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Raising productivity through structural reform in Brazil

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Robert Grundke**

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ECONOMICS DEPARTMENT

RAISING PRODUCTIVITY THROUGH STRUCTURAL REFORMS IN BRAZIL

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By Jens Matthias Arnold and Robert Grundke

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Abstract/Resumé**Raising productivity through structural reform in Brazil**

The recovery from the current deep recession caused by the COVID-19 pandemic will require raising productivity through structural reforms. This implies a number of challenges for economic policies. With large parts of the economy shielded from competition, firms face weak incentives to become more productive. Sizeable shares of labour and capital are trapped in low-productivity firms that survive on the back of support from distortive policies. Reallocation mechanisms such as continuous firm entry, exit or the growth of stronger firms on the expense of less productive ones appear weaker than elsewhere. Domestic regulatory burdens and market entry barriers are high, reducing domestic competitive pressures. External competition is hampered by high trade barriers that have precluded Brazil from the opportunities that an increasingly integrated world economy can offer. A fragmented tax system gives rise to one of the world's highest tax compliance costs and a wide array of exemptions and special regimes reduces fairness and the redistribution effect of taxes. Financial markets used to be dominated by directed credit, but thanks to a successful policy reform that aligned directed lending rates with market rates, they are now undergoing a profound transformation. Challenges in contract enforcement suggest scope for changes in the organisation of the judiciary to reduce judicial uncertainty and reduce trial durations.

Key words: Brazil, structural policies, productivity, allocative efficiency, product market regulation, trade policy, judicial efficiency

JEL codes : D24, O47, O54, F13, F15, L51, K23, K41, H20.

This Working Paper relates to the 2020 OECD Economic Survey of Brazil (<https://oe.cd/brazil-snap>)

Augmenter la productivité à travers de réformes structurelles au Brésil

La sortie de la profonde récession actuelle causée par le COVID-19 exigera une croissance plus forte de la productivité, grâce à des réformes structurelles. Cela implique un certain nombre de défis pour les politiques économiques. Une grande partie de l'économie étant à l'abri de la concurrence, les entreprises sont peu incitées à devenir plus productives. Des parts importantes du travail et du capital sont piégées dans des entreprises à faible productivité qui survivent grâce aux distorsions causées par les politiques économiques. Les mécanismes de réallocation tels que l'entrée, la sortie continue d'entreprises ou la croissance d'entreprises plus fortes au détriment d'entreprises moins productives, semblent plus faibles qu'ailleurs. Les charges réglementaires et les barrières à l'entrée sur le marché sont élevées, réduisant les pressions concurrentielles. La concurrence extérieure est entravée par des barrières commerciales élevées qui ont empêché le Brésil des opportunités qu'une économie mondiale de plus en plus intégrée peut offrir. Un système fiscal fragmenté entraîne l'un des coûts de conformité fiscale les plus élevés au monde et un large éventail d'exonérations et de régimes spéciaux réduit l'équité et l'effet de redistribution des impôts. Les marchés financiers étaient autrefois dominés par le crédit dirigé, mais grâce à une réforme politique réussie qui a aligné les taux des prêts dirigés sur les taux du marché, ils subissent maintenant une transformation profonde. Les défis liés à l'exécution des contrats suggèrent des possibilités d'améliorations dans l'organisation du pouvoir judiciaire pour réduire l'incertitude liée aux décisions judiciaires et réduire la durée des procès.

Mots clés : Brésil, politiques structurelles, productivité, efficacité dans l'allocation des ressources, régulation, politique commerciale, efficacité du système judiciaire.

JEL codes : D24, O47, O54, F13, F15, L51, K23, K41, H20.

Ce Document de travail a trait à l'Étude économique de l'OCDE du Brésil 2020 (<https://oe.cd/brazil-snap>)

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Raising productivity through structural reforms in Brazil

By Jens Matthias Arnold and Robert Grundke¹

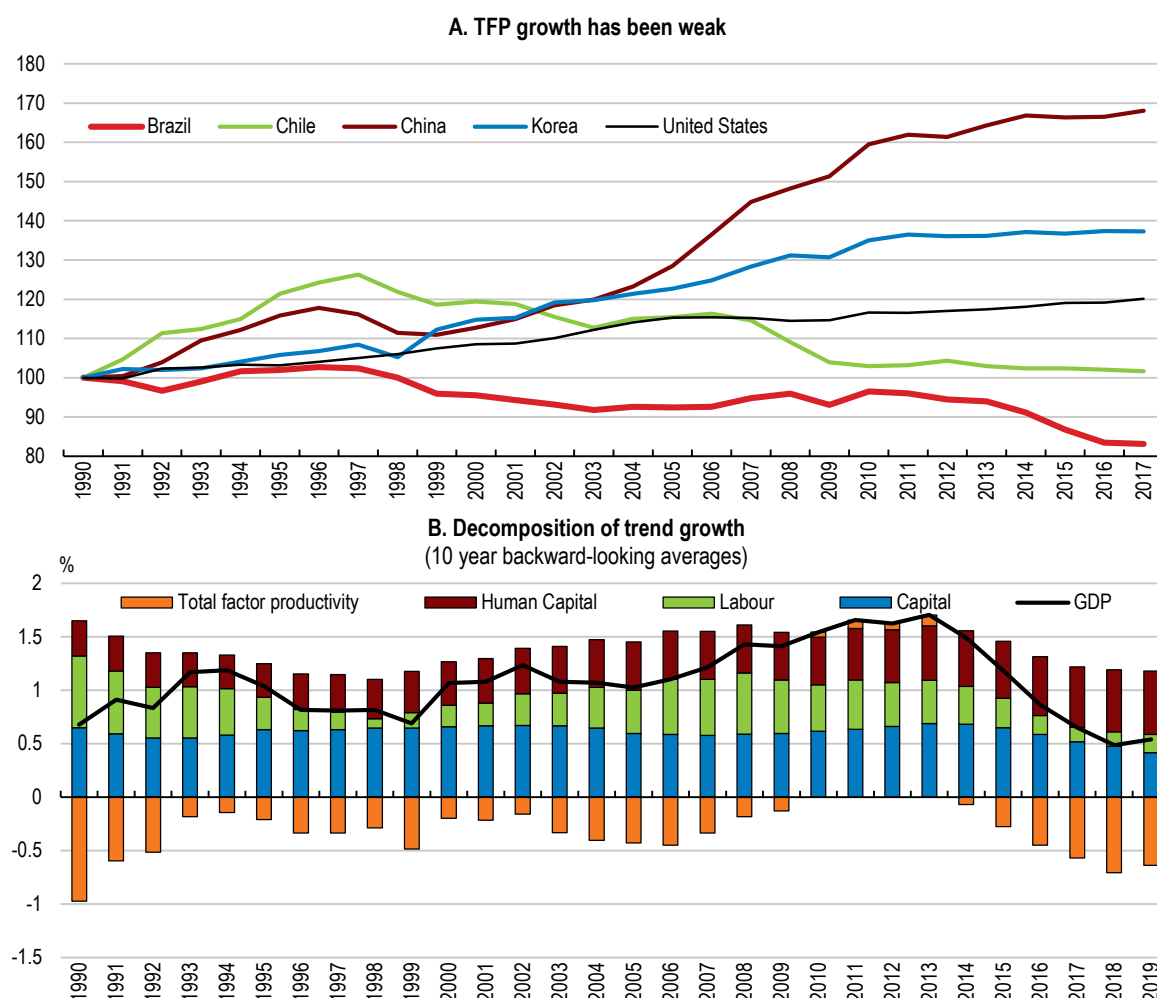
Productivity is the principal source of long-run growth in most economies and provides the basis for better material living standards, reductions in poverty and inequality and improvements in well-being. However, in Brazil it has been declining slowly since 1990 and its contribution to growth has been negative, except for a few single years (Figure 1). Instead, growth has largely been the result of the accumulation of the factor labour, resulting from demographic changes, rising labour participation and improvements in human capital, and to a lesser extent of capital investment, which has declined since 2011.

This pattern contrasts with the experience of other countries, especially emerging market economies. In China and India, for example, the capital stock and TFP have been the main contributors to growth, while other Latin American countries share Brazil's weak productivity growth (Dutz, 2018^[1]).

Looking ahead beyond the deep recession caused by the COVID-19 pandemic, growth and improvements in material living standards will hinge on policy reforms that can raise productivity, as changing demographic developments will no longer support the economy as in the past. In fact, as less and less young people join the labour force, the population as a whole will age rapidly and demographics will soon turn into a drag on growth (OECD, 2020^[2]).

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Figure 1. Total factor productivity is contributing less and less to potential growth

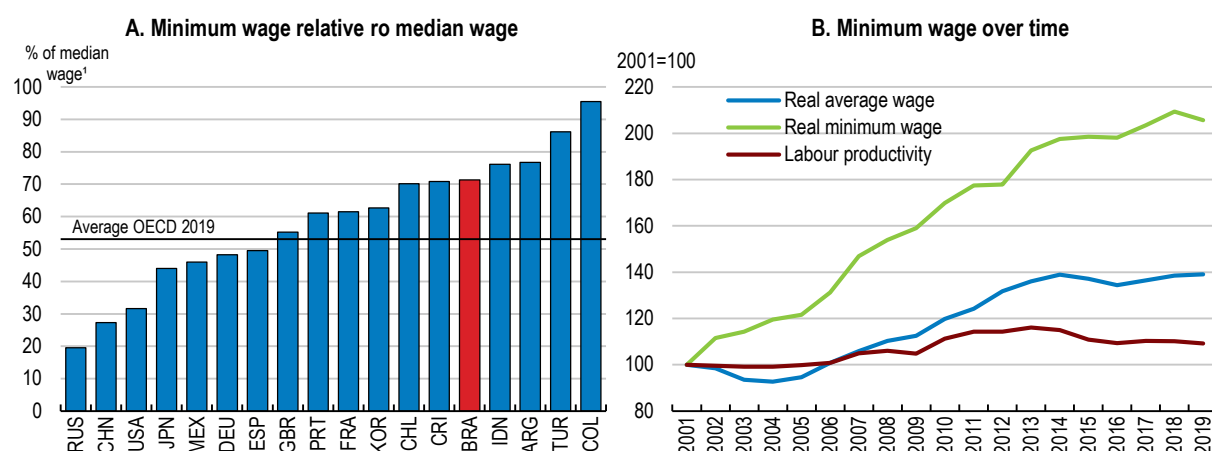


Source: Penn World tables, OECD calculations.

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Productivity growth will also need to become the basis for sustainable improvements in wages and living standards. Wages, and especially minimum wages, have increased strongly over the last 20 years. While this has contributed to falling income inequality for some time, wages are now fairly high relative to median wages compared to other countries (Figure 2). In fact, 55% of Brazilians currently have incomes below the minimum wage (OECD calculations based on PNAD 2019 Household Survey). Without productivity improvements, there is a risk that future increases in minimum wages could drive workers out of the labour market or into informal contracts, particularly those with low skills. Against this sobering background, this paper will look into the causes of slow productivity growth in the past and analyse the scope for structural policy reforms to achieve stronger productivity advances in the future.

Figure 2. Minimum wages are high



Note: Exactly half of all workers have wages either below or above the median wage for the OECD countries. Data refer to 2018, except for China, Indonesia and the Russian Federation, where they reflect percentage of minimum to average wage 2017.

Source: OECD database LFS - Minimum relative to median wages of full-time workers, IBGE, INDEC.

