Addison Wesley. 2003. P. 694-6.

problem of under development.

4.3. Local and Regional Industrial Policy

Another debate about industrial policy is the necessity and effectiveness of local and regional industrial policies for economic growth and job creation. Despite the applications of national industrial policies, according to World Bank (1998, p.1)

> There are big differences between the per capita incomes of backward and advanced regions in developing countries - and little reason to believe that these differences will disappear very quickly. Addressing poverty may require direct policy interventions that encourage the faster development of poorest regions.

The same World Bank's study conclude that

> The results so far suggest that income disparities across sub national regions in developing countries are likely to remain substantial for some time. Relying on market forces alone to remove sub national inequality is not enough, yet long experience with regional policy in industrial countries suggests that there is no easy way to iron out sub national differences" (1998, p. 4).

Regional policies concern the employment, poverty, inequality and wealth in the sub-national level. These policies may help to reduce the regional growth rate differentials, and, consequently, balance the differences in per capita income.

The Organisation for Economic Co-operation and Development (OECD) asserts that "local development and job creation initiatives first emerged in the early 1980s as a direct response to a new phenomenon of high, persistent and concentrated unemployment, which national policies appeared unable to defeat on their own" (OECD 2000, p. 1).

As a result of the failure of centralizing planning to reduce the economic differences,

> Regional policy approaches also are changing. Regional policies used to be common, often centrally planned and implementation through agencies devoted to regional matters. But political difficulties in implementation of regional policy and mixed results have encouraged a decentralized approach to economic development in the past decades" (Markunsen 1995, p. 281).

According to the authors mentioned, the central planning can fail in reducing the inequalities. The application of regional policies may achieve better results and complement the national policies. But there is a high risk involved in these policies: insufficient planning and data, high cost, political decisions, and support for inefficient industries.

Markunsen (1995) analyzed the interaction between national and regional industrial policies in Brazil, Japan, United States and Korea. This study concluded that as the tension between these two policies increased, the central government tends to transfer the responsibility of regional industrial policy to the local level government. The regional or local government may be can decide better the location of industries and the need of investments in infrastructure, but the local government have to take account of the costs involved in the local development process, and the level of minimal scale that industries can have without sacrificing efficiency.

OECD's study about local development and job creation presented what can be correct and incorrect ways of local development policies, as showed in the following table:

Do’s and dont’s of a local development policy

Policy-makers should:

? Start with a clear initial framework, setting a relevant territory and timescale, appointing key partners and forming a core working group to audit, consult and draft the strategy.
? Carry out a thorough assessment of local strengths, weaknesses, opportunities and threats.
? Consult on an appropriate strategy and allow local people and organizations to have the opportunity to influence it.
? Emphasize economic activities that build on local resources and initiative, while taking account of opportunities afforded by globalization in trade, technologies and finance.
? Stress the principle of sustainable development to achieve a diverse and flexible economic base, a healthy environment and a good quality of life.
? Seek to integrate various policy instruments and funding streams for maximum effectiveness, combining actions in different sectors (economic, social and environmental) and between different bodies at local, regional, national and international level.
? Make strategies flexible enough to evolve with changing circumstances.

Policy-makers should not:

? Depend too much on national government programs.
? Let the available tools determine the strategy (for example, by attempting job creation activities without adequate consideration of whether the local people will obtain those jobs).
? Blindly follow the latest trend. After all, a strategy, which focuses on developing high technology firms or “techno poles”, is likely to fail if the locality does not have the necessary attributes.
? Overlook potential and by failing to assess thoroughly the area’s resources and competencies.

Figure 02: Do’s and dont’s of a local development policy

The list presented above shows the importance of coordination and planning. Before applying the policies the local government has to establish the procedures, including the participation of society in discussions, the instruments, set the goals, and the way to measure it. The policy making has to consider the national scenery, such as federal economic and industrial policies. The procedures, instruments and goals have to be analyzed, measured and discussed continuously, and, if necessary, have to be corrected according to the results of these policies.

