

Stimulating Growth, Improving Competitiveness in Brazil: Beyond Industrial Policy and Outsourcing Responsibility¹

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1 Introduction

By and large, there was no industrial policy in Brazil in the last four years. More than that, industrial policy was a dirty word, and this not without reason. Although industrial policy had its merits in the past, it also had severe shortcomings. On the one hand, there can be little doubt that Brazil would not be the industrialized country it is today had there not been industrial policy. Key sectors of the economy owe their existence to decades of industrial policy, starting in the 1940s with the creation of the first steel-plant, continuing in the 1950s with the creation of the car industry, and culminating in the 1970s with the Second National Development Plan, which, among many other things, led to the massive amplification of production capacity which made the petrochemical industry one of Brazil's most important industrial sectors.

On the other hand, these successes bear inside what today appears as one of the main weaknesses of Brazil's industrialization effort. It was directed to the development of dynamic comparative advantages, especially in those industrial sectors where Brazil had no static comparative advantage. Brazil thus displays a heavy bias in favor of capital intensive industries. It would be unfair to condemn past industrial policy makers for this as their strategies reflected the prevailing philosophy of their time, and were indeed masterfully implemented at least until the 1970s. Industrial policy makers in countries like Korea did very much the same thing. However, they never neglected industries in which their country had a comparative advantage to the extent their Brazilian colleagues did. Korea's industrialization effort was for quite some time focused on consumer non-durables and simple durables, like radios. Exports of clothing and shoes made up the larger part of overall exports for a long time, and Korean firms always understood that it was possible to create a competitive advantage in industries which appeared as simple and low-tech. In Brazil, competitive advantage was never an issue anyway as the industrialization drive mainly aimed at the domestic market; industrial firms received generous subsidies and other benefits in order to be able to sell on the international market. And seemingly traditional industries like clothing, furniture, or toys underperformed, the only notable exception being the export of women's footwear from the cluster in Sinos Valley, Rio Grande do Sul. Industrial policy makers believed that it was not possible to build sustained growth in this kind of industry, or they thought that they would thrive anyway, without specific government support. Looking back, it appears that industrial policy makers made a serious mistake here, leaving these fast growing segments of world trade to other developing countries. This is the first unfortunate heritage of the past industrial policy: a distorted industrial structure and little export potential in sectors where Brazil is supposed to enjoy a comparative advantage.

Another serious deficiency of the industrial policy of the past today comes to haunt Brazil's macroeconomic policy makers: the lack of an adequate financial structure. Industrial investments used to be financed either from cash flow, or by the National Development Bank (BNDES), or through capital imports. The commercial banking industry initially was too weak to play a serious role. Later on, it refused to provide long-term financing due to incalculable

risks in a highly inflationary environment. As long as inflation was high, firms with a competent financial management had little problems in generating the necessary cash flow to generate funds for investment as profitability was high, too. Accordingly, things became difficult after 1990. Before that, competitive pressure on the domestic market used to be limited, and it was hard to detect for outsiders whether a firm had raised its prices above inflation. When the market opened up and competitive pressure increased, profits started to drop. Firms increasingly had to rely on external financing. However, only large firms with access to international capital markets were able to get credits with conditions close to those in advanced industrial countries. Small and medium-sized firms had to rely on short-term financing from commercial banks, which usually bore astronomic interest rates, and on long-term finance from BNDES, which was quite expensive by international standards. This is the second unfortunate heritage: Brazil has never managed to create an adequate, competitive, and efficient system to channel domestic savings into industrial investment.

2 Macroeconomic stabilization: From awful to bad enough

Industrial policy was a non-issue after 1993, when Fernando Henrique Cardoso was appointed Minister of Finance. With him entered a team of economists with a neo-liberal orientation who were deeply suspicious of government intervention in the economy. More precisely, one must say that they were deeply suspicious of government intervention at the micro- and meso-level while practicing highly interventionist policies at the macro-level. Anyway, given the experience of the 15 years before, it is hard to condemn them for this view. Industrial policy had turned into compensatory policy, trying to compensate for the profoundly business-unfriendly macroeconomic conditions by means of supportive meso-level interventions. This only exacerbated macro-economic imbalances. Creating a stable macroeconomic framework was without doubt a good idea: A halt to inflation and frequent stabilization efforts would create favorable conditions for the private sector. Privatization would enhance efficiency in crucial areas, like telecommunications, transport, and ports. And combating the „Custo Brasil“ would further improve the competitiveness of private firms. This seemed a much more sensible approach than combining a turbulent macroeconomic management with unpredictable meso-level interventions, which had little credibility anyway.

Unfortunately, it did not quite work out like that. Although the Plano Real in 1994 solved the problem of high inflation, it was far from successful in creating a stable macroeconomic framework and a business-friendly environment. Two main issues must be mentioned. First, the structural reasons for government deficits persisted. Second, macroeconomic policy makers tolerated an appreciation of the Brazilian currency in the first months after the start of the Plano Real, which led to an overvaluation of about 30 %. The result was the vicious circle of a high-interest low-growth policy depicted in Figure 1. The macroeconomic framework was better than the extremely unstable high-inflation environment of the past, but it was not stable as it was highly vulnerable. The fact that Brazil suffered from the Tequilaeffect after the

Mexicocrisis of December 1994 , could be ascribed to the unwillingness of international capital markets to distinguish between different Latin American countries. However, when Brazil suffered speculative attacks against its currency in late 1997 and after August 1998, this was indeed due to domestic reasons, namely the double deficit in the government budget and the current account balance. In all these instances the government took refuge in raising interest rates from an already unsustainable level (that is, unsustainable in terms of borrowing conditions for the private sector) to a much higher level, i.e. almost 50 %. And yet, this was not enough to stabilize the situation. The collapse of the exchange rate anchor in January 1999 did not much improve things, however. Public debt, and the debt of some recently privatized utilities, jumped, and interest rates were hiked again, making it unlikely that government can get itself out of the deficit by means of cuts in expenditure. High macroeconomic instability is back again, and even if inflation does not return with a vengeance, instability will persist for some time.