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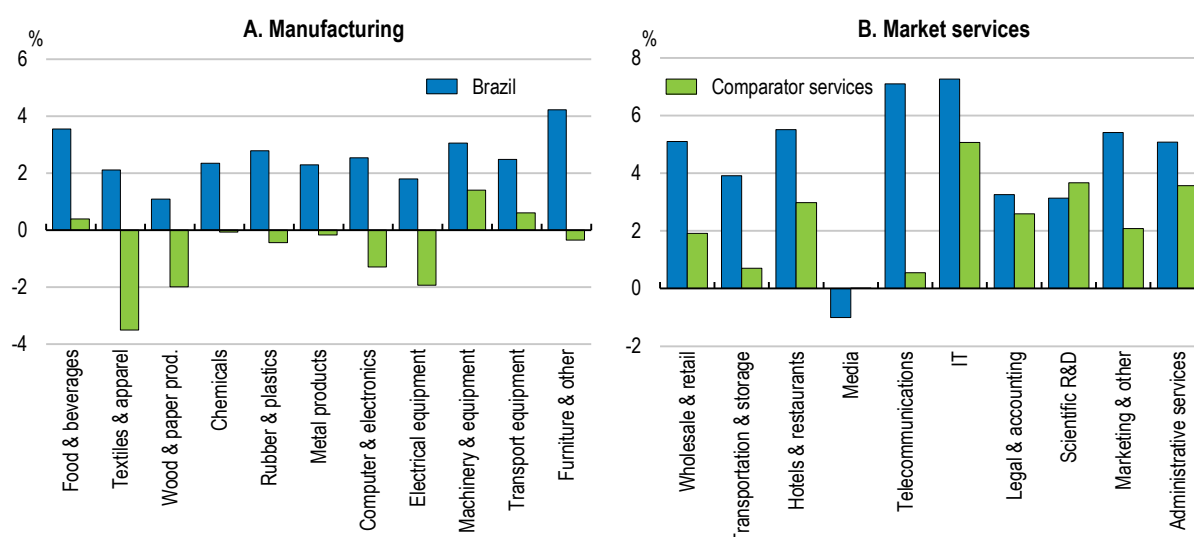
Possible sources of low productivity growth

There are several explanations for the weak productivity performance of the economy. One string of explanations is related to how the overall factor resources of the economy, capital and labour, are distributed across sectors and firms. The allocation of factors has been highlighted as an important part of the explanation behind differences in productivity performance across countries (Hsieh and Klenow, 2009^[3]). A second string of explanations are barriers to productivity enhancements at the level of individual firms, which could potentially affect many firms in similar ways.

Resource allocation at the level of broad sectors is not able to explain much of Brazil's weak productivity growth. A number of empirical studies looked into this question recently, in part motivated by policy discussions about a possible declining role of the manufacturing sector and its potential implications for productivity (Álvarez et al., 2019^[4]; Dutz, 2018^[1]; Veloso et al., 2017^[5]; Bacha and de Bolle, 2013^[6]). However, since the 1990s, the main pattern of movements of labour across broad sectors was from agriculture to services sectors, which had a mild positive effect on aggregate productivity. Most of Brazil's manufacturing sectors actually continued to attract labour through the period 1998-2015, although less so than services sectors (Figure 3). This contrasts with the experience of other advanced and emerging economies that lost manufacturing employment as China and other Asian economies emerged as major manufacturing producers (Autor, Dorn and Hanson, 2016^[7]).

Figure 3. Job creation has been strong in services, but also in manufacturing sectors

Average net job creation rate over the period of 1998-2015 by economic sector (in %)



Note: The net job creation rate is defined as the number of jobs created minus the number of jobs destroyed in year t divided by the average stock of employment stock. The figures show the average of the years 1998-2015 by sector. Comparator countries include Belgium, Costa Rica, Finland, France, Hungary, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Turkey.

Source: OECD Dyemp3 database.

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The empirical evidence generated by this discussion overwhelmingly suggests that low productivity is not the result of how factors are allocated across sectors, or the activities that Brazil specialises in. Simulation experiments suggest that the productivity gains potentially obtained by raising productivity of individual sectors to those of advanced economies would far outweigh productivity gains that could result from optimising Brazil's industry structure (Veloso et al., 2017^[5]). Weak productivity is a feature of most sectors, with the notable exception of agriculture (Dutz, 2018^[1]). It is also a pattern that Brazil shares with several Latin American economies (Álvarez et al., 2019^[4]). This implies that there is no strong case for policies favouring the expansion of one sector over another as Brazil's productivity problem cannot be solved by simply changing specialisation patterns.

Resource allocation may still play a role for explaining the productivity slump, but within rather than across broad sectors. Within sectors, factor movements including entry, exit or the growth of strong performers at the expenses of weaker firms, are an essential element of aggregate productivity growth (Hopenhayn, 1992; Melitz, 2003; Aghion et al., 2005). In advanced economies, these reallocations can often account for a larger share of productivity growth than developments within individual firms (Olley and Pakes, 1996; Foster et al., 2001; Bartelsman et al., 2008; Andrews and Cingano, 2014).

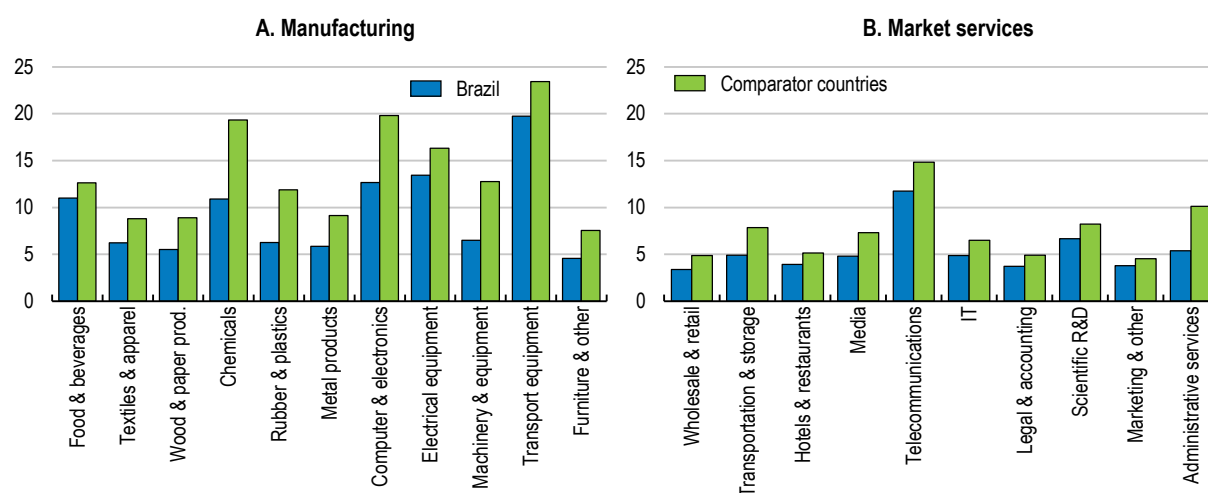
In Brazil, however, these reallocation mechanisms do not seem to work well (SPE, 2020^[8]). Productivity levels differ widely across firms within the same sector, and these differences are persistent. Empirical evidence on this exists for both manufacturing and services sectors (Vasconcelos, 2017^[9]; De Vries, 2014^[10]; Busso, Madrigal and Pagés, 2013^[11]). It is often the less productive firms within a sector that enjoy large market shares (Gomes and Ribeiro, 2015^[12]; OECD, 2015^[13]). This suggests scope for improving productivity levels by reallocating resources from less productive firms to more productive ones. With respect to productivity growth, the empirical evidence also points to the within-sector component as the principal explanation, with evidence that less productive firms have been able to grow at the expense of

more productive ones, at least among large firms (Dutz, 2018^[1]). Many countries that experienced growth spurts, particularly in Asia, have indeed seen sizeable within-sector reallocations (McMillan and Rodrik, 2011^[14]).

Entry and exit play a key role for within-sector resource allocations. Compared to other economies, Brazilian market entrants are on average smaller than in other economies (Figure 4). In fact, Brazil has considerably less entry of medium and large firms than other countries (Dutz, 2018^[1]). This in turn reduces the pressure for the exit of less productive firms, which is essential for releasing the resources that allow more successful firms to grow to an efficient scale (Andrews et al, 2017). Indeed, many sectors are characterised by low firm exit and dominated by firms that are at the same time large and old (Maciente, Silva and Gukovas, 2015^[15]). The dispersion of firm productivity shows a fat lower tail of less productive firms, suggesting that inefficient firms are not driven out of the market, as they are in other countries with significantly less low-productivity firms (Barbosa Filho and Correa, 2017^[16]).

Figure 4. New market entrants are relatively small

Average number of employees of market entrants by sector



Note: Comparator countries include Belgium, Costa Rica, Finland, France, Hungary, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Turkey. Data relate to 1998-2015.

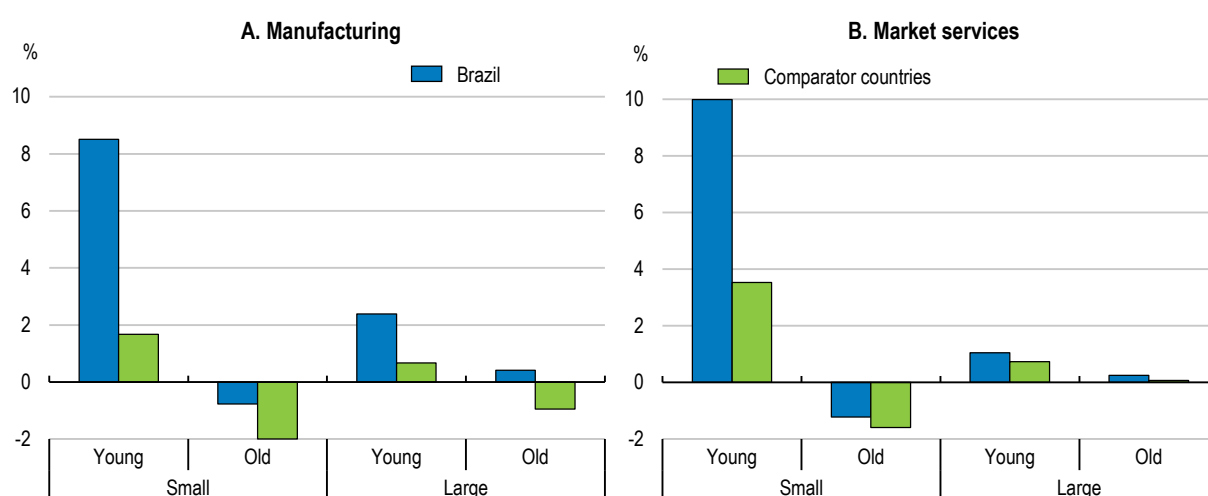
Source: OECD DynEmp v.3 database.

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The limited role of new market entrants contrasts with their potential contribution to productivity growth. In many countries, firms that are relatively younger and smaller contribute disproportionately to productivity growth (De Negri and Ferreira, 2015, Criscuolo et al., 2014). In Brazil, entry also plays a key role for job creation, as young firms are the main source of newly created jobs (Figure 5). At the same time, the number of jobs in older firms tends to decline on balance in benchmark countries, which is consistent with exit and the renewal of industry structures. In Brazil, this mechanism is significantly less visible, particularly in the manufacturing sector.

Figure 5. Net job creation is concentrated among firms aged less than 6 years

Contribution of net job creation to aggregate employment change by age- and size-class



Note: Comparator countries include Belgium, Costa Rica, Finland, France, Hungary, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Turkey. The Figure reports the contribution of net job creation to aggregate employment change by size (with a cut-off at ≥ 250 employees) and age (with a cut-off at ≥ 6 years) for manufacturing and non-financial market services. It is defined as net job creation (i.e., the difference of total employment at time t and $t-1$) of the particular group over total employment in the macro-sector on average over the period 2000-2008. Source: OECD DynEmp v.3 database.

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How can policies help to strengthen productivity growth?

The relatively weak functioning of the essential mechanisms of creative destruction presents significant challenges for economic policies and calls for wide-ranging reforms. Low levels of competition imply that incumbents are not driven out of the market by high-performing entrants as they would in economies where competition is stronger. This reduces market discipline and the incentives to perform better to survive, including incentives for productivity-enhancing investment and innovation. Instead, low competition tends to foster rigid industry structures, perpetuating resource misallocation.

Impediments to competition can be related to two kinds of policies. For one, Brazil's stringent domestic regulations and administrative burdens create explicit or implicit barriers to entry, or confer advantages to incumbents relative to entrants (Dutz, 2018^[1]). Direct interventions such as directed lending can reinforce this, and rising allocative distortions have been linked with an expansion of directed lending in Brazil (Calice, Ribeiro and Byskov, 2018^[17]). Regulations and taxes can also act to fragment the domestic market by obstructing inter-state commerce, thus curtailing local competition. Second, large parts of the economy remain shielded from external competition through high trade barriers. Lowering trade barriers has significant potential to trigger productivity-enhancing reallocations, as documented for example for the case of Chile (Pavcnik, 2002^[18]).

Besides a lack of competition, there are also policy factors that influence productivity directly. The by now infamous "Brazil cost" which refers to the fact that many aspects of doing business are simply more expensive, raises costs without raising production. For example, complying with a cumbersome tax system or infrastructure bottlenecks generate dead-weight losses as they absorb resources that could be used more productively elsewhere. This puts Brazilian producers at a competitive disadvantage vis-à-vis foreign competitors. A similar effect occurs when firms have to source inputs from sectors characterised by low

levels of competition and economic rents. Excessive costs of enforcing contracts, or long delays and high judicial uncertainty, also put Brazilian producers at a disadvantage. Well-functioning judicial systems are an essential ingredient of a good business climate.