Uderman presents the same idea when she analyzed the planning for industrial development:

> The idea of a articulated strategy, that settles priorities, presents the details of instruments and institutions to achieve the goals, taking into consideration the nature of the actions proposed, is fundamental to find alternatives for regional development and have to consider the knowledge of local reality and the participation of the agents involved. (in Bahia Seculo XXI, 2002, p. 133).

As showed, regional or local policy set some rules for increasing the industrial production in a region or area. The importance of these policies is that they are institutions that can affect significantly the economic growth and development, as well as the industrial organizations behavior and choices. The companies take into consideration the policies that exist in many areas and the costs or benefits involved in each one to decide where they should do business and produce.

5. The Industrial Policy in the Northeast and in Bahia

This chapter is divided in two parts. The first will analyze superficially the policies that the federal government applied to reduce the inequalities between the Northeast and the other regions and its results. The second will discuss the industrial policy applied by the local government in Bahia. Since 1991, in order to complement the federal policy and attract industrial companies to the state of Bahia, the local government created some programs and policies.

5.1. Federal Industrial Policy in the Northeast

The Northeast region represents 18% of the national territory and 28% of the Brazilian population, but the region contributes only 13% to the national GDP. These data indicate that the region is less developed compared with others regions in the country. The chart bellow presents the GNP per capita in Brazil, in its regions, and in Bahia in 2001[5].

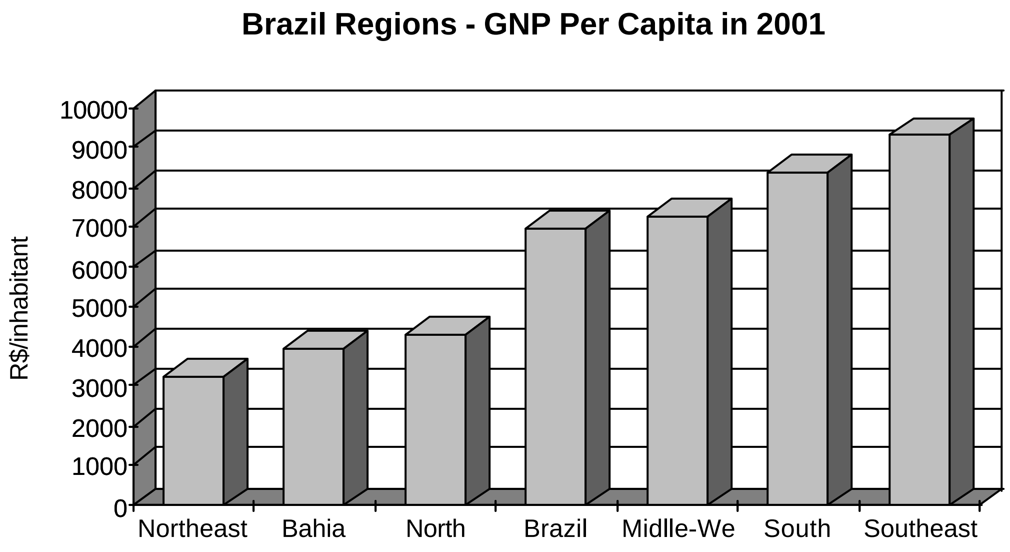

Chart 01: Brazil’s Regions – GNP per Capita in 2001

[5] Adapted from “Brazil - National Account System” - Instituto Brasileiro de Geografia e Estatistica - IBGE *in* http://www.ibge.gov.br/home/estatistica/economia/contasregionais/2001/contasregionais_2001.pdf

The chart shows the different levels of developments in the Brazilian regions. The South, the Middle West, and the Southeast have a GDP above the Brazil average. The figures in the North and Northeast regions are below the average. The high income in the South and Southeast is a consequence many factors: in the beginning of the last century these regions are the main producers of coffee, the most important commodities produced in the country; between the 1930s and 1970s the federal government implemented a policy of import substitution, but the investment and the economic growth occurred most in the Southeast, by state-owned enterprises; in the 1970s the federal government tried to implement a policy of decentralization, but the political pressures maintained the heavy public investments in the area around Sao Paulo.