3 Shaping competitive disadvantages

But it was not only by means of extremely high interest rates and an overvalued currency that the government was creating a very business-unfriendly environment and an anti-export-bias:

1. The *Custo Brasil* problem persists. There is no question that the government is trying a lot to resolve this problem. Privatization of infrastructure and regulatory reforms (for instance regarding ports) have somewhat reduced the cost disadvantages which firms were suffering. But at the same time there is little advance regarding some key reforms, and the government is even creating new cost elements:

- So far, there has been little progress regarding the reduction of indirect labor costs. With the stabilization program of October 1998, one of its elements, COFINS, was even supposed to be raised.
- The direct and transaction costs of an extremely complex tax regime persist. Part of the October 1998 stabilization program was the proposal to raise the tax on financial transactions, a tax that increases the cost of each business transaction.
- Export firms are facing all kinds of obstacles and harassments.³ For instance, Receita Federal demands two days (that's 48 hours) to inspect export goods. If a firm in the interior has gone through this procedure with the local *delegacia*, it may still happen that the *delegacia* at the port or airport does not accept this and demands another inspection, taking another two days. Also, Brazil exports only during 40 hours per week, namely during the regular work hours of *Receita Federal*.

3 For an excellent overview see Lima, Carvalho & Velasco (1998).

Accordingly, it is unlikely that the devaluation of the Real will lead to a surge in exports. Non-tariff barriers to exports proliferate in Brazil, and changes in the exchange rate do not necessarily compensate for them.

2. Government at all levels is only partially able to fulfill its basic tasks, particularly in fields like education, training, and health. Firms have to compensate for this by creating in-house programs or rely on costly commercial providers in these fields. At the same time, government is busily creating regulatory obstacles and nuisances for firms,⁴ and in some cases municipalities have been known to impose fines on firms as a means of generating additional revenue (often to reduce budget deficits which were to a large extent due to political favoritism, clientelism, and outright robbery).

3. There is a massive anti-SME bias in Brazil's business environment. Government acknowledges the negative overall effect of macroeconomic framework conditions in that it tries to introduce compensatory measures, especially in the fields of investment financing and export insurance and finance. These programs are most easily accessible for large firms which can deal directly with BNDES, the National Development Bank. SMEs usually have to try to access these programs through commercial banks, something that adds costs or obstacles (if these banks are unwilling to manage such funds, which is quite frequent and, from the perspective of the local bank manager, perfectly rational behavior – a portfolio of bad debt will have a negative impact on his career perspectives, whereas a small portfolio with little risk will not). Accordingly, BNDES's efforts to give support specifically to SMEs, laudable as they are, are not that promising. Moreover, large firms are the primary beneficiaries of the subsidy race (*guerra fiscal*) between federal states. Micro firms enjoy other advantages which to some degree compensate for otherwise unfriendly conditions, especially the *Simples* (a simplified regime to pay reduced taxes and labor charges) and access to programs of SEBRAE, originally a promotion service for small and medium-sized enterprises.. All this leaves small and especially medium-sized firms unsupported.

4 Regime Automotivo and Guerra Fiscal, or how to shoot yourself into the foot

It would be wrong to state that there was no industrial policy at all in the last years. One sector was the aim of a significant industrial policy effort: the car industry. In 1995 and 1996, the central government introduced a series of measures to stimulate this branch.

4 There is, for instance, a regulation that defines rules for labels on textiles and garments. If a label says 30 % cotton, 70 % polyamide it is subject to a fine because the component with the largest content has to be named first. There will also be a fine if it says Nylon instead of Polyamide. Not only the manufacturer but also each shop where such merchandise is detected by government inspectors will have to pay a fine, which may amount to some thousand Reais.

In order to understand the Regime Automotivo, it is important to look back at the early 1990s. Part of the (largely ineffective) industrial policy effort of the Collor government was the creation of *Câmaras Setoriais*, i.e. sectoral working groups which consisted of representatives of government, business associations, and trade unions. Of the more than forty *Câmaras*, the only one that displayed significant results was the chamber of the car industry. It managed to reach agreement on an accord in which every participant gave in, at least a bit –government lowered taxes, especially for small cars (*carro popular*, i.e. passenger cars with less than 1,000 cc), trade unions promised moderate wage demands, and manufacturers and retailers promised lower prices. This program was a huge success, especially in terms of traffic jams, as sales of cars exploded. As the average speed in urban agglomerations dropped, with more cars jamming the old road network, economic growth accelerated, and all of a sudden Brazil looked like a promising, dynamic market for the car industry.

So stimulating the car industry looked like a good idea in terms of stimulating economic growth and creating jobs. Now, how exactly to do that is a different question. One answer would be: lower prices, raise the income of the middle class, and demand will take off – and as the car industry is quite competitive, producers will queue up to grab their share. This would especially be true in a country where a four-company-oligopoly with outdated models and factories had to appear like a sitting duck to potential new entrants. However, things worked out differently as the car industry compensated low competitiveness with good lobbying. ANFAVEA, the association of the multinational car firms active in Brazil, has always been one of the few really effective business associations in the country. And ANFAVEA cried *foul!* when the government started to open the domestic market for car imports. ANFAVEA's proposal was to open the market only to those manufacturers who were already producing in Brazil. The government was not really opposed to this idea, especially when the deficit in the trade balance soared as Brazilians grabbed more and more BMWs and Mercedeses. Import taxes on cars were raised in March 1995, initially to 70 %. Imports of manufacturers who produce locally and export cars, too, are subject to only half the normal import tax, provided their imports do not exceed the exports.

Reduced import taxes are the central government's main instrument in the context of the *Regime Automotivo*. Using this trade policy instrument created a delicate situation vis-à-vis the Argentinian government. It had been the first one to launch a special regime for the car industry, trying to attract as many firms willing to set up factories in the Mercosul market as possible. Argentina's government reacted promptly, launching a harsh protest against Brazil's measures. However, the manufacturers got the message, namely that it would be wise not to direct more than the fair share of investment to Argentina.

What were the effects of the *Regime Automotivo*?⁵ In 1996, 125 firms were approved, and in 1997, 40. Most of these firms were car parts manufacturers, yet the number of car

5 The following data are taken from IPEA, Boletim de Política Industrial, No. 5, Agosto 1998, p. 14 ff.

manufacturers amounted to no less than 15. Planned investments amounted to US\$ 19.3 billion within the normal regime and US\$ 2.3 billion within the special regime for the Northeast. 10 % will be financed with inflow of fresh capital. In 1996/97, the participating firms displayed a positive overall trade balance, and they also purchased more capital goods on the domestic than on the foreign market. It is anybody's guess what would have happened without the regime (maybe much the same as Brazil looked like a very attractive market in the last years). What is quite obvious is the cost of the regime which created distortions on the domestic market and opened opportunities for producer rents. Researchers at IPEA have calculated that consumers have to pay an overall surcharge of R\$ 35.6 billion. Calculated against the creation of 20,000 direct jobs, this would put the price tag of a job at US\$ 340,000.