These links between different policy areas underline the role of appropriate sequencing for the success of reforms. Reallocation of production factors to more productive firms and sectors, triggered by reforms, often combines long-term benefits with significant adjustment costs, particularly when distortions in product and factor markets are high (OECD, 2012^[19]; Autor, Dorn and Hanson, 2013^[20]). For example, labour market rigidities are one reason why many displaced manufacturing workers have struggled to find new formal sector jobs in other firms, sectors or regions (Erten, Leight and Tregenna, 2019^[21]). By contrast, adjustment costs can be significantly reduced by policies that facilitate the mobility of labour and capital across firms, sectors and regions (OECD, 2012^[19]; OECD, 2005^[22]). Improvements in education and professional training play a particularly important role to facilitate job transitions of workers. This important issue will be discussed in a companion paper (Grundke et al., 2021^[23]).

Recent reform progress in many areas provides a better starting point for further reforms (OECD, 2020^[2]). Delays involved in establishing a company have fallen. There have been tariff reductions and some restrictions on foreign entry have been lifted. Financial market structures are improving following a reduction of interest subsidies. An ambitious tax reform is currently being discussed in Congress. The introduction of precedence-based court rulings (see below) has laid the grounds for further improvements in judicial efficiency.

Enhancing domestic competition through reforms on product markets

Product market regulations, like any kind of regulations, may drift away from their original public interest aims and hamper competition. This can influence the productivity of existing firms by altering the incentives to grow, innovate and adopt modern technologies. They can do so by reducing rivalry among incumbents and hampering the entry of new firms. In addition, regulations and administrative burdens sometimes involve compliance costs that exceed their expected benefits or they may become obsolete as technological progress reduces the need for public intervention in the first place. Against this background, a long-standing literature, including contributions by the OECD, has documented that the pace and depth of product market reforms – and in particular reforms in those aspects of regulations that matter for firm dynamics and resource reallocation – are important for understanding differences in productivity performance. This has direct effects on standards of living, as estimates suggest that the additional job creation and the lower consumer prices resulting from more competition on domestic markets could lift as many as 9 million Brazilians out of poverty (Dutz, 2018^[1]).

Brazil's regulatory requirements on product markets have long been significantly more cumbersome and restrictive than in OECD countries, and lack transparency and simplicity. The 2018 OECD Product Market Regulation (PMR) indicators measure regulatory barriers to firm entry and competition in a broad range of key economic sectors and policy areas by benchmarking a country's regulatory set-ups against internationally accepted best practices (Figure 6). Brazil stands out as one of the most restrictively regulated economies when the overall indicator is considered, but also in both its main sub-components: barriers to domestic and foreign entry and distortions induced by state involvement. The widely used Doing Business indicators confirm the picture drawn by the PMR indicators, Brazil ranks 124 out of 190 economies surveyed (World Bank, 2020^[24]).

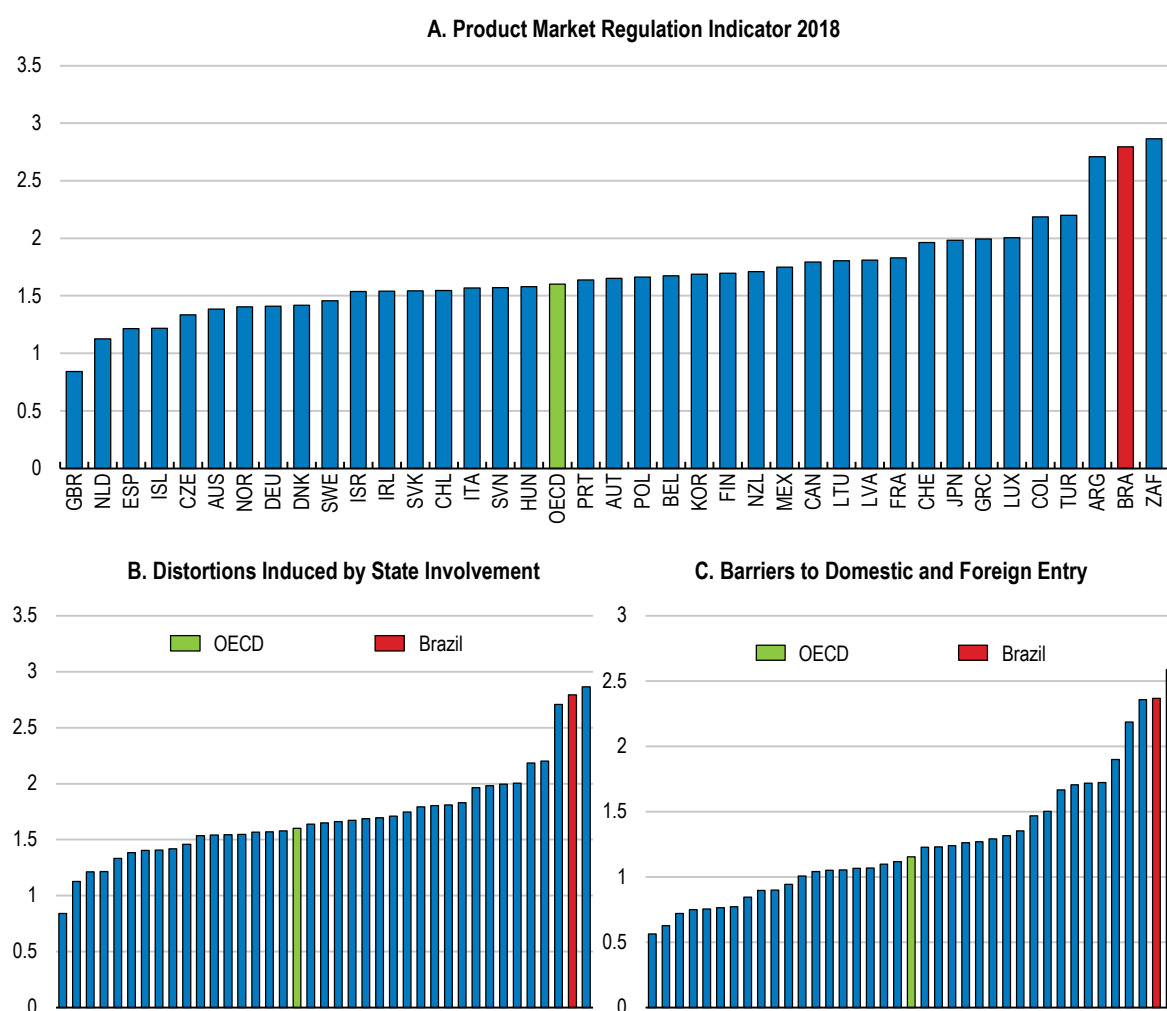
Regulatory barriers to firm entry reduce competitive pressure

The OECD PMR indicators measuring barriers to domestic and foreign entry show that Brazil's policy settings are close to or even weaker than the average of the 5 least competition-friendly OECD countries

on several of the detailed sub-indicators (Figure 7). High administrative burdens on start-ups reduce the likelihood of market incumbents being challenged by new entrants, which is a crucial component of competitive pressures.

Opening a business in Brazil has traditionally required approval from local authorities and interactions with four different public entities, both for the cases of personally-owned enterprises and limited liability companies. Significant recent progress, however, has brought Brazil closer to the current best practice among OECD countries to eliminate the approval requirement for all but a few high-risk activities. Opening a business is now automatic and done within a day for low-risk activities, which cover around 96% of applications. Local authorities will need to adjust their own rules to comply with these simplifications and implementing regulations for this are currently being rolled out. Moreover, a 2019 law has enhanced the scope for applying silence-is-consent rules. Efforts are underway to apply silence-is-consent rules wherever possible and establish one-stop-shops for the remaining requirements. Progress has been made in the digitalisation of government procedures. Over 1000 government services across all areas can now be delivered online, an increase of 100% since early 2019.

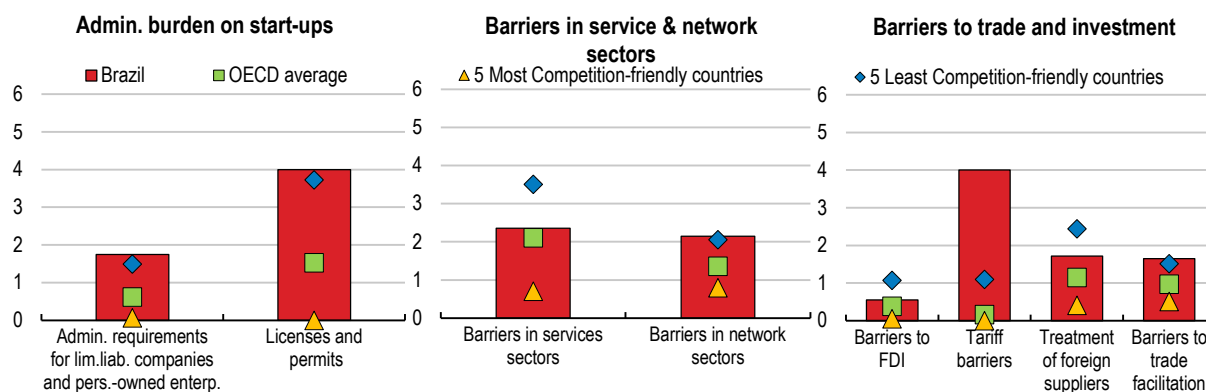
Figure 6. Regulatory barriers to competition and entrepreneurship are high



Source: OECD Product Market Regulation Indicators, 2018, available at <http://oe.cd/pmr>

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Figure 7. Product markets have high barriers to domestic and foreign entry



Note: Averages include only OECD countries. Information refers to laws and regulation in force on 1 January 2018.

Source: OECD Product Market Indicators 2018.

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Sector-specific rules, however, are often more restrictive. Professional associations can restrict the scope for new entry and provide an easy forum for price collusion, which is sometimes reflected in outright minimum charges. Engineers, lawyers and other professionals have to be part of the respective professional association in Brazil, for example, which limits the ease of market access for foreign professionals through lengthy accreditation procedures and determines the list of tasks that can only be performed by members of the association. The latter is a task that other countries delegate to more independent bodies (Reis et al., 2018^[25]). Brazil still reserves exclusive rights for certain ancillary tasks to legal, accounting or architectural firms, although these tasks could also be performed by other professionals.

One factor that can delay licensing procedures is that public sector managers can be held personally liable for their decisions. In fact, officials have much to lose if ex-post a judge takes a different view on the impact of a specific license than the official had at the time of granting it. As a result, public officials tend to be overcautious and try to back up any decision with long legal analyses. Limiting the possibilities to take public officials to court over their decisions to cases of abuse or bad faith would have significant potential to speed up licensing procedures.

In contrast to other countries, Brazil's national government does not keep a complete count of the number of permits and licences required. This makes it hard to keep control over excessive burdens imposed by lower-level governments that may not always have an eye for competition. Recent efforts to take stock of the complexity of current regulations have led to a review of over 3700 pieces of legislation, of which 3300 were revoked in February 2020. These efforts should continue with a view towards identifying further scope for easing and simplification. The OECD's Competition Assessment Toolkit (OECD, 2017^[26]) can provide guidance not only for identifying but also for revising policies that unduly restrict competition (Box 1). It has already been used in Greece, Mexico, Portugal, Romania, Tunisia and Asean countries.

Recent progress has also been made in a few specific areas. Natural gas, for example, has long been a monopoly market dominated by the state oil company Petrobras. It is now being opened to competition, including regulation on the access of essential distribution infrastructures and a divestiture of Petrobras' participation in distribution companies. Given current price differentials of up to 40-50% relative to US prices, competition in natural gas has substantial scope for providing cheaper inputs to many activities. More recently, the requirement for insurance agents to pass an entry exam into a centralised register was lifted and has potential to reduce high commissions (Valor Econômico, 2020^[27]).

Box 1. The OECD Competition Assessment Reviews for Greece

Similar to Brazil today, Greece used to have many regulations that effectively hampered competition, but careful competition analysis allowed identifying many of these and produced concrete recommendations. A first assessment in 2013 looked at tourism, retail trade, food processing and construction materials. The review identified 555 problematic regulations and 329 provisions where changes could be made to foster competition. The OECD has estimated that implementing about 60 of these recommendations (those for which quantification was possible) would generate benefits of about 2.5% of GDP in the form of lower prices, higher expenditure and turnover. A second competition assessment in 2014 identified competition-distorting rules and regulations in beverages, textiles, clothing apparel and leather, machinery and equipment, coke and refined petroleum products. The review made 88 recommendations on specific legal provisions. A final review in 2016 covered pharmaceuticals, chemicals, rubber products, paper and paper products, printing as well as construction, media, wholesale trade and e-commerce, leading to the identification of 577 potential restrictions to competition and 356 recommendations.