To reduce the difference in development among the regions the federal government applied some policies and created a specific organization, Superintendence for Development of Northeast (SUDENE), in 1959, to coordinate these policies in Northeast. The main instruments applied were fiscal and financial incentives. The federal government offered reduction in the payment of income tax and created a fund to finance industrial projects.

The results of these policies are disappointed. The chart bellow presents share of the Northeast in the Brazil GNP. It shows that no significant change occurred in development in the Northeast between 1985 and 2001.

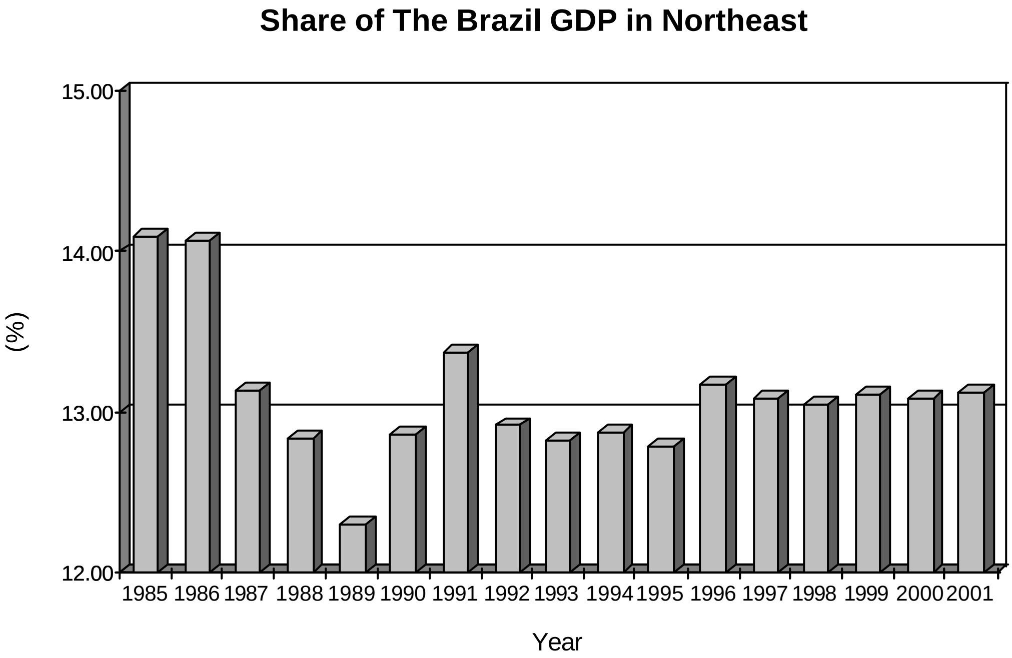

Chart 02: Share of Brazil's GDP in Northeast[6]

The chart above shows that the participation of Northeast in the GDP declined in the second half of 1980s from 14% to 12%. Their participation increased in the beginning of the 1990s, but it stabilized around 13%. These data, clearly, point to the failure occurred in the last 16 years in the industrial policies for Northeast.

Markunsen appointed the main reasons of the failure of these policies in Brazil:

> Four factors diminished the effectiveness of regional policy. First, subsidies and incentives proved to be relatively weak tools. Second, infrastructure investments to integrate the national economy allowed core-area plants to expand their markets and out compete smaller regional plants. Third, prosperous states such as Sao Paulo counteracted national commitments to decentralization. Finally, public investments in education, research institutes, and high-tech industries continued in the state of Sao Paulo, ensuring a concentration of leading-edge economic activity in the dominant region (1995, p. 286).

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[6] Adapted from the Superintendence of Economic Studies - Secretariat of Planning (Bahia) – http//www.sei.ba.gov.br/pib/brasil/index.htm.

In 2001, after numerous corruptions problems the SUDENE was extinguished by a federal low. The same law created the Agency of Development of Northeast (ADENE), but no policy was conducted by this agency. After that, the investments in the Northeast stopped.