However, this is only part of the cost. With the prospect of a series of large, highly visible investments, state (and to some extent local) governments entered into the *Guerra Fiscal*, i.e. a subsidy race to attract car factories. A typical package would look like this: The firm receives a large lot, conveniently located, for free. State and local government pay for the preparation of the land and for infrastructure. The firm receives a ten-year tax credit on the state-level sales tax, or is even exempted from this tax for several years. In some cases, like Renault's investment in Paraná, the state government even took a share in the firm.

What is the logic behind such strategy which can become ruinous for state coffers? Ask Jaime Lerner, the recently re-elected governor of Paraná. The mid-term evaluations of his governorship were not enthusiastic. What got him re-elected was, to a large extent, his record of attracting investors – not only car manufacturers like Renault, Audi, and a BMW-Chrysler joint venture to produce engines, but also firms from other branches, like Mafisa, owned by a Portuguese firm, today the largest factory of MDF boards in Brazil.

While it may have been a political success for many governors and mayors, the *Guerra Fiscal* was an economic disaster. It was an enormous redistribution scheme from Brazilian tax-payers to multinational firms and to large domestic companies (with the latter ones being lured from Greater São Paulo to the interior of the state and to Minas Gerais, and from southern states to the Northeast). Its effect on the financial situation of states was disastrous; there have been no calculations so far, but one can assume that part of the states' financial troubles are due to foregone tax revenue. What makes things worse is the fact that, quite obviously, local firms are not at all amused by the pots of money thrown at foreign investors. They demand equal treatment, and that effectively leads to a situation in which most firms (i.e. all firms which did pay taxes and which have invested) pay much less taxes. The losses for state coffers were recently estimated at R\$ 9 billion in 1999.

5 Lots of complaints, little collective action

Probably everybody who has been doing field research in Brazilian industrial firms has made this experience: As soon as you ask a businessowner about the performance of government, he reels off an endless chain of complaints. You ask him what he does to change things, and he a) finds excuses why he cannot do anything about it or b) starts another chain of complaints about business associations that never inquire about his problems and thus do nothing to resolve them. This is one of the important elements of „outsourcing responsibility“.

The lack of political articulation of the private sector is one of the remarkable features of Brazil's polity. To be sure, some branch associations are quite powerful, like the association of the car manufacturers. However, as a rule business associations are weak. This applies to all levels – sindicatos (with mandatory membership) and ACIs (Chambers of Industry and Commerce, with voluntary membership) at the municipal level, federations of industries and federations of ACIs at the state level, the confederation of industries at the national level.

How can this phenomenon be explained? I want to put forward three main reasons. First, there is the persistence of the system of business associations and trade unions created in 1943 under the Consolidação das Leis de Trabalho. Being a typical corporatist system, organized in a top-down way, it was never meant to create collective action but rather to permit the government to control capital and labor. With mandatory membership and a quasi-tax as financing mechanism, there was no performance pressure on business associations. Offering services to the members has never been on the agenda of these organizations. In terms of lobbying, it was complicated to reach unanimity on whatever issue as the membership was extremely diverse.

Second, there is the way Brazilian politics usually work, i.e. based on clientelism. For many firms, especially large ones, individual access to politicians and government agencies was much more promising than an effort to organize effective collective action. This created a vicious circle: Large firms played a dominating role in business associations, but they did not really need them, and therefore associations were hardly effective. This helps explain why ACIs, with voluntary membership, did not fare much better than sindicatos.

Third, there was little necessity for collective action due to the proliferation of business opportunities. A reasonably dynamic and smart entrepreneur could (and actually still can) get rich quick so that getting involved in a business association, the construction of which usually takes some time, did appear as a waste of time.

The question what to do about the weak performance of business associations has not been settled. Some thought that new associations might fill the void. Entities like IEDI, an association of some 40 large domestic firms, or PNBE looked like promising candidates. However, today insiders comment that IEDI consists of those firms that dream of 1970s Korean-style etatist industrial policy, a proposal that is outside the reality of Brazilian political structures; a document released by IEDI in October 1998 did not even remotely resemble the state of the art of business association proposals on how to promote industrial competitiveness.

And one has not heard much of PNBE since its president became Secretary of Industry in São Paulo.

So reforming the old associations – sindicatos, ACIs, federations of industries – looks like the more promising option. The once-mighty FIESP seems to be in free fall, but other federations may pave the way, for instance FIESC, the Federation of Industries of Santa Catarina, which has recovered a virtually defunct structure, the Instituto Euvaldo Lodi, and turned it into a unit which gives manifold support to firms. It also created other business support units, like an information center on international trade. Also in Santa Catarina, a fundamental restructuring of ACIs is underway, many of which have more than doubled their membership in the last years, expanded their staffs substantially, and turned themselves into professionalized service and lobby entities.

6 Ministério da Produção: Gosplan or pork barrel?

After several years of mostly avoiding industrial policy, it was expected that the second Cardoso administration would set up a new ministry, namely *Ministério da Produção*, an entity which will oversee BNDES and other financing agencies. As unemployment is an increasingly pressing problem its main task will be to create jobs by means of dynamizing the private sector. In the end it was called *Ministério de Desenvolvimento*.

So far, it is anybody's guess what the concept behind this proposal is. The government has not published strategy documents so far, and it also appears that there is not much of a conceptual discussion going on. It is likely that the new ministry and its agencies will do much the same as in the past, i.e. create specific, subsidized credit lines to stimulate specific activities or industrial branches.

The proposal to set up the ministry has already raised a fair amount of politicking. Leading politicians from PFL, the largest party in the government coalition, have declared that they will resist the creation of the ministry. The explanation for this behavior is easy: They expect that a likely candidate for this office is José Serra, a PSDB politician who is a possible candidate for the race for the succession of Fernando Henrique Cardoso. They also expect that as secretary of production he would have access to extensive funds, thus being able to build up a clientele which would support his eventual candidacy. In other words: PFL politicians have no doubt that *Ministério da Produção* is about pork-barreling.