Source: OECD Competition Assessment Reviews: Greece, available at <http://www.oecd.org/daf/competition/greece-competition-assessment-reviews.htm>

A new competition law passed in 2011 led to an overhaul in Brazil's competition regime, which implied a significant improvement for Brazil's competition law and policy, according to the OECD Peer Review of Competition Law and Policy for Brazil (OECD, 2019^[28]). The consolidation of competition surveillance in a single autonomous competition agency (CADE) that is equipped with strong powers and enforcement tools effectively modernised antitrust enforcement in Brazil, including the introduction of a pre-merger notification system. Further improvements could be obtained by giving higher priority to abuse of dominance investigations, of which there have been few (OECD, 2019^[28]) and reviewing the settlement regime and clarifying the methodology for calculating fines.

State interventions

The second pillar of the OECD Product Market Regulation indicators relates to distortions induced by state interventions, including market interventions such as price regulations, the complexity of rules and as the efforts undertaken to limit this complexity, public procurement and public ownership (Figure 8).

More or less explicit price floors established by professional associations or by law exist in several sectors, including legal, notary, architect, engineer services, long-distance coach transport and some non-prescription medicines. As recently as 2018, price floors were also established for road freight services following a transport strike. These anticompetitive practices are far from international best practice and should be swiftly prohibited. Wide parts of the economy including the tradable sector stand to gain from more competition in upstream non-manufacturing sectors, as access to cost-effective and innovative services inputs can play an important role for productivity in downstream sectors (Arnold, Javorcik and Mattoo, 2011^[29]; Arnold et al., 2016^[30]).

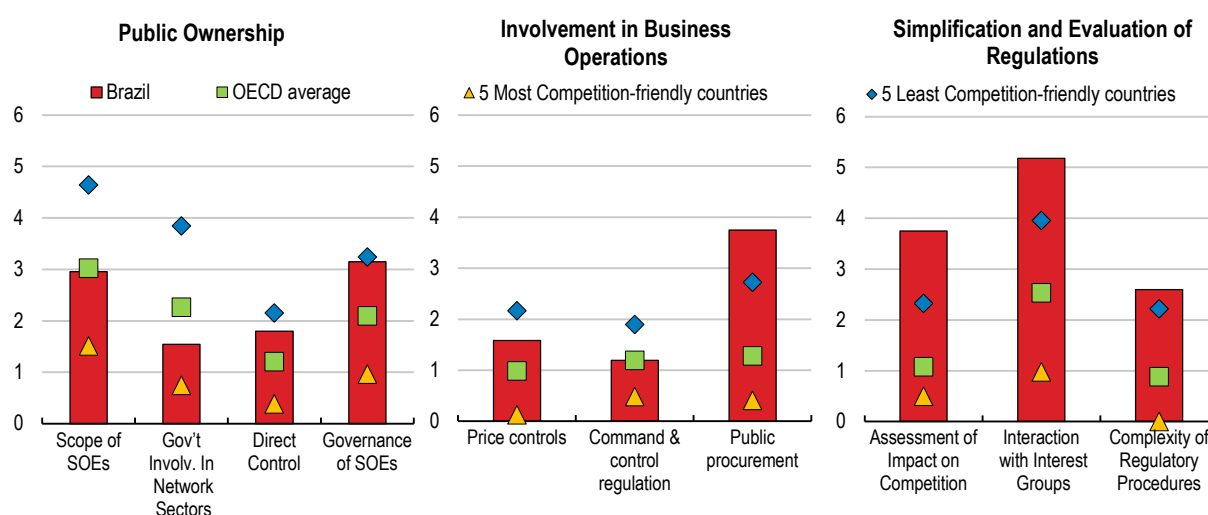
Another challenge relates to containing the complexity of rules and regulatory procedures. A 2020 presidential decree explicitly defines, for the first time, cases of new regulations that require an ex-ante regulatory impact analysis in cases of new regulations with potential economic impacts, including on competition. Such assessments have made systematic inroads in other countries' regulatory procedures. But there is still room for further progress. Regulatory impact assessments can only lead to non-binding recommendations in Brazil, whereas other countries often require a systematic follow-up in such cases. In addition, systematic use of ex-post evaluation to assess whether regulations achieve their objectives is

mostly unexplored in Brazil. Some countries like the UK and the US have combined the requirement of conducting regulatory impact assessments with the application of one-in, two-out rules, where further regulations can only be introduced by alleviating the cost of compliance with other regulations.

Moreover, Brazil has no legal framework for the legitimate interaction between public officials and interest groups in the regulatory process, nor is there a mandatory public register of interest groups, which can help to enhance transparency. Some countries also enhance transparency by requiring disclosure of the interest groups that have been consulted, or by mandating the publication of the meeting agenda of key officials. None of these practices are applied in Brazil, although a code of conduct for interest groups is currently being prepared. While Brazil follows best practice by having established specific conflict of interest regulation for cabinet members, political advisors and senior civil servants, it has yet to extend this framework to members of legislative bodies.

Public procurement has seen improvements. A newly created electronic repository of public procurement purchases can serve for price comparisons, and will be converted into a centralised public purchasing body, with the possibility to register online for bidding in many public tenders. For foreign bidders, the requirement of having a legal representative in Brazil and the need for certified translations of foreign-language documents have been abolished. Brazil is also in the process of joining the WTO Government Procurement Agreement. These efforts should be continued with a view towards systematically publishing all tender documents and receiving bids online at all levels of government, and abandoning the current practice of providing a reference price in the tender documentation for goods and services or for public works. Improvements in this area are not only relevant for strengthening competition, but also for reducing the scope for corruption and collusion in public procurement. Recent years have shed light on many corruption and collusion cases in the context of procurement by state-owned enterprises, with overcharging and kick-backs to politicians partly made possible by the lack of transparency and competition in the procurement process, including renegotiations after the initial bidding process (Campos et al., 2019^[31]).

Figure 8. Distortions induced by state involvement are high



Note: Averages include only OECD countries. Information refers to laws and regulation in force on 1 January 2018.

Source: OECD Product Market Indicators 2018.

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In the area of public ownership, Brazil scores about average with respect to the scope of state-owned enterprises (SOEs), but displays significant weaknesses with respect to SOE governance. Improvements in this area could enhance the efficiency of state-owned enterprises and level the playing field between

privately and publicly owned firms. Progress has been made in the transparency of procurement by SOEs, which are now required to publish all procurement processes on their respective website.

Brazil has 133 directly and indirectly owned SOEs across a wide range of activities, with a total net worth of 9.5% of GDP and almost half a million employees. This is about lower mid-range when compared to OECD economies, some of which maintain sizeable SOE sectors (OECD, 2018^[32]). Twenty-two of Brazil's SOEs have negative net worth, including several member firms of the Eletrobras Group, a utility company. Taken together, the sector's financial performance has improved from a deficit of almost 0.5% of GDP in 2015 to a surplus of 1% of GDP, although this improvement includes asset sales. A 2016 SOE law was a first step to harmonise and improve governance. For example, the law set minimum qualifications for SOE managers, which limited the scope for appointments made purely on political grounds.

More recently, the authorities have announced a privatisation package. During 2019, some subsidiaries of SOEs were privatised and BNDESPar, the private equity arm of the national development bank BNDES, reduced its participation in several companies. Further privatisations of smaller SOEs are planned, but the political consensus for privatising key public enterprises such as large public banks, which would require congressional approval, appears limited.

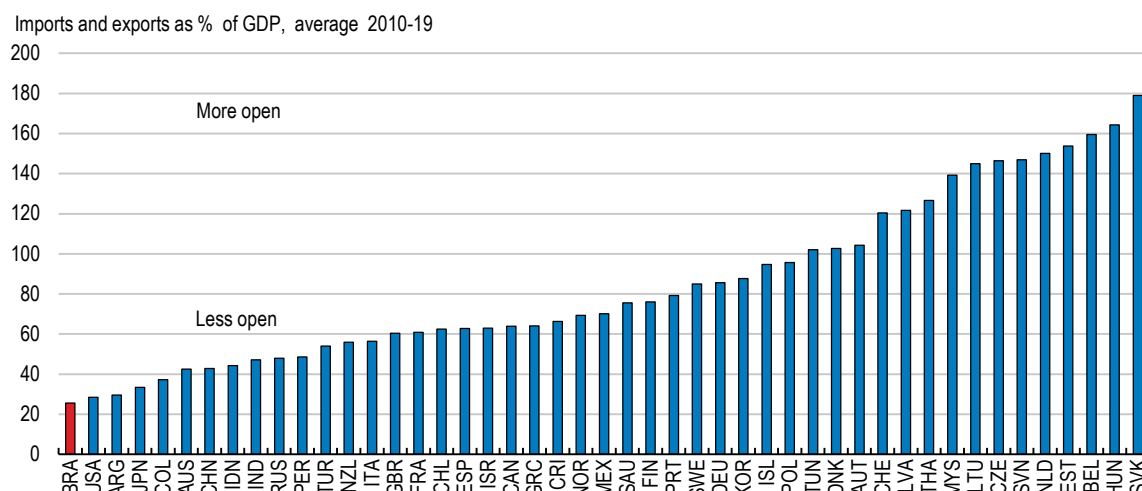
While privatisations generate one-off revenues that can help improve fiscal accounts, the cost-benefit analysis applied to each potential privatisation case should look beyond these short-term effects and instead strive for finding the most effective arrangement to improve governance and raise efficiency. Public sector operation may have disadvantages in some cases as Brazil's public enterprises are bound by stringent budget rules and lack the flexibility to adapt to changing market conditions that private companies could have. Moreover, while the scope for political appointments has been reduced by the new SOE law, management quality and governance is likely still weaker than in the private sector. At the state level, political parties have maintained strong influence over local SOEs. For those companies likely to remain under public ownership, the OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015^[33]) can be a powerful tool to address governance challenges usually faced by state-owned enterprises.

Enhancing foreign competition by fostering the trade integration

Strengthening competitive pressures from abroad provides a powerful way to raise competition. With exports and imports below 30% of GDP, the economy is significantly less integrated into international trade than other emerging market economies of similar size (Figure 9). Brazilian companies have also shown only scant participation in global value chains, where Brazil's only discernible link is with neighbouring Argentina (Criscuolo and Timmis, 2018^[34]). In Latin America, Mexico, Chile and Costa Rica exemplify how trade and the integration in global value chains can contribute to economic growth (OECD, 2017^[35]).

External competition is hampered by trade barriers of various forms. Average tariff levels weighted by imports are almost twice as high as in neighbouring Colombia and more than 8 times higher than in Mexico or Chile (Figure 10). Brazil's most frequently applied tariff rate is 14%, while around 450 tariff lines are at the maximum of 35%, including textiles, apparel and leather and motor vehicles. Brazil is the country with the highest number of tariff lines above 10%. In addition to tariffs, various forms of non-tariff barriers including local content requirements are adding to the protection of domestic producers and model simulations suggest that they are at the root of significant reductions in imports and exports (Stone, Messent and Flaig, 2015^[36]).

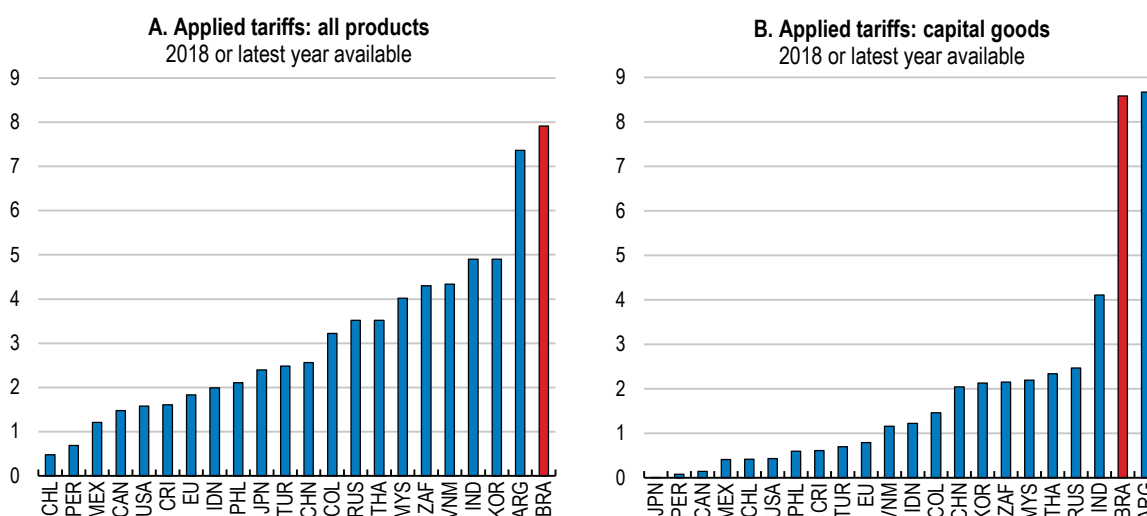
Figure 9. The economy has little exposure to foreign trade



Source: OECD Economic Outlook database.