In 2003, the federal government conducted a discussion with the society about a new agency and policies to develop the Northeast, and, in 06/31/2003, sent to the congress the final project of "The New SUDENE", but until now the congress has not voted it yet. The project establishes the planning of the policies, coordination of the various agencies related with the subject, and the management of a fund to finance public and private investments in infrastructure, research, education, technology, and local development.

It is clear that the central policies applied in Northeast did not reach the targets. The poverty and inequality in the region persist, despite the money spent in the last forty years by the federal government. The corruption and the lack of evaluation of results can be including among the reasons that causes this failure.

The federal government for the Northeast region has created some specific programs. The most important of these programs are the ones that focus on to developing the computer and the automobile sectors. Both consist in reduction of the industrialized products tax (IPI).

In the case of the computer industries, the reduction of IPI is high to incentive the production of computers and high technology products in the North, in the city of Manaus, state of Amazonas. So the big companies have been established their sites there. In the Northeast only basic assembly lines were installed, most in Bahia. It occurs because the state government implemented a program to reduce the ICMS.

In the case of automobile industry the only significant project was installed in the state of Bahia. The Ford Motor Company build factory in Camacari in 2001. As in computers industry, the incentives offered by the state were very important to influence the company decisions and to attracting them to invest in Northeast.

5.2. Bahia Industrial Policy

The state of Bahia started to apply specifics public policies concerning development in 1991. The first program that is called Program for Promoting the Bahia Development (PROBAHIA). The program is able to finance the payment of a percentage of ICMS, the state value added tax, up to 75%. The amount financed has to be repaid in 6 years subject to a nominal interest rate of 3%. This incentive has the following targets: diversify the industrial framework; increase the industrialization of natural resources in the state; expand the industry inward the state; and increase de competitiveness supporting quality, productivity and technology of the goods produced in Bahia. As the PROBAHIA consists of an incentive based in the ICMS due, and that tax do not incise in sales for abroad, there was no incentive to firms export. This program still exists, but is not applied by the state since 2002.

In 1993, in other to complement the PROBAHIA, the Bahia government created the Fund of Social and Economic Development (FUNDESE) to finance private companies. Whereas the PROBAHIA was useful to finance the operation of companies that pay ICMS, the FUNDESE was able to finance the initial investment of a project, such as land, building, installations and equipments. Not only the industrial sector could be financed, but also the economic sectors in general, such as tourism and commerce would benefit.

After two years the state created a program to develop the high technology industry to the region of Ilheus, a city in the South of Bahia that was the most important producers of cocoa. However because of a disease in the cocoa agricultural reduced significantly the wealth in this area. This program consists in reduction of 100% of ICMS due and helped to attract more then

50 companies that created about 1,500 job positions[7]. The main activity of these companies is assembly computers.

In 1997, the state presented specific program (Decree # 6.734/97) to develop the footwear industry, because it is intensive in labor, so create more job opportunities. It was based in a discount of ICMS up to 99%. The state also provides job training, finance support, and infrastructure (land, building, and utilities) for the companies. From 1997, 50 shoes companies installed in Bahia, including suppliers of raw material. It created more than 16,000 job positions.

In the following year, the state created a specific program to develop the plastic industry, Program for Development of Plastic Transformation Industry (BAHIAPLAST). The most important Brazilian petrochemical complex is located in the state of Bahia, but the polymers produced there were almost totally sent to the South. This program has the target to increase the industrialization of polymers inside the state, to produce final plastics goods.

In 1999, the state created the Special Program for Automobile Sector in Bahia (PROAUTO). As the Decree # 6.734/97, it also is based in a discount of ICMS, up to 100%. The state also provides job training, finance support, and infrastructure (land, harbor, building, and utilities) for the companies. The incentives to the automobile industry helped to attract the Ford Motor Company to Camacari. Almost 6,000 job direct positions were created and 30 other companies have already been installed in Bahia to supply the Ford project.