This would still be better than the other option, namely Gosplan. I admit that this label is an exaggeration, but it is not far away from reality. Just like Gosplan, i.e. a central government economic planning agency, would look like a very foolish idea, any proposal to go back to the glorious days of the build-up of the car or the petrochemical industry appears like one that is far away from today's realities. The government is much weaker than it used to be, both in

terms of technical competence and regarding the availability of funds, and the private sector is much stronger and is likely to resist any kind of detailed government intervention.

Does it make any sense to create such a ministry? Probably not. The central government has to accept that the days of old-style industrial policy are gone. It has little resources, both in terms of finance and of planning capacity. The economy is far too complex for a centralized approach. Moreover, it must acknowledge the fact that the private sector perceives government as the problem, not as the solution. Government activities to stimulate the private sector have little credibility in an environment in which government is creating all sorts of obstacles to private business activities. So should the central government continue its hands-off approach? Certainly not. But instead of creating a production ministry, it should pursue a different course, namely encouraging and supporting decentralized activities to create locational advantages.

7 More about outsourcing responsibility, or why should local government care about economic development?

When we conducted a research project on the competitiveness of industrial clusters in Santa Catarina in 1996, we did not come across a single municipal administration that pursued a systematic effort to strengthen local industry. Some of them had economic development strategies, but they were mostly about attracting new firms, preferably car assembly plants. The state government was no better. When we inquired about the reasons for this posture, the typical answer was: This is none of our concern. Industrial policy is a central government task, we have other urgent tasks to solve. It was, in other words, another case of outsourcing responsibility.

Behind this notion is a traditional pattern of Brazilian politics, namely the expectation that, in case of doubt, the central government will take care of whatever problem. And if central government does not do so of its own accord, local actors will mount a mission to Brasília to lobby for central government action. Specifically, in the area of economic development, central government has in fact always been by far the most important actor. So it is only natural that local actors do not consider it their business, also because they often have no idea what to do anyway.

This posture has started to change recently. As productivity continued to grow much faster than GDP, more workers were laid off. Unemployment is becoming a serious problem in Brazil, and it is felt most urgently at the local level. This is the reason why local governments are increasingly caring about economic development and employment. A typical approach is the creation of fora to unite various actors, sometimes at the municipal level, sometimes at the regional level, like the *Câmara do ABC* in São Paulo's southern industrial suburbs (seven municipal administrations, business associations and trade unions) or the various roundtables in

Santa Catarina's *Forum Catarinense*. The minimum effect of such fora is to make sure that local actors know of each other's activities. Beyond this, the aim is to jointly define strategies and concrete activities for job creation. The following two examples illustrate why this makes a lot of sense.

Case 1: Why to act locally – The example of the furniture cluster in São Bento do Sul

The furniture cluster in São Bento do Sul / SC at first sight appears like a spectacular success, even as another supercluster.⁶ Exports from São Bento grew spectacularly in the 1990s. They more than doubled in 1992 and 1993 and continued to grow strongly until 1997. Exports from São Bento increased tenfold from about US\$ 20 million in 1991 to about 200 million in 1997, amounting to about 50 % of Brazil's overall furniture exports.

However, São Bento's performance has been more the result of a positive external shock than built on a local competitive advantage. Sure, many of the about 200 furniture manufacturers in São Bento are quite up-to-date in terms of production machinery, and being able to meet the demands of European and U.S. customers in terms of timeliness, high quality, and low prices is quite an achievement. Nevertheless, the export boom was the result of an external occurrence, namely the tumultuous transition in Eastern Europe, the traditional supplier of pine furniture to Western Europe, especially Germany. When Eastern European firms were no longer available, or at least not at competitive prices, traders looked for suppliers elsewhere, and one of the locations they found was São Bento.

Yet there are a lot of indications that the boom will be short-lived. Firms from São Bento have increasing problems to stay competitive in Europe as Eastern European manufacturers re-enter the market – they are closer to the market, and they benefit from advantageous exchange rates in an industry where cut-throat pricing is the rule. Exports to Germany have dropped dramatically, and it does not look much better in other markets. For some time, the North American market looked like an alternative, but there firms from São Bento have to compete with manufacturers from Southeast Asia, and after dramatic devaluations in that part of the world there is no way to beat them on price. Exports started to drop in 1998. The only way to stay in the market is to offer products nobody else can manufacture, at least not with consistent quality and at a relatively low price. The strategy has to be: better than Indonesia, cheaper than Denmark.

Alas, it is not easy for manufacturers in São Bento to pursue this strategy. There are several severe obstacles. The most important one is that the manufacturers don't have the faintest idea who their final customer is, and what the final customer wants. The smaller firms do most of their exports through three local export agents, and the larger ones interact both with export agents and with trading houses abroad. Neither small nor medium-sized manufacturers have a

6 Schmitz (1995) called the footwear cluster in Sinos Valley / RS a „supercluster“.

profound knowledge of their final markets. Most of them don't even regularly visit fairs in the main markets.

The second most important problem is the lack of qualified employees at all levels. Many workers have not even completed the eight years of primary education, and formally trained, highly skilled workers, technicians, and engineers are extremely rare. Professional designers do not exist at all. This observation is all the more striking as local firms created a technical school for the furniture industry in the mid-1970s, a place that became the widely known center of excellence in the 1980s. However, it fell into decline in the late 1980s and early 1990s, and is only now in the process of rehabilitation.

What does this story tell regarding a policy to create competitiveness? There is little doubt that the macroeconomic conditions are not favorable, and local firms point out that they suffer from the overvalued exchange rate and high interests. However, the exchange rate was even more overvalued three years ago, when growth was still strong. Even with a realistic exchange rate and internationally competitive interest rates, firms from São Bento would find it difficult to compete in Europe and the U.S. Their main problem is lack of knowledge, and this is related neither to the exchange nor the interest rate.

Who then could do what to solve the knowledge problem? Central government might try to launch a program to do so (and in fact it has just set up a program to increase furniture exports, but it allocated very limited funds, and this program targets clusters with profoundly different internal structures and deficiencies). But even if central government threw pots of money at the local firms, it is unlikely that this would change the local business culture. Quite the contrary, the availability of subsidies might even slow down the necessary change.