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Figure 10. Tariff barriers are high, including for capital goods



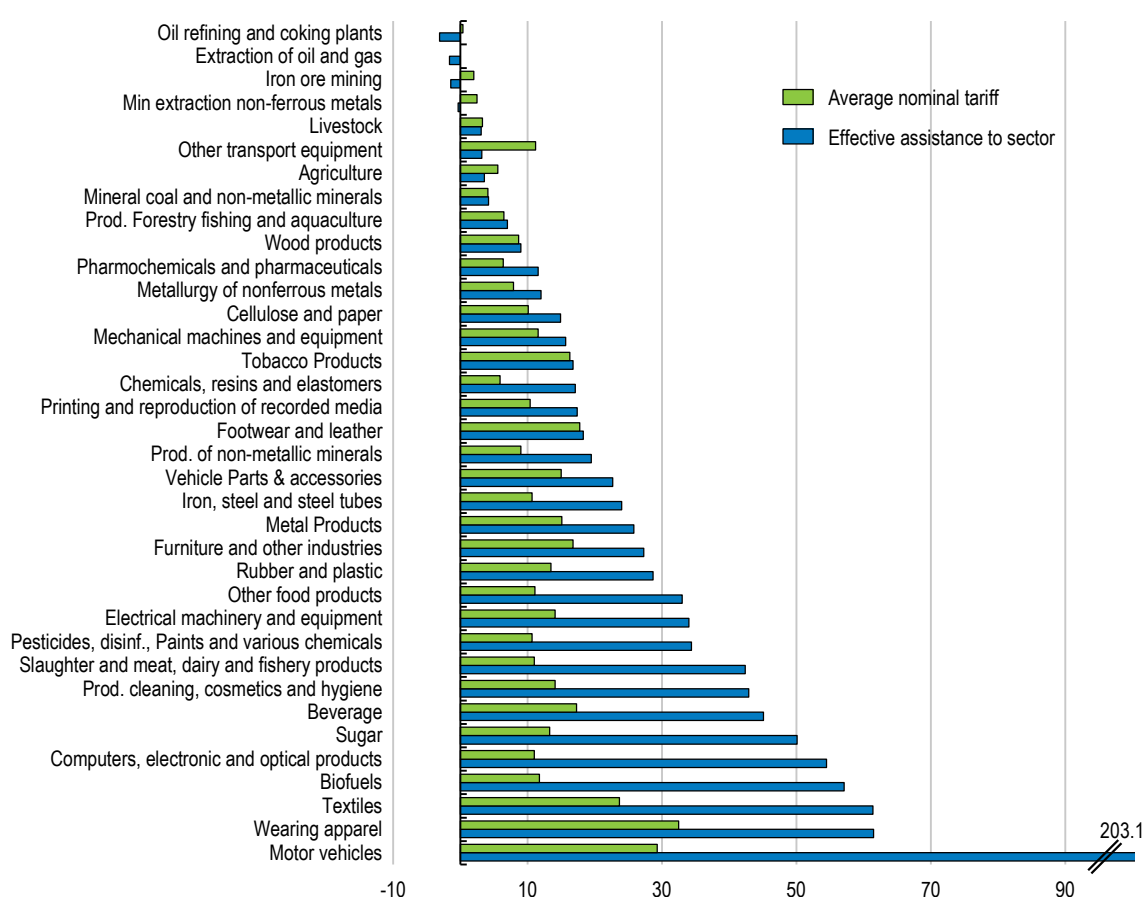
Source: World Integrated Trade Solution database (WITS).

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These trade barriers imply that many sectors are cushioned from the forces of external competition, and opening up would probably be the most effective way to boost competition. The high trade barriers preclude Brazil from many of the benefits of an increasingly integrated global economy. Both consumers and companies purchasing intermediate or capital goods are paying markedly higher prices than in other countries. Trade barriers on capital goods tend to be even higher than average tariffs and Brazilian firms use the least of imported inputs among Latin American and emerging market economies, which contributes to low productivity at the firm level (Brambilla, Depetris Chauvin and Porto, 2017^[37]). Reducing import barriers would also support Brazil's export performance which has declined by almost 25% over the past 15 years, while Mexico's export performance has increased by 25%.

Protection also has distributional consequences, as it transfers significant resources from consumers to domestic producers. Estimates of effective assistance suggest protection levels above 20% for 17 sectors, peaking above 200% in the case of the automobile sector (Figure 11). Effective protection levels estimate the amount of resources that society transfers to a given sector as a result of the wedge between domestic and world prices.

Figure 11. Many sectors are enjoying high levels of protection



Note: Effective protection measures final goods tariffs net of input tariffs, relative to the hypothetical sector value added without protection.

Source: Oliveira et al. (2018).

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Stronger integration would boost competition, productivity and lower consumer prices

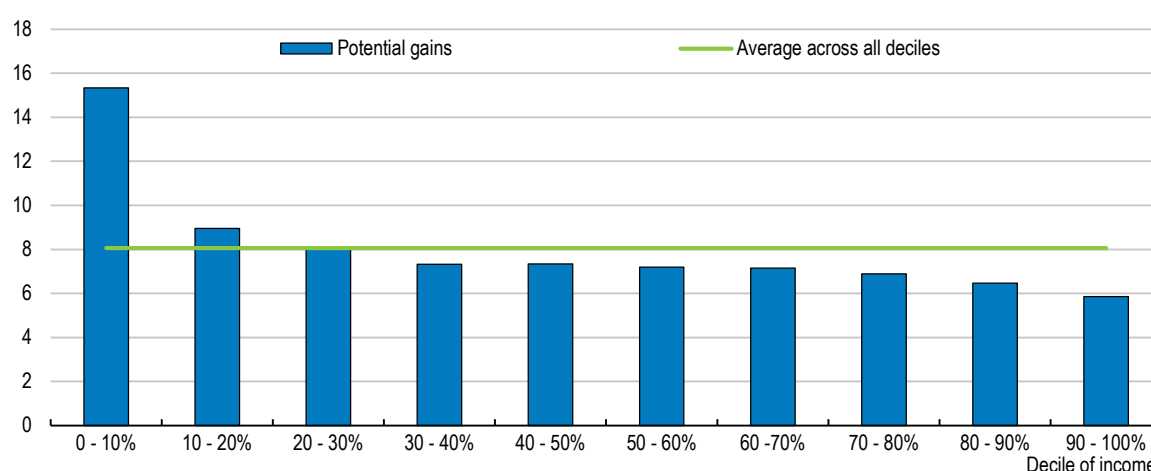
The most evident and immediate effects of lower trade barriers would be falling import prices for consumers and firms in downstream sectors. Partial equilibrium estimates suggest that Brazilian consumers could see their purchasing power increase by 8% without tariff barriers (Figure 12). Moreover, these benefits are highly progressive as lower income households spend larger shares of their incomes on tradable goods such as food, home appliances, furniture and clothing. A detailed analysis of reducing trade protection, taking into account differences in the consumption basket across households, suggests that the lowest-income decile could gain as much as 15% in terms of additional purchasing power, compared to 6% for the top decile (OECD, 2018^[38]). Lower prices from trade could lift as many as 6 million Brazilians out of

poverty (Dutz, 2018^[11]). Lowering tariffs would not result in significant tax losses as they currently amount to around 0.5% of GDP and the productivity effects of better integration would likely lead to an expansion of activity and additional tax revenues.

Firms would simultaneously gain improved access to intermediate and capital inputs, and they would be more exposed to external competition. This would induce them to upgrade products and processes and reduce slack and economic rents. Just like in the case of stronger domestic competition, it would also allow high-performing firms to grow on the expense of less productive ones. This reallocation process towards stronger sectors or firms would allow new and better-paying jobs to be created there, raising aggregate productivity (Criscuolo, Gal and Menon, 2014^[39]).

Figure 12. The potential consumer benefits from lower trade barriers are highly progressive

Potential gains in purchasing power by deciles of income distribution (in %)



Source: OECD Economic Survey of Brazil 2018, Chapter 2 (OECD, 2018^[38]).

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A stronger integration into the global economy would bring sizeable benefits that are widely spread across the population. Firms that seize newly arising export opportunities will expand and hire new workers. As Brazilian exporters pay 51% higher wages than non-exporters and employ more formal labour, these jobs are likely to be of higher quality (Brambilla, Depetris Chauvin and Porto, 2017^[37]). Evidence also suggests that previous reductions in trade protection were associated with an increase in female employment (Gaddis and Pieters, 2012^[40]). This is in line with international evidence suggesting that women benefit particularly from job opportunities arising in the context of stronger integration (UNCTAD, 2009^[41]).

However, embracing international trade is likely to generate transition costs, for which policies should prepare. For some workers, job reallocations will involve the need to search for a new job, and temporary income losses. There may also be temporary employment losses in specific sectors and regions. This is a significant challenge, but accompanying policies such as professional training and vocational education can go a long way to mitigate the transition costs and lead to substantially better outcomes for all.

Policy options for strengthening integration

Defining a concrete policy agenda for integration requires thinking about the right sequencing and the role of international trade negotiations. On the former, it is tempting to argue that domestic policy reforms to strengthen the competitiveness of Brazilian companies should precede stronger integration. Despite ample

scope for improvements, in practice this argument is likely to block any progress in the nearer term. Given the low growth prospects in the absence of structural reforms, Brazil cannot afford to hold its breath for a political consensus to arise on all domestic reform agendas.

Integration can combine a variety of instruments, including bilateral negotiations and unilateral action. Brazil is a member of the MERCOSUL customs union, which has helped to strengthen trade linkages with other members of the trade bloc, in particular Argentina. At the same time, Mercosul's common external tariffs, for which a reform is currently being negotiated among MERCOSUL members, remain high. Beyond Mercosul members, the exchange of goods and services with the rest of the region is weak (IMF, 2017^[42]). Regional integration could be supported by negotiations with the Pacific Alliance or Mexico, although for integration within South America, improvements in infrastructure could even have stronger effects than reducing already relatively low trade barriers. A significant boost in competition and access to intermediate goods, however, is more likely to result from tighter integration with large foreign markets. The most immediate effect could come from the implementation of the recently negotiated trade agreement between Mercosul and the European Union/EFTA, the conclusion of which was an important achievement. But other agreements with large advanced markets would also help. At present, Brazil has bilateral agreements with only about 10% of global GDP, while Peru and Chile have trade agreements covering about 70-80% of global GDP. Bilateral negotiations with Canada, Singapore, South Korea and the United States have been taken up.

At the same time, the sometimes glacial and uncertain pace of progress on large trade agreements suggests to make simultaneous progress on unilateral reductions of trade barriers. Many Asian countries pursued a strategy of liberalising unilaterally in addition to regional and bilateral agreements, with tariffs often reduced for the purpose of attracting investment (Baldwin, 2006^[43]). This underlines the case for advances according to a gradual, pre-announced schedule on both tariffs and non-tariff barriers. Pre-announced policy changes give domestic companies time to adapt and can help to create momentum for domestic reforms. Ongoing efforts to improve the business environment will undoubtedly help in the transition to a more open economy.

One area where more scope for foreign market entry could have an impact on logistics costs is cabotage, i.e. the shipment of goods by sea between domestic ports. Currently, cabotage is mostly used for shipping mineral oils and metal ores, especially to servicing off-shore oil platforms. Given that the bulk of Brazil's population lives close to the coast and distances are large, cabotage could be a cost-efficient and low-emission means of transporting many goods across large distances. One 6000-ton ship can replace 172 trucks and reduce CO2 emissions per ton of goods by as much as 20 times (SAE, 2018^[44]). A general prohibition of foreign shipping companies in cabotage shipments restricts competition severely, as the domestic supply of shipping services is highly concentrated. Low quality of port infrastructure and high bureaucratic requirements add to these challenges (SAE, 2018^[44]).