In 2001, the state created the Program for Industrial Development and Economic Integration of Bahia (DESENVOLVE). This program replaced the PROBAHIA, but the incentives of these programs are very similar. Both finance the payment of a percentage of ICMS. The DESENVOLVE can only be applied for industrial projects. Since the 2001, the program has been applied for almost 150 companies of many sectors, such as: petrochemical and chemical,

[7] The Secretariat of Industry, Mining and Commerce of Bahia estimated the data presented about numbers of job positions and companies.

plastics, mineral, food, ceramics, beverage, and textiles.

The tax incentives in general are granted after a board of secretaries (Industry, Treasury, Planning and Agricultural) conducts an analysis of the finance project that the company offers. The board analyzes the viability of the project and its impacts in the Bahia's economy. The board takes into consideration the localization of the industry, the social responsibility, and the impact in the environment, job creation and the activity.

Besides the tax incentives, the state of Bahia continue to offer and use other incentives, such as financial support, land, building, infrastructure, utilities installations, and support for job training and do research. The results of these programs are measured only using number of companies installed or planned, number of job positions created, and the total investment of projects.

There are not enough studies to evaluate the real effects of each program. An indicative of the results can be seeing the chart below that shows the evolution in the ratio GDP per capita in Bahia/GDP per capita in Brazil:

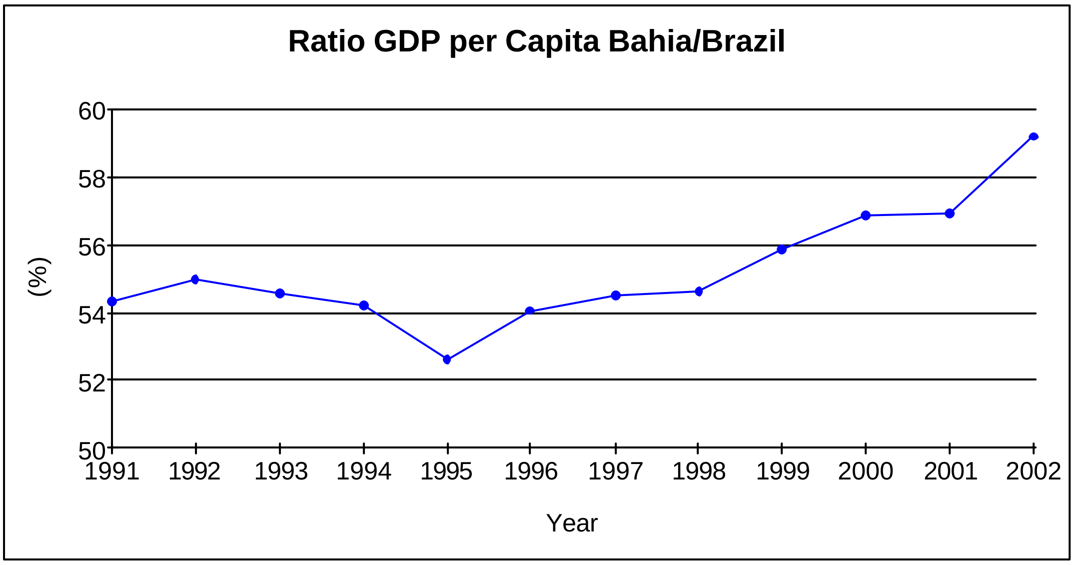

Chart 03: Ratio GDP per Capita Bahia/Brazil[8]

[8] Adapted from IBGE. The value in 2002 was estimated.

The chart shows that in 1999 the GDP per capita in Bahia increased more compared with the Brazilian data. The industrial policy applied by the state government may be is one the factors that affected the ratio. But others aspects may influence, such as the change in population growth rates, migration, development in other regions, and an increase in the agricultural production in Bahia.

The Planning Secretariat of the Bahia Government did some studies on the programs created, including one about the footwear industry (SEPLANTEC, 2000). Some conclusions of this study can be applied for the others programs. The recommendations emphasize the necessity of interventions for the following objectives: to increase the quality of products and raw materials; to improve the labor skills; to invest in infrastructure (roads and telecommunications systems); to implement a continuous studying on the segments and they influences on Bahia's economy; to consider the calculation or estimation of the ratio cost/benefit of the public investment; and to create organizations to discuss the program with the society.