What is necessary is a change in the local business culture. So far, there is fierce rivalry, various instances of predatory behavior, and hardly any cooperation, collaboration, and collective action. In other words, São Bento is a typical case of an uncooperative cluster which benefits from passive advantages (like availability of experienced workers, suppliers and subcontractors, and export agents) but displays hardly any actively created advantages. The way out for this cluster would be to turn around this situation, creating a cooperative business culture to build collective efficiency. In practical terms, this would mean things like creating local courses for employees at all levels and from different firms (rather than just in-house training), organizing trips to highly competitive clusters abroad and fact-finding trips to fairs, and disseminating information about trends in the final demand. Such activities might contribute to a change in the mind-set, creating the conditions for more ambitious cooperative ventures, like joint purchasing, export consortia, or joint design activities. External change agents may play a role in initiating the first steps, but essentially this has to be a local effort because it is a project that is on trust and ownership.

Case 2: How to act locally – The ceramic tile industry in Criciúma

The ceramic tile cluster in Criciúma / SC is a positive example of local action to create, collectively, a competitive advantage. Among the clusters in Santa Catarina, the ceramic tile firms were the first to come under serious pressure. This was initially not due to the opening of the market but to the fact that the country was on the verge to hyperinflation in 1989/1990, and the economy stagnated due to macroeconomic stabilization efforts. This led to the collapse of the construction market, and the sales of the firms decreased accordingly. At the same time, real interest rates went up and penalized those firms which had pursued debt-financed expansion and modernization strategies in the years before. The largest firm filed for the Brazilian equivalent of Chapter 11 in 1991 (*concordata*), and some other firms were on the brink of financial collapse. Yet, in the end all survived due to vigorous adjustment efforts.

Today, the firms account for about 30 % of Brazilian tile production and 70 % of exports. They seem to be close to leading Italian and Spanish competitors in terms of production technology, and they have introduced new management techniques more widely than firms in other branches. Firms are cooperating informally with each other, business associations play a very active role, and the industry has been active in shaping its supporting environment.

Firms have developed a strong effort in training at all levels, among other reasons in order to create the basis for the comprehensive application of quality management techniques like statistical process control. In one large firm, all employees completed a primary education program in 1997, which is quite unusual among industrial firms in Brazil, and in one medium-sized firm 98 per cent of the employees have completed secondary education, and 39 per cent have completed or are attending courses in higher education. Common practice is to set up inhouse courses in basic education (to complete *primeiro grau*, i.e. primary education, which normally lasts eight years in Brazil), and to support employees in secondary and tertiary training in external institutions (which often takes place after working hours and on weekends), inter alia by arranging transport and reducing the weekly working hours.

There is at least some 'information in the air' of the ceramic tile cluster. There is substantial informal information exchange going on between professionals from tile producers; unlike in other branches, it is perfectly normal for them to visit competitors' factories. Some firms regularly pursue a benchmarking exercise. Three factors lie behind this. First, suppliers of inputs and vendors of equipment stimulate exchange among firms. For instance, if a vendor (typically an Italian firm) has set up a given equipment in one of the firms, he will use this as a showcase for other local firms.

Second, local actors share the notion that local firms should stick together to maintain their position vis-à-vis domestic competitors. Apart from one large firm that is located elsewhere in Santa Catarina, managers in Criciúma point out that their main competitors are located in a cluster in the state of São Paulo (Santa Gertrudes). These firms, they say, are mainly small and medium-sized firms, which are lean and agile and thus cause a permanent performance pressure on firms in the Criciúma cluster.

Third, firms' engineers claim that production technology is on the whole standardized so that there is little risk of losing crucial secrets by information exchange between firms. Thus, the competitive pattern plays an important role in explaining cooperation. Competitive advantages rather lie in original design and in logistics.

Firms themselves admit that vertical integration so far is higher than in Italian industrial districts of the same industry. However, firms are working on this. They have started to persuade suppliers from elsewhere in Brazil and from abroad (Italy, Spain, USA) to set up factories in the Criciúma region, and they have taken care not to create a monopoly on the supply side by trying to attract competing suppliers.

Business associations play a more active role in the ceramic tile industry, and firms from SC actually maintain close contacts with their associations.⁷ First, there is the local *sindicato* of the tile industry, which has been playing a pivotal role in stimulating exchange among firms. It has also been active in the lobbying process for the construction of a link to the pipeline which supplies Brazil with natural gas from Bolivia. The use of natural gas will substantially reduce the energy cost of the ceramic tile producers.

Second, there is Anfacer, the National Association of Tile Manufacturers. Anfacer plays an important role in stimulating technological exchange among firms, inter alia by organizing an annual congress of the industry and by maintaining a separate institute, founded in 1993, the Brazilian Ceramic Center, which is active in training, research, and consumer information. Unlike the other branches, firms from SC play a very active role in Anfacer. Moreover, Anfacer has played an important role in organizing an alliance of business associations which lobby the central government to allocate more funds for housing, something that could stimulate the demand for various branches of the construction materials industry.

Local firms and the *sindicato* also play an important role in shaping the supporting mesolevel environment. They formulate and implement measures to create locational advantages. In this respect the region of Criciúma fared outstandingly by Brazilian standards:

- One of the two largest firms set up its own technical school long ago and opened it for students from competing firms in 1991.
- Firms have pressed the local university to offer a special course for technicians in ceramics technology, and lobbied the state to authorize this course within one year (what is supposed to be much faster than thought possible under the usual bureaucratic requirements).
- Together with the state's Federation of Industries (FIESC), in cooperation with the Federal University of SC (UFSC), and with some financial support from the state the firms founded

7 This is not self-evident as we found that in the metal engineering and electromechanical industry firms from SC generally had hardly any links with branch associations although these are quite important in other parts of the country, particularly in the state of São Paulo.

the Center for Ceramics Technology (CTC), modeled after a similar institution in Spain. Getting this venture off the ground involved a lot of tough bargaining by the Criciúma firms, and there was literal collective action: The presidents of the leading firms boarded a business jet to get to the state capital, Florianópolis, and invaded first the office of the President of FIESC and afterwards that of the state governor to press them for firm commitments for support and financing of CTC. An important element of support was the relocation of a specialized laboratory from the Federal University of Santa Catarina (UFSC) in Florianópolis to CTC.