Brazil can build on recent progress on unilateral reductions of trade barriers. Several tariff lines have recently been reduced unilaterally, including in the chemicals sector. The scope of tariff exemptions for capital goods has been extended by applying a narrower definition of the availability of domestic equivalents, which rules out these tariff exemptions. In addition, rules for foreign entry in air transportation and banking, as well as import licensing requirements, have been eased in 2018, 2019 and 2020. In 2020, the removal of non-automatic licensing has affected imports worth USD 5.6 billion. This has resulted in a significant decline of the OECD Services-Trade Restrictiveness Indicator (STRI) for air transportation. A single window (Portal Unico) has reduced import and export delays. Moreover, Brazil is in the process of acceding the WTO agreement on Government Procurement.

The structure of financial intermediation is improving

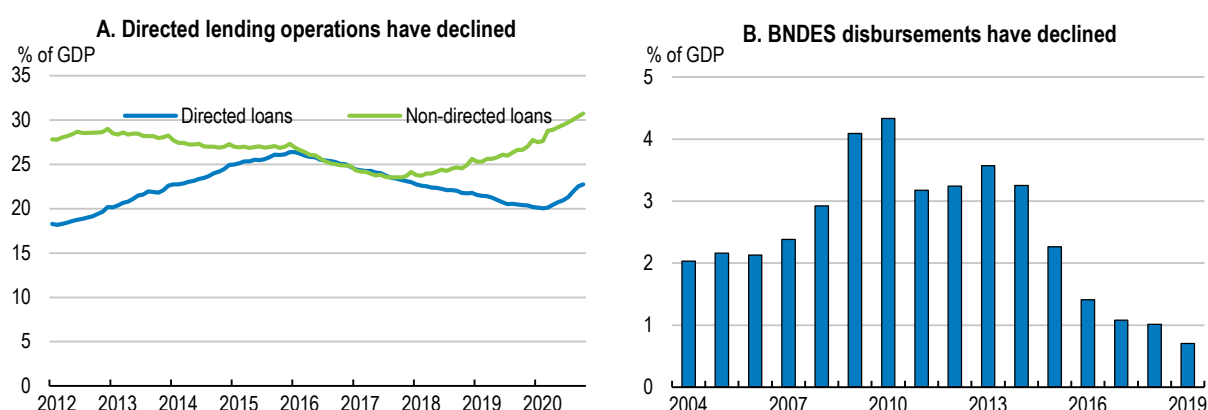
Financial markets and the resulting allocation of credit and capital can also be a significant source of allocative inefficiencies, with negative effects on productivity. Evidence suggests that Brazil's formerly large directed lending volumes and the sizeable associated credit subsidies benefitted mostly larger, older and less risky firms, and did not lead to increased investment or performance (Lage de Sousa and Ottaviano, 2018^[45]; Pazarbasioglu-Dutz et al., 2017^[46]). Directed lending also led to an unequal allocation of subsidies across sectors.

Following a financial market reform that aligned the benchmark interest rate for directed credit with market rates, financial markets are now going through a remarkable transformation. Directed lending is now playing a lesser role, after being on par with market credit for much of 2016 and 2017 (Figure 13). In particular, disbursements of distortive directed credit by the national development bank BNDES have declined visibly. The reform also starkly diminished interest subsidies, which had peaked at 2% of GDP in 2015. These developments have facilitated a structural decline in interest rates and reduced financing costs for the economy.

Fading interest subsidies are also gradually levelling the playing field between public and private lenders, thus facilitating the development of private long-term credit markets. Public banks had been used to expand credit in the past and accounted for the majority of credit up until 2019, when rising private credit started to exceed public lending.

Private banks are still struggling to lend at the maturities required to finance capital investment. Average loan maturities for non-directed credit are around 2 years for corporate borrowers. One reason for short maturities is the absence of longer-term funding options for banks, but structurally lower interest rates are likely to push investors previously pampered with high-yielding liquid assets into sharing more risks and longer maturities. At present, long-term investment credit beyond 3 years is still almost exclusively provided through directed lending operations, in particular by the national development bank BNDES. For the largest firms, bond financing has become an increasingly accessible option to finance investment, but smaller firms are likely to remain dependent on banks for some time. An in-depth assessment should be undertaken in due course to determine if further policy action is needed to develop private long-term credit markets.

Figure 13. Financial markets are changing



Source: CEIC, BCB, BNDES.

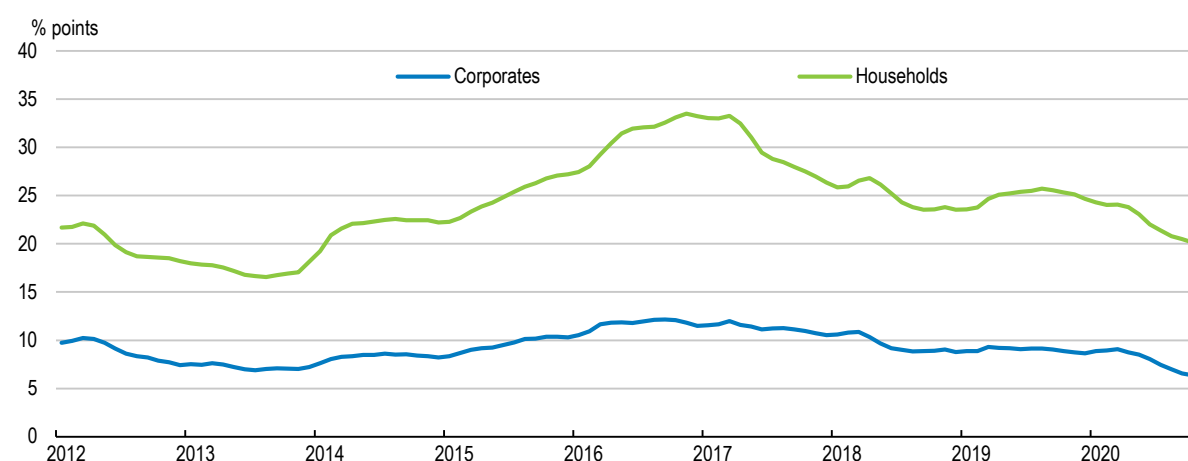
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Smaller directed lending programmes for housing and rural finance continue to contain interest subsidies and should be subjected to a thorough analysis regarding their effectiveness and distributional impact (World Bank, 2018^[47]). At a minimum, the rural credit programme could be harnessed better to strengthen compliance incentives with environmental regulations, such as the 2012 Forest Code that limits deforestation (OECD, 2020^[2]). Reducing subsidies in directed lending programmes that fail to reach legitimate policy objectives could reduce distortions and cross-subsidies in financial markets, potentially allowing further reductions in the neutral interest rate.

The next step in improving financing conditions is to reduce lending spreads, which remain high and reflect, among other things, limited competition in financial markets (Figure 14). Lower lending spreads in non-directed lending have been associated with higher employment and output in Brazil (Joaquim and van Doornik, 2019^[48]). Strengthening competition in financial markets has rightly become an active part of the Central Bank's policy agenda. This also includes open banking and competition from innovative entrants including FinTech and BigTech companies, and this agenda should be pursued without unnecessary delays. A previously required presidential decree for new foreign bank entry has been abolished and competition between different kinds of providers and business models is fostered through open banking and interoperability requirements. The authorities also improved access to credit histories through a new shared credit registry containing positive payment information. In addition, rates for overdraft facilities, a small segment where competition was particularly limited and rates exceeded 300%, have been capped at 150%. Similar caps on debit card fees applied to merchants are likely to foster the use of bank services and could potentially bring more transactions into the formal sector. Continued policy action on strengthening competition in financial markets would be welcome.

Improving insolvency procedures and reducing judicial uncertainty would have the potential to reduce lending spreads further. Recovery rates on distressed loans are below the regional average as insolvencies are often protracted and creditor rights are weakened by judicial decisions that question the original terms of contracts (Guimaraes and Salama, 2017^[49]; Salama, 2016^[50]; Arida, Bacha and Lara-Resende, 2005^[51]). A new draft insolvency law has been submitted to Congress, which contains a number of improvements, such as more scope for extrajudicial arrangements to speed up insolvency procedures, the possibility of obtaining new financing during the stay on assets and lower requirements for a “fresh start” of entrepreneurs.

Figure 14. Lending spreads remain high



Note: Data are presented as 3-month moving averages.

Source: BCB.

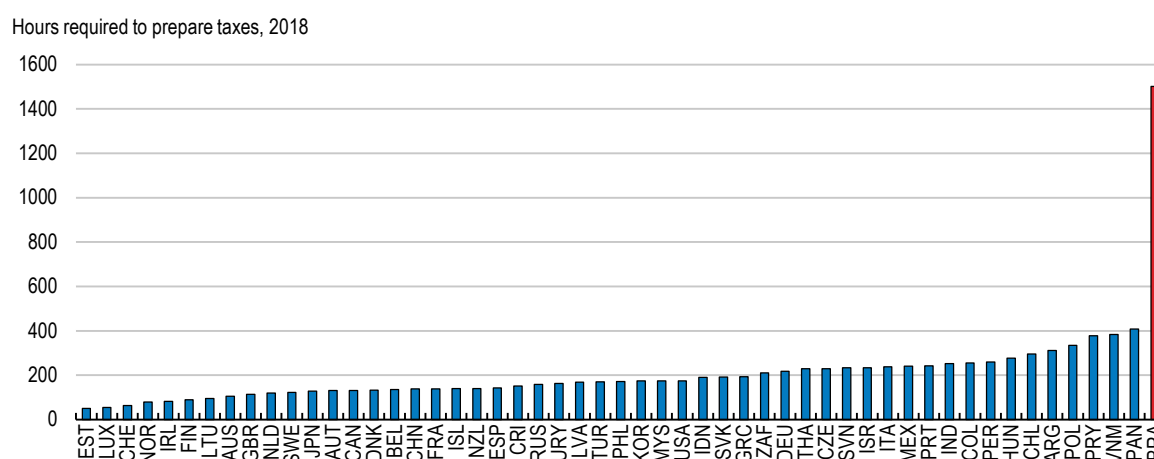
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Simplifying taxes and reducing compliance costs

The complex nature of Brazil's tax system reduces productivity through high compliance costs for firms, which command resources that could be used more productively in other activities. According to the Doing Business indicators assembled by the World Bank, Brazil is one of the countries with the highest tax compliance costs. A benchmark firm requires 1500 hours to pay taxes, as opposed to 317 in the average Latin American country or 159 in the average OECD country (Figure 15). This requires companies to maintain huge tax departments, adding substantially to fixed costs. Estimates suggest that aligning tax complexity with the OECD average could save Brazil's business sector up to 3.5% of GDP (Rittner, 2019^[52]). Complex tax rules also distort incentives for productivity enhancements.

Scope for simplification exists primarily in the area of indirect taxation. Brazil has six different kinds of consumption taxes, which generate around half of public revenues. The largest of these called ICMS raises revenues of around 8% of GDP. It is levied by Brazil's states and each state applies its own tax code, tax base and tax rates. Brazil applies a mixture of the origin and destination principles to interstate commerce and companies wishing to sell goods and services nationwide are required to comply with 27 individual tax codes.

Figure 15. Tax compliance is extremely cumbersome



Source: World Bank Doing Business 2020.

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ICMS is quite distant from the usual “neutrality” of a well-designed VAT and generates significant distortions. Tax credits for consumption taxes paid on inputs are granted only for inputs embodied in the final good sold. This rules out tax credits for consumption taxes paid on overhead expenses and in particular fixed assets, raising the cost of capital. It also requires companies to prove that every input for which they claim a credit goes directly into the final product. A practical example is that industrial companies often hire tax accountants to identify how their electricity consumption is divided between the part that powers the machines and the part that lights the companies’ offices, with the former being deductible and the latter not. These common situations give rise to excessive litigation, which consumes resources that could be employed more productively. Obtaining a tax credit for interstate transactions is even more cumbersome, and these are regularly delayed or refused.

Another large consumption tax is a set of federal “contributions”, including those known as PIS/Pasep, and Cofins, with joint revenues of 7.5% of GDP. These apply the same partial deduction of intermediate inputs and are often applied on top of ICMS, thus making the two taxes cumulative.

Consumption tax burdens are also far from uniform across sectors. Most services are not subject to the above-mentioned consumption taxes, but instead subject to a municipal service tax called ISS, with lower tax rates but no credit for inputs at all. This results in a generally lower tax burden on most services, but creates disincentives to source intermediate inputs from potentially more productive external providers. As high-income households typically consume disproportionately more services, the lower tax burden on services also makes consumption taxes less progressive.

Another special federal tax called CIDE has been levied on select goods and services, most notably on imports of services and financial transactions including remittances abroad. CIDE contributes to the very high taxation of imported services, with effective tax rates often approaching 50% (PNST, 2018^[53]). This is not only a very high tax burden but also a barrier to competition and precludes Brazilian companies from the competitive advantages stemming from imported tradeable services.