Unfortunately, these suggestions were not completely applied and the results of the investment still consider only the total investment and the number of job creation.

The main organization responsible for applying the industrial policy in state of Bahia is the Secretariat of Industry, Mining and Commerce. But the function of contact companies and present the state industrial policy are disperse in many departments. Similar activity is conducted by the Superintendence of Industry (SIM), by the Superintendence for Industrial and Commercial Development (SUDIC), and by the Agency of Fomentation of State of Bahia (DESENBAHIA). This framework, if not conducted with coordination, can spend energy and public money and not achieve efficient results.

6. Propose an Institutional Framework

In order to propose an institutional framework it is necessary to clarify that the state of Bahia is part of a Federation, so the Brazilian rules and laws have to be obeyed. These laws and rules influence the life and the business in all states. The same occur in relation to the institutional framework. The national framework affects human and organizational behavior across the country. So, the federal, the regional and state institutional frameworks affect development in Bahia, and all have to be discussed.

The first analysis is about the national framework. There are a lot of problems in the national framework that do not invite investment to Brazil. Some of these problems are historical, the governments, politicians and people understand these problems, but there has been no interest or political power to change it. It is possible to list some Brazilian institutions that can be reviewed and to facilitate development, such areas as the judiciary system, the enforcement of laws, regulations agencies, property rights, and the tax system.

The judiciary system is the branch responsible for the application and interpretation of the law, where contests between people and organizations are solved. This institution reduces the cost involved in the solution of the contest. Nevertheless, in Brazil the judiciary system is not efficient and the time it takes to judge a process is problematic.

Now, the congress is discussing a bill called “Judiciary Reform”. This bill proposes that judges in inferior courts must follow the decisions of superior ones and it will create external control. But the main problem is not being discussed now, namely, the process laws. These laws have so many appellations that increase the time necessary to finish any process. They make it difficult to charge a loan, to collect tax, and most importantly, as punishments do not occur efficiently, it creates an atmosphere of impunity. This atmosphere stimulates the corruption. The time and money spent to charge a loan increases the cost and the spread, therefore the interest rate in Brazil has remained very high.

The reform of the judiciary has to change the judicial process and guarantee that those who do not obey the law will be quickly and correctly punished.

The regulatory system also is an important institution for development. It sets guidelines and influences the possibility of investing in important sectors, such as energy, water, ports, roads, and telecommunications. If there is no guarantee of the ownership of assets and if the rules that define prices and market regulations are not stable, an investment will not occur. The investment in infrastructure involves high amounts of money and an unstable or unclear regulatory framework could increase business risk. The public sector has a constraint budget and does not have the capacity to invest in such sectors, so the public policies in these areas have to take into consideration that the private investors will want to obtain profit. If risks increase, the possibility of investment decreases.

An important aspect of economic growth is technological advance. To improve the technology it is necessary to invest in research and development. This kind of investment requires property rights laws. If they do not exist or are weak, the incentive to invest in such areas will not exist. The congress has to approve laws that guarantee that the people or organizations that create or develop new technologies, goods or services will receive the profits from their inventions or creations. Currently, in Brazil, the property rights and the enforcement of those that do not respect patent rights are weak.

Another important aspect is the tax system. In Brazil there are four kinds of taxes: federal taxes, state taxes, municipal taxes, and taxes to finance the social security. At the federal level there are six taxes: income tax, importation of foreign products tax, exportation of national products tax, industrialized products tax, credit foreign exchange and insurance transaction tax, and rural property tax. At the state level, there are the value added tax, the transfer by death and donation of property tax, and the ownership of automobiles tax. Each of the twenty-seven states have their own legislation, so a company that does business in Brazil has to comply with different rules for the same tax. In Brazil the municipalities have the power to collect tax too. There are the urban building and land property tax, the transfer of real assets property tax, and service tax. To finance social security, there are some welfare contributions that companies must pay. The most important of theses incise in the payroll, in the revenue, and in the profits.