In order to explain this experience, two factors appear to be most important. First, fierce rivalry and non-cooperation has led some firms to the brink of bankruptcy. The two largest firms were involved in a race to become the largest tile producer in the 1980s, investing in new factories and taking over smaller firms, to a large extent based on development bank credits. When sales decreased dramatically after 1989/90, both were extremely vulnerable. Medium-sized firms report that the two large firms were not at all open to cooperation in the past. Moreover, medium-sized firms may have sought some distance from the two largest as they feared to be taken over as well. All this has changed after the crisis of the late 1980s/early 1990s – out of necessity (i.e. the need to consolidate), due to the interventions of creditors (which forced the family out of the management of one of the large firms), and due to moderation by two persons, the president of the *sindicato* and the president of the local Chamber of Commerce and Industry,⁸ who brought the large firms together to settle their dispute.

Second, this industry found a role model in Italy's tile industrial districts in the 1980s. Local firms started to develop close links with firms in Italy, in particular with equipment suppliers and manufacturers of inputs, but also with their Italian competitors. Representatives and technicians of Italian equipment manufacturers and suppliers frequently visit the region, and they behave in the way they are used to, i.e. based on the notion that firms, even competitors, cooperate. Moreover, managers and employees of local firms pay frequent visits to Italy and thus have started to develop a notion of what things are like in industrial districts in Italy.

8 Shaping locational advantages: A compact between federal, state, and local governments

Even though the localized approach has hardly big success stories to present so far (even Criciúma is no smashing hit as firms are constantly on the brink of financial difficulties –

8 The president of the *sindicato* is the owner of one of the medium-sized firms. The president of the Chamber of Industry comes from the metal-engineering industry.

producing ceramic tiles is capital intensive, credit is expensive, and also the construction market displays wide fluctuations), it appears promising for several reasons:

- Not only problems but also knowledge about production systems and their deficiencies are highly localized. For instance, in the case of the furniture industry the problems, challenges and opportunities differ vastly between the major clusters (Bento Gonçalves / RS, São Bento do Sul / SC, Ubá / MG). It is thus unlikely that central government one-size-fits-all programs like the export promotion program launched in late 1998 can succeed. It is much easier to define a concrete strategy, for instance to improve the competitiveness of a given cluster, at the local level than in the state or federal capital where actors have to rely on third-hand information.
- An exercise of strategy formulation at the local level can more easily involve the target group, thus improving the quality of the problem definition and the definition of measures, and the prospects of implementation.
- Other countries have been pursuing local economic promotion policies for quite some time, and often with satisfactory results.

Advocating local economic promotion does not mean to demand inactivity by federal and state governments. On the contrary, what is necessary today is a compact between federal, state, and local governments that defines a division of tasks in the field of economic promotion, competitiveness policy, and industrial policy between the three levels. Table 1 gives an idea of how this might look like in the perspective of the systemic competitiveness concept (Esser et al. 1996).

Table 1: Elements of Competitiveness – Levels of Analysis and Levels of Aggregation in the Perspective of the Systemic Competitiveness Concept			
	<i>National</i>	<i>Regional</i>	<i>Local</i>
<i>Meta</i>	National integration Strategic capacity of national actors Competitive economic framework	Regional identity Strategic capacity of regional actors	Local identity Strategic capacity of local actors Trust creative milieu
<i>Macro</i>	Stable macro-framework Liberal trade policy Competition policy Generic environmental policy	Solid fiscal policy Investment capacity	Solid fiscal policy Investment capacity Attractive environment, quality of life
<i>Meso</i>	Control of subsidies Technology policy Education policy Performance-related regional policy Industrial policy Specific import policy Export promotion Sector-specific environmental policy	Regional economic promotion Technology demonstration centers R&D institutes Education and training institutions Financial institutions Information exchange between regions	Local economic promotion Education and training institutions Technology centers, incubators Effective chambers
<i>Micro</i>	Medium and large firms Disperse networks Supplier relationships national alliances	SME Cluster Supplier relationships	SME Cluster Industrial Districts

Local activities to create a locational advantage

When it comes to local initiatives to improve competitiveness, the key term is *locational advantage*. Creating a locational advantage is similar to what Michael Porter would call advanced and specialized factors. It aims at creating factors that distinguish a location from other places – factors that cannot easily be replicated elsewhere and thus lay the base for sustained growth of the location.

Table 1 gives an overview of what such factors might look like. At the **micro-level**, there is not only the element of intra-firm competitiveness but also the issue of collective efficiency, i.e. a competitive advantage created through dense interaction (formal and informal cooperation and collaboration) between firms. At the same time, Michael Porter is correct in pointing out that local rivalry is a key element in creating competitiveness. Actors, especially business owners, often find it difficult to understand that competition and cooperation („co-opetition“)

may co-exist. Accordingly, at the local level, especially within the context of clusters, exist both the biggest latitude and the biggest obstacles for inter-firm cooperation to collectively shape competitive advantages.

At the **meso-level**, the key actors are local institutions in fields like education and training (including SENAI schools and local universities) and business associations (sindicatos and ACIs). Local governments are usually facing financial difficulties so that it would be unrealistic to expect important financial contributions from that side. Moreover, instruments like public purchasing policy are unrealistic in a setting where government is notoriously late in paying its bills so that firms prefer to do business with other customers. Nevertheless, municipal administrations can play a crucial role regarding locational advantages, for instance by facilitating firms' access to government bodies and by creating first-stop or even one-stop agencies, i.e. offices which inform and advise firms about administrative requirements or work as the sole intermediary between firms and various agencies of the local administration. Local government can also play a role as a facilitator and moderator of a joint strategy formulation exercise. But the same role can be played, for instance, by the ACI. Table 2 presents a few suggestions regarding instruments.

Regarding moves towards a local economic development strategy, the *first challenge* is to get different actors and institutions to know each other, something that even in small municipalities often is not the case. Knowing each other may create opportunities for specialization and cooperation, but it may also create a healthy rivalry between supporting institutions; consolidating business support services into one organization only creates a monopoly with the usual shortcomings.

The *second challenge* is to stimulate articulation between different actors, for instance technical schools and firms, or local university and firms, or different business associations. The outcome can be tailor-made offers by meso-institutions which are better adapted to local demands. Lack of customer focus and communication with clients often was an important feature of Brazilian meso-level institutions in the past.

The *third challenge* is to get the key actors together to define, jointly, a development strategy – with a clear definition of concrete measures, responsibilities for their implementation, and responsibilities for their monitoring and evaluation. The typical sequence in such activities is problem identification → problem definition → definition of concrete measures → implementation → monitoring and evaluation → identification of more problems. In other words, it is an iterative process, not a one-time effort. Quite obviously, the key issue is adequate problem identification. This is a point which is frequently weak in Brazil – whoever thinks that he has identified a problem and promotes his view may get a process of problem definition and definition of concrete measures started, even if the problem identification is highly subjective, biased, and inadequate. What is missing is a systematic process and an adequate structure for problem identification. This is the reason why bringing the relevant actors together is such an important issue.

Whether or not this is possible is one of the important elements at the **meta-level**. Lack of political articulation, unwillingness or inability of local political actors to work together to solve problems, lack of organization of the private sector, and an uncooperative business culture are important obstacles to any effort to create locational advantages. Under such conditions, isolated meso-level activities or proposals for cooperation at the micro-level will often fail, reinforcing negative expectations and thus adverse meta-level conditions.

It may not appear obvious why the macro-level is mentioned in connection with the local level. Evidently, local governments have no say in monetary or trade policy. Nevertheless, they have an enormous potential to complicate things for the private sector if they pursue an irresponsible budget policy. Therefore, balancing the budget and maintaining a capacity to invest in fields like education, health, and infrastructure are crucial macro-level issues for competitiveness at the local level.

State-level activities to shape competitive advantages

The most important message to federal states addresses the **macro-level**: Get the budget in order, rehabilitate the capacity to invest. Without this, initiatives of state governments to support competitiveness lack credibility – not only in the sense that an actor who is not able to manage his own domain cannot expect to be accepted as a competent partner / provider of services by the private sector, but also in the sense that firms know perfectly well that financing of state-level meso-activities is often unpredictable so that it may be preferable not to rely on government institutions.

Once an effort to balance the budget is well on track, state government can do a lot of things to support firms' efforts to create competitive advantages. First, and most importantly, it is essential that it supports local efforts to create locational advantages – by contributing financially to local strategy formulation, by offering funds on a competitive basis for local meso-level institutions (e.g. incubators), by stimulating exchange of experiences between different regions. Secondly, it is important to create an adequate institutional infrastructure, for instance in terms of MSTQ institutions (measurement, standards, testing, quality assurance), decentralized research institutions and higher education institutions, an export information agency, or a venture capital fund.

Yet what state government can do, and what it actually should do, are quite different issues. Politics in Brazil tend to be highly clientelistic at all levels. It is not rare that after a change in government the new administration discontinues support for meso-level institutions created by its predecessor. In fact, the central government has a hard time convincing new governors that they have to honor the debts incurred by predecessors from different parties. The main question therefore is not *What can a state government do?* but *How can a state government create a sustainable structure for business support?*

Part of the answer is easy: Important institutions in this field do not depend directly on government, like SEBRAE (assistance to micro and small firms), SENAI (vocational training in the industrial sector), and SENAC (vocational training in the service sector). All three are financed by a levy on wages. SENAI and SENAC are administrated by the private sector, and SEBRAE is semi-autonomous with a supervisory board with government and private sector representatives. Then there are Federations of Industries, some of which have started to offer important services to their members; and if they have not, it would be a good idea to encourage them to do so. There is no reason why a state government should not work together with these institutions, at least as long as they maintain a reasonable degree of autonomy.

Another part of the answer is easy, too. Many important meso-level activities can be organized as private enterprises, possibly with a government grant for the start-up phase. This applies to training at secondary and higher level and R&D and technology extension activities as well as infrastructure activities, like ports. It even applies to certain parts of the MSTQ system, especially the T and Q components – as firms come under pressure to have their products and processes certified, demand for such services grows. In fact, I have come across cases where firms are lobbying hard for the creation of such institutions, and cases where such institutions do well with little government funding (Meyer-Stamer 1998).

Part of the answer is more complicated. Provided that state government is competent, it is not too complicated to identify ways and means of organizing business support in a sustainable way. But what if it is not particularly competent, or sticks to traditional political practices, or does not care about economic development, or inherits a financially broke state and does not succeed in recuperating financial maneuverability? At least one of these features probably applies to the majority of states. Under such conditions, the only way out is that non-government actors unite to formulate a strategy, and articulate this with government so that it disturbs as little as possible, and also lobby for government support to selected projects.

Federal-level activities to support the creation of industrial competitiveness

The agenda for central government to stimulate industrial competitiveness is straightforward.

1. Create a business-friendly macroeconomic environment. Admittedly, this is not a particularly ingenious proposal. Nevertheless, it is essential to acknowledge that macroeconomic management is a major culprit when it comes to explaining the unsatisfactory performance of the private sector. Interest rates are ridiculously high, and the anti-SME bias is an outright disaster.
2. Determine limits for state and municipal subsidies to firms, and implement a control and sanctioning mechanism, for instance based on the EU model. This would have a number of positive effects. First, it would prevent states and municipalities from ruining themselves financially by offering outrageous incentives to firms. This would be an important contribution to the overall effort to rehabilitate government finances. Second, it would

force state and municipalities to come up with creative means of competing for new investment, thus encouraging innovative initiatives.

3. Increase efforts to eliminate the *Custo Brasil* and the tariff and non-tariff barriers to exports. Some measures proposed in the October stabilization plan, like increases in COFINS and the tax on financial transactions (CPMF), do precisely the opposite. Under such conditions government proposals like the one to double exports in the next years are a just a joke.
4. Stop tinkering with traditional-style, detailed, interventionist, and discretionary industrial policy measures. Instead, encourage and support efforts to create locational advantages at the local level and support competitiveness-building activities at the state level. Reformulate regional policy in such a way that it supports such activities, based on a competitive system that encourages good performance (instead of non-performance, like in the past). Introduce a clearly distinct line of transfers to low-performance regions, i.e. a kind of support that is part of social policy, not of industrial policy.
5. If we take the two points mentioned before together, a viable strategy to promote exports, to reverse the deficit in the trade balance, and thus to eliminate the largest obstacle for growth becomes visible. It is central government's task to remove obstacles to exports, something that could unleash a new dynamism in exports, especially through much increased exports by SMEs. It is local and state governments' task to formulate, together with local firms, business associations, trade unions, and supporting meso-institutions, specific measures to increase international competitiveness.
6. Keep, but reform, SEBRAE. During the last years, there have repeatedly been voices that proposed to discontinue SEBRAE, or at least to get rid of the current model of compulsory financing. The first proposal is ridiculous; it is not by chance that various other Latin American countries look at the SEBRAE model when they create or reform their SME support systems. The second proposal has some plausibility. There can be no doubt that the current system is somewhat bizarre: Mostly medium-sized and large firms finance an institution that gives support to micro and small firms, many of which are unfair competitors of medium-sized and large firms (since they enjoy a cost advantage which is partially based on evasion of taxes and social contributions). An alternative way of financing SEBRAE would make sense, but there is no obvious alternative – government budget allocations are unreliable, creating another *vinculação* does not sound like a good idea, either, and other proposals (like creating an interest-bearing fund, for instance based on privatization revenues or forgiven state debt) are difficult to imagine. A further issue regards the governance of the SEBRAE system. Today, an external observer finds it difficult to identify who defines SEBRAE's lines of action, who monitors them, and who evaluates them. The idea to make this more transparent, and in fact introduce mechanisms to secure constant monitoring and evaluation and their feeding-back into program formulation, suggests itself.

One might conceive further proposals for central government action, like initiating future searches for issues like knowledge-based development or sustainable development, and how to implement this in terms of industrial policy. It would also be nice if central government had a serious technology and innovation policy. But, to repeat one of the main arguments of this paper, as long as the central government's core competence lies in shaping competitive disadvantages, such proposals are just out of reality. Before anything else, the government has to mount a serious effort in creating a business-friendly environment. And it is essential to understand that several of the proposals explained before have the merit of not only directly stimulating competitiveness but also contributing to the key goal of macroeconomic policy, namely creating a sustained basis of macroeconomic stability.

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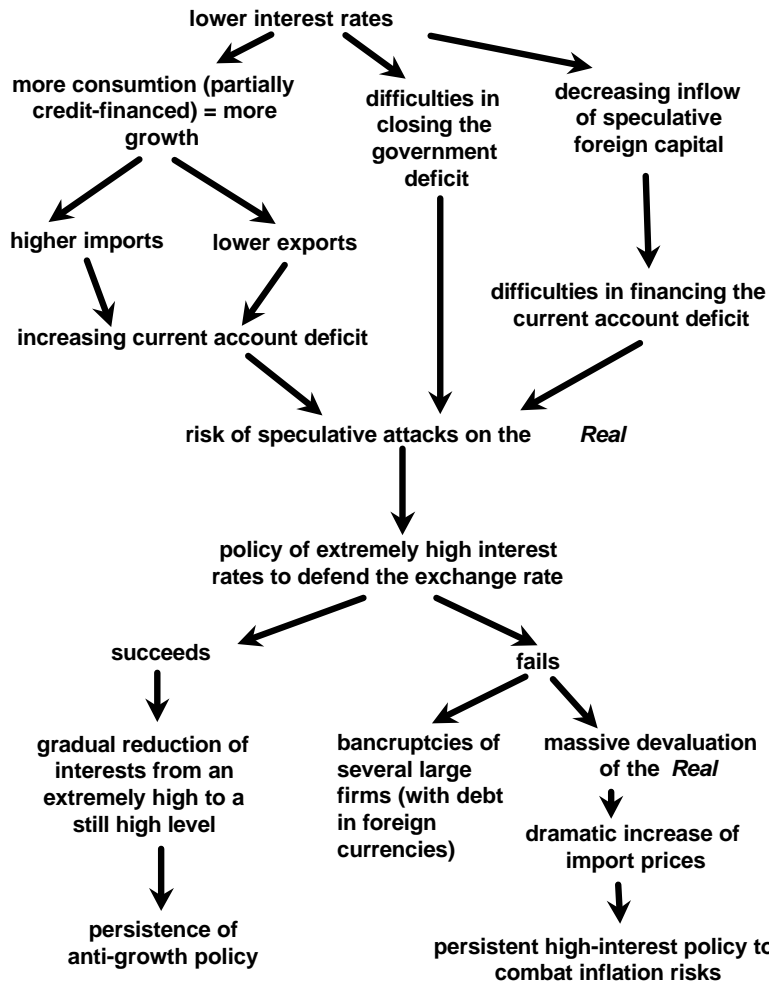
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Table 2: Building Competitive Advantage – Contributions of Different Actors		
<i>Who?</i>	<i>What?</i>	<i>How?</i>
Local government	Encourage inter-firm relationships	<ul style="list-style-type: none"> • Involve groups of SME and their associations in formulation of local development strategy • Public purchasing policy geared at groups / consortia of SME
Business associations	Stimulate information exchange between firms	<ul style="list-style-type: none"> • Establish sectoral and topical working groups, managed / moderated by association's professionals • Organize seminars with external speakers • <i>Bolsa de subcontratação</i>
Research institutions, universities, training institutions	Direct support to SME: education and technology	<ul style="list-style-type: none"> • Tailor-made training courses for groups of SME • Dissemination of technology information
Medium and large firms	Supplier development	<ul style="list-style-type: none"> • Individual assistance to suppliers • Training courses for groups of suppliers
State government	Encourage inter-firm relationships	<ul style="list-style-type: none"> • Public purchasing policy geared at groups / consortia of SME
	Direct support to SME: technology	<ul style="list-style-type: none"> • Technology demonstration centers • Extension service
	Direct support to SME: finance	<ul style="list-style-type: none"> • Credit guarantees for firms with strategies and projects formulated in the context of regional development strategy • Subsidizing networking initiatives to cover transaction costs
Central government	Encourage inter-firm relationships	<ul style="list-style-type: none"> • Value-added tax rather than cumulative sales tax • Realistic regulatory framework: licensing, labor, taxation, workplace safety, environment (no incentives for informality or semi-formality) • Transparent proceedings of public administration • Transparent and efficient foreign trade procedures
	Direct support to SME: technology	<ul style="list-style-type: none"> • Finance decentral activities on a competitive basis
	Direct support to SME: exports	<ul style="list-style-type: none"> • Export promotion agency • Export finance and insurance at internationally competitive terms
	Direct support to SME: finance	<ul style="list-style-type: none"> • Finance decentral activities on a competitive basis

Figure 1

Macroeconomics in Post-Real Plan Brazil: The Low-Growth High-Interest Rate Vicious Circle



(c) Meyer-Stamer