Addressing the productivity losses resulting from taxes requires a comprehensive reform of indirect taxes. One reasonable possibility that is currently discussed in Congress would be to consolidate the different consumption taxes into one value-added tax with simple rules, a broad base, full refund for input VAT paid and zero-rating for exports. This would reduce distortions and the scope for litigation at the same time. The tax rate should be as uniform as possible, applying if possible a single rate across all consumption, with no exemptions, reduced rates or special regimes. As a first step, a draft bill to unify two federal consumption taxes and enhance the deductibility of taxes paid on inputs has been submitted to Congress.

The progressivity of taxing consumption could be enhanced by devolving taxes paid to poor households registered for the Bolsa Família benefit, which would be significantly more progressive than applying lower rates on basic items that are also consumed by high-income households. Current tax exemptions for basic items do not have a particularly progressive footprint (SUASU/SECAP, 2019^[54]).

If necessary, it is possible to accommodate the desire for individual states to tax consumption at different rates, once taxation strictly follows the destination principle and tax credits are refunded swiftly for interstate transactions. Such a system is applied in the European Union, for example, where different member states apply different tax rates but consumers are normally subject to VAT in the destination country. Tax collection could be centralised, with automatic redistribution of revenues to states and municipalities (which currently levy consumption taxes on services). In addition, a specific excise tax could be introduced on tobacco, alcohol and fuels, to further regulatory and health objectives, in addition to raising revenue.

Discussions to harmonise the state-level ICMS have been going on for years, but the challenge is to find a political consensus among the states, some of which are threatened by revenue shortfalls from a rationalisation of the system as they effectively tax consumption taking place in other states. Moving towards a destination principle would make this impossible. To address these concerns, a reasonable proposal has been elaborated and discussed in Congress (Centro de Cidadania Fiscal, 2019^[55]). This proposal would guarantee current state revenues for a period of 20 years, adjusted for inflation, followed by a gradual transition towards the destination principle thereafter. The substitution of current consumption taxes by a single VAT with the same definition of the tax base would be phased in over a period of 10 years. Given the enormous distortions that the current tax system imposes on economic activity and the growth effects that could be unleashed by reform, reasonable simulations suggest that such a careful transition would effectively ensure that no states would face revenue losses (Centro de Cidadania Fiscal, 2019^[55]). While tax reforms involving different levels of government tend to be politically difficult everywhere, India has recently managed to unify state-level consumption taxes, including with a shorter transition period of 5 years (Box 2).

In the area of corporate taxes, transfer pricing rules for affiliates of multinational enterprises differ substantially from those applied in OECD countries, but an ongoing project between the OECD and Brazil's tax authorities is reviewing the differences and exploring options for Brazil to converge with the OECD transfer pricing standard (OECD and Receita Federal do Brasil, 2019^[56]).

Box 2. Tax reform in India

India successfully implemented a tax reform in 2017 and established a national value added tax, called the Goods and Services Tax (GST). The GST replaced about 30 different taxes previously levied by the central, state and local governments. The GST harmonised tax rates across the country for any given good and eliminated interstate trade barriers, which are also an issue in Brazil. In addition, the GST created incentives for formalisation and compliance, as purchasers of intermediate inputs have an interest in those inputs being tax compliant. Achieving consensus across states was politically difficult, just as it is in Brazil today, but concerns about revenue shortfalls were addressed by a central government guarantee that state revenues would grow at 14% a year over 5 years. A compensation fund was created to compensate states for lower revenues. Governance of the tax was delegated to a council of Ministers of Finance by all states and the Union, similar to Brazil's Confaz (Conselho Nacional de Política Fazendária). Decisions by the council require a 75% majority, not unanimity, although de facto, all states ended up adopting a collaborative stance and all decisions have so far been taken unanimously. One cost of building consensus was to keep a few items out of the GST, including petrol, alcohol, real estate and electricity. An appealing feature of the GST for state governments was its potential to reduce tax evasion by matching invoices and applying advanced data techniques to identify compliance gaps, which would have been out of reach for most individual states.

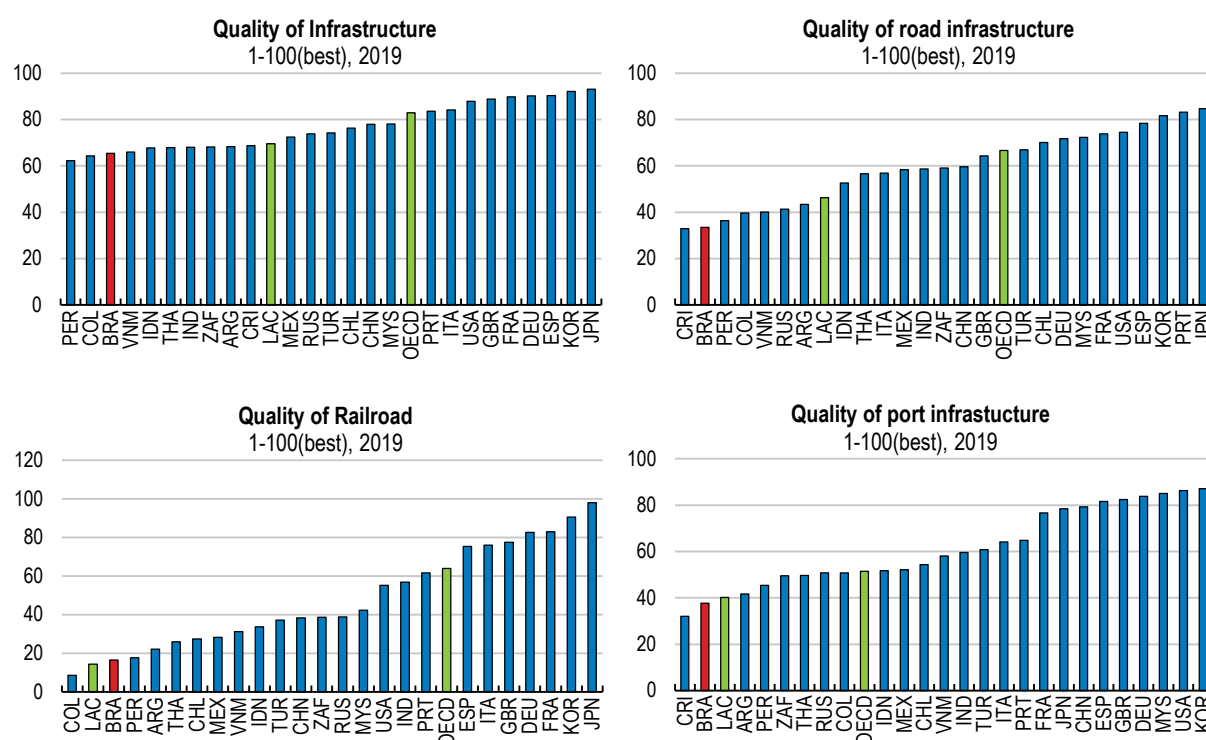
Source: (OECD, 2017^[57]).

Addressing infrastructure bottlenecks

Infrastructure bottlenecks are acting as a drag on productivity, export performance and the integration of the domestic market. Infrastructure quality lags behind in several sectors (Figure 16). This reflects low infrastructure investments of only 1.8% of GDP, below the 2.3% attained in 2010, and less than half of estimated investment needs (Inter.B). Estimates suggest that infrastructure investment has fallen short of depreciation over 2016 to 2019, with some mild improvements as of 2020 (de Castro Souza Júnior and Moraes Cornelio, 2020^[58]). In particular, Brazilian companies suffer from high costs of transport and logistics resulting from severe infrastructure bottlenecks. For domestically oriented producers, infrastructure shortcomings limit the possibilities to exploit economies of scale, while exporters are put at a comparative disadvantage vis-à-vis foreign competitors.

Public investment has become severely constrained by a lack of fiscal space, and –as part of discretionary spending– has often borne the burden of fiscal adjustment in the face of rigid mandatory spending items. Until these rigidities can be resolved, tapping further into private infrastructure financing, which already accounts for a large share, will become increasingly important. Brazil has 30 years of experience using private concessions, for example in the road sector. Significant scope exists for expanding the scope for private participation in infrastructure finance, as discussed in Chapter 1 of the 2018 OECD Economic Survey of Brazil (OECD, 2018^[38]). As discussed there, this may imply addressing constraints that go beyond financing, including improvements in the structuring of projects and tender calls, and addressing regulatory risks (OECD, 2018^[38]). The Federal Government's Investment Partnership Program (PPI), created in 2016, has helped to attract private investments to priority projects in ever more infrastructure sectors. Thus far, 184 projects have been completed, worth an estimated BRL 709 billion of investments to Brazil, while the current portfolio comprises another 203 initiatives with projected investments worth BRL 600 billion. Moreover, the recently approved new legal framework for investments in sanitation is expected to attract more investment into that sector.

Figure 16. Infrastructure quality is low



Source: World Economic Forum, Global Competitiveness Indicator database.

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Improving judicial efficiency

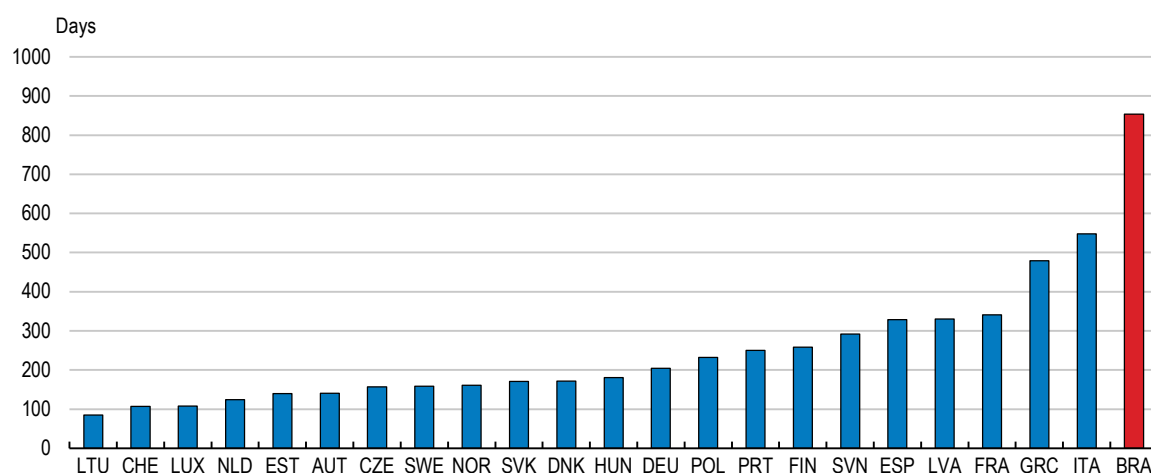
Reducing trial length and judicial uncertainty are key to boost business activity

A well-functioning justice system is fundamental for business activity and productivity. Institutions that ensure property rights and their enforcement are the basis for market-transactions and one of the main determinants of economic development (Acemoglu, Johnson and Robinson, 2005^[59]). Hence, an effective justice system is a necessary complement to good legal and regulatory frameworks, as it enforces their implementation. Beyond that, society more widely relies on the effectiveness of the justice system to protect individual rights and to resolve social conflicts. An effective justice system is characterised by efficiency, fairness, and a high quality of judicial decisions.

Trial length shows particularly strong links to economic growth, according to cross-country comparisons using an indicator of judicial efficiency developed at the OECD (Palumbo et al., 2013^[60]). The average time needed to resolve civil and commercial cases is high in Brazil compared to OECD countries (Figure 17). Lengthy trials are costly, weaken the enforceability of contracts and distort market transactions and investment decisions. In addition, the predictability of judicial decisions and the accessibility of judicial services are also essential for business activity. However, the latter two are strongly related to trial length as the capacity constraints of courts associated with longer trials reduce access to judicial services and the quality of judicial decisions. This can generate feedback loops where the low quality of judicial decisions at lower court levels induces appeal procedures that further contribute to court congestion and longer trials.

Figure 17. The time to enforce contracts is high

Average time needed to resolve civil and commercial cases, first instance courts, 2018 or the latest year available



Source: CNJ (2019), Justiça em Números; CEPEJ (2019), The 2019 EU Justice Scoreboard, European Commission.

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Moreover, Brazilian firms face difficulties in contract enforcement due to the significant discretionary power of judges and large heterogeneity in judicial decisions, which translate into high legal uncertainty for firms and create disincentives for investment (Dutz, 2018^[11]). Young and small firms are particularly vulnerable to weak contract enforcement, as they tend to be less diversified and do not have the financial resources to cope with late payments or default of clients and related lengthy trials to recover collateral (Intrum, 2018^[61]).

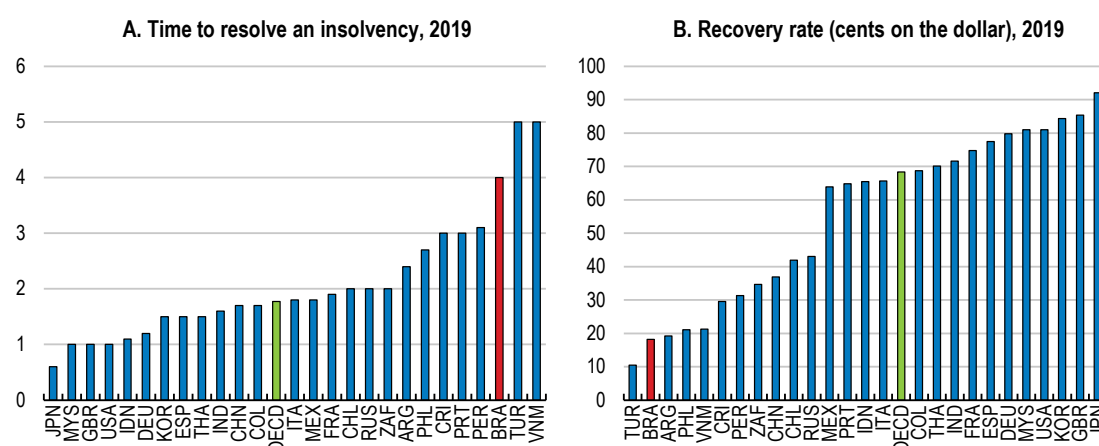
Efficient insolvency procedures play a crucial role to boost investment and productivity, as they facilitate the reallocation of capital and labour to young and innovative firms (Adalet McGowan, Andrews and Millot, 2017^[62]; Adalet McGowan and Andrews, 2016^[63]). By ensuring timely recovery of collateral, they positively affect bank lending and its conditions and increase access to finance for young and innovative firms (Bae and Goyal, 2009^[64]; Djankov et al., 2008^[65]; Bergthaler et al., 2015^[66]). Moreover, they can facilitate the restructuring of viable companies and boost entrepreneurship by providing second chance opportunities to entrepreneurs.

Brazil implemented a reform of its insolvency law in 2005, which strengthened creditor protection by providing higher priority for secured creditors vis-à-vis workers and tax authorities. This reform showed strong positive effects and was particularly effective in alleviating credit constraints for high productivity firms (Arnold and Flach, 2017^[67]). After the reform, better access to credit allowed these firms to thrive on the expense of others, improving the allocation of resources across firms and raising aggregate productivity. Despite this improvement, however, insolvency procedures continue to be less efficient and more costly than in OECD countries (Figure 18). A typical bankruptcy resolution takes 4 years in Brazil, compared to 1.8 years in OECD countries. Since assets of distressed companies tend to lose value quickly, Brazil's recovery rate on debt with insolvent companies is only 18 cents on the dollar, while it is 68 cents in OECD high-income countries (Figure 18). A new draft insolvency law has been submitted to Congress, which contains a number of improvements, such as more scope for extrajudicial arrangements to speed up insolvency procedures, the possibility of obtaining new financing during the stay on assets and lower requirements for a "fresh start" of entrepreneurs.

More effective contract enforcement and insolvency procedures would have potential to increase private lending to young and innovative firms. This would boost growth and employment creation in young firms

and contribute to improvements in productivity and real wages (Calvino, Criscuolo and Menon, 2016^[68]). Simulations based on cross-country firm-level data suggest that reducing the time to resolve insolvency procedures in Brazil to the OECD average would raise employment growth in young firms by 31 percentage points to 97% in the first three years after market entry (Figure 19). Employment growth for incumbents could increase by 8 percentage points, to 17% over three years. Reducing the average time of enforcing a contract to the OECD average would also have significantly positive effects on employment growth in entering and incumbent firms.

Figure 18. Insolvencies are slow and recovery rates low

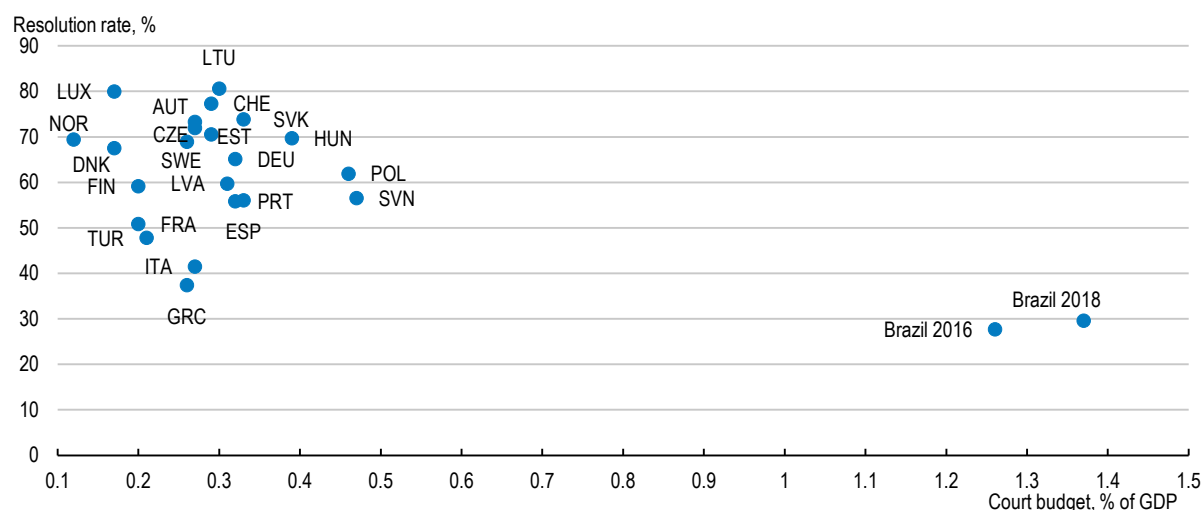


Improving the organisation of courts

One factor behind difficulties in contract enforcement is the slow and uncertain case resolution by courts that suffer from case congestion and could be organised more effectively. Although Brazil spends more on its judiciary than other countries, case resolution in Brazilian courts is slow (Figure 20).

Figure 20. Spending for courts is high, but case resolution low

Resolution rate (in %) and total court budget (in % of GDP), 2018 or latest year available



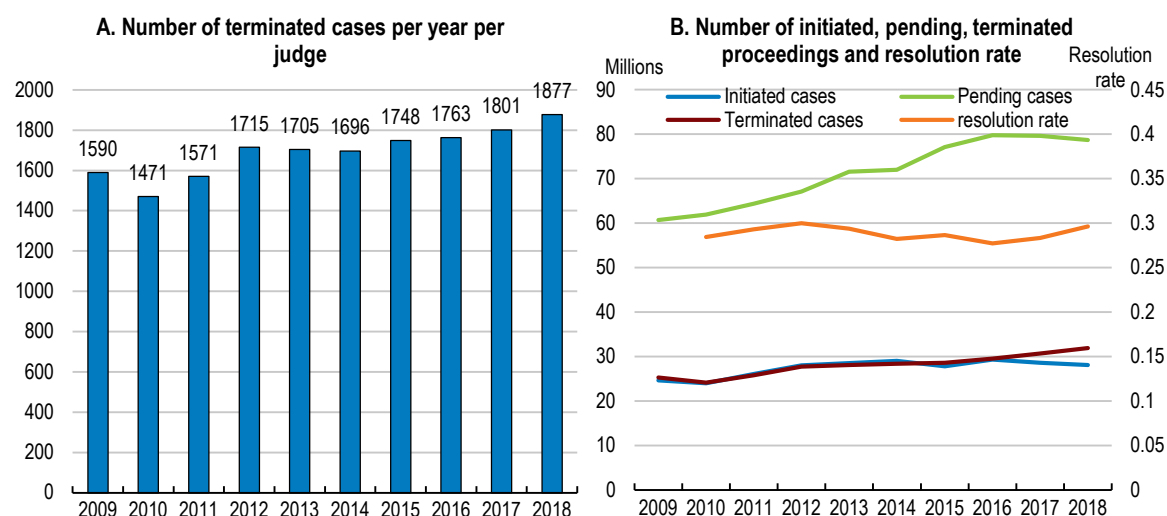
Note: The resolution rate is the number of resolved cases in 2018 divided by the stock (pending cases end-2017 plus incoming cases in 2018).
Source: CEPEJ/CNJ, *Justiça em Números 2018*, *Justiça em Números 2019*; IBGE; BSPN, *Tesouro Nacional*.

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International evidence suggests that common factors for slow case resolution include the structure of trial procedures and procedural formalism (Djankov et al., 2003^[69]), an inefficient allocation of resources across courts (Palumbo et al., 2013^[60]), and weak incentives for judges (Miceli and Coşgel, 1994^[70]). OECD analysis has also identified additional factors favouring judicial efficiency, including the use of specialised commercial courts, which is underexploited in Brazil, and systems of court governance that assign greater managerial responsibilities to the chief judge (Palumbo et al., 2013^[60]). In addition, the systematic use of information and communication technologies (ICT) for actively managing and controlling case-flow can improve internal procedures and resource allocation (Palumbo et al., 2013^[60]).

Recent reforms in the organisation of Brazilian courts have laid the grounds for improvements in the productivity of judges and court congestion (Figure 21). A National Council of Justice (CNJ) was created in 2004 to improve the efficiency of the judiciary and strengthen its autonomy. In recent years, measures taken by the CNJ have considerably improved the supervision and administrative control of courts.

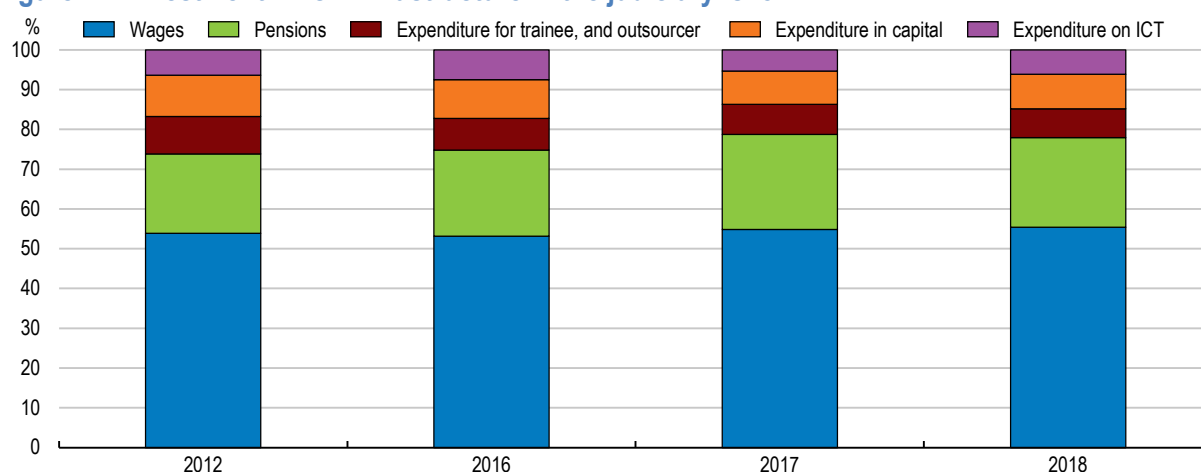
One achievement of the CNJ has been the introduction of ICT-based case-flow management, which has facilitated progress in streamlining court proceedings and collecting data on judge's workload and performance. Some court districts have used this information to better allocate resources across courts and define deliverables and timelines for judges. Moreover, the data collection system contributed to improving the transparency of the judicial system, allowing a yearly publication of statistics related to the judiciary (Lorenzon, 2017^[71]; CNJ, 2019^[72]).

Figure 21. Judicial performance indicators show incipient improvements

Source: CNJ (Justiça em Números). 2019.

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Looking ahead, there may be scope to invest more into effective ICT systems as the current system suffers from design issues complicating information processing for judges. This would require additional resources. In Brazil, staff expenditures are almost 80% of spending on the judiciary, and the share devoted to ICT has decreased in recent years (Figure 22). In OECD countries, the average budget share devoted to staff expenditure is 65% (CEPEJ, 2016^[73]; Palumbo et al., 2013^[60]). This suggests scope for reallocating resources from salaries to ICT and management systems, while streamlining court administration.

Figure 22. Investment in ICT infrastructure in the judiciary is low

Note: Expenditure on