So, the tax system in Brazil is complex. It causes an increase in the cost for companies to pay and to know how to pay these taxes. The possibility of error increases, and so does the chance of corruption. These complex systems result in high costs for the public sector too, because it becomes necessary for more authorities to collect all taxes.

The points analyzed above are necessary to the improvement of the capacity for growth in the country. In order to reduce the differences among regions, regional industrial policies are necessary. The Northeast is not close to the most important markets located in the Southeast. In order to locate there, companies have to receive incentives and the region has to offer the infrastructure they need. In June 2003, the federal government presented to the society the plan of the "New SUDENE", but it had not yet been implemented. The program, if implemented, can motivate companies to locate to the Northeast. This program contains financial and fiscal incentives, such as income tax exemption, reduction for import taxes, and loans for private companies. This program includes a fund designed to invest in infrastructure. This program has been widely discussed with the society and organizations.

At the state level, the government of Bahia has already applied many policies toward the economic growth. But the local industrial policy can be improved. Some weak points of the programs created are the process of creation, implementation and evaluation. The evaluation of number of companies installed or planned, number of job positions created, and the total investment of projects is not enough to determine the success of a program. The government has to increase the number of variables to be measured and the methodology used. The impact of such policies in the development indexes has to be measured. In time of scarce public resources, different options have to be compared and the cost/benefit ratio of a policy has to be identified.

The state government has to improve the interaction among the different departments. To avoid problems of coordination, the different offices involved in industrial policies have to participate in the process, and the responsibility of each one has to be clearly defined and pursued. It may increase the capacity and opportunities to achieve the goals and reduce the cost for the private sector to relate with these institutions or organizations.

Another point that can be increased in Bahia's industrial policies is the relation with the society. The Industrial Development Council (CDI) was created in 2003, but it has not been regulated yet. This council involves almost all departments related to areas that affect development, such as Industry, Mining and Commerce; Planning, Science and Technology; Treasury; Agricultural; Infrastructure; and Labor. The Agency of Fomentation of State of Bahia, and different confederations that represent the industrial, commercial, farmers' and workers' sectors are also listed in the council. The CDI can be the forum to discuss and present the industrial policies.

In order to create opportunities of economic growth, the government has to develop economic studies to identify potentialities and weaknesses of the state for all production sectors and set the priorities of investment. The quality of the information and results of theses studies may increase if the government and the private sector work together. The private sector is more efficient and provides more information than the government.

7. Conclusion

This final paper analyzes the role of the government and institutions for economic growth in the Northeast region of Brazil and in the state of Bahia.

The importance of institutions for development and economic growth is discussed. It is clear how they can affect the human and organizational behavior. One of the most important institutions is the government. It has the power to create and to affect others institutions.

In order to accelerate economic growth the governments apply public policies, more specifically, industrial policies. Industrial policies provide resources or rules to supporting the private sector and their target is to attract companies. The same instrument can be used to reduce differences in the wealth among regions. So, the regional industrial policies are used to attract companies and investments to a specific area or local.

As showed, this kind of policies has to be applied carefully. The public resources are involved and, if the policies are not planned or applied correctly, they can cause damages or have no effect. The public managers have to evaluate all effects and costs involved in these policies.

The Brazilian federal government applied some policies to reduce the difference of wealth between the Northeast and other regions. This planning failed and the region continues to be the least developed in the country. To compensate it, the State of Bahia government applied industrial policies to the local level. A lot of companies have been attracted and thousands of job positions have been created in the state, but there are no detailed studies about the benefits and the costs involved in these policies.

This paper highlights some institutions that can be changed in the Brazilian economy and society, to push a sustainable economic growth in the country as a whole. Some changes have to occur in state level too, mainly in the coordination and evaluation of the public policies.

It is important to emphasize that economic growth is a necessary, but a sufficient, condition to achieve the development. The economic growth can occur, but it can only increase the inequalities. Brazil is always listed as an example of a country where the wealth distribution is not fair. To push the development, the institutions and the government have to take in consideration the importance of reducing inequality, eradicating poverty, improving education, and guarantying basic health to citizens.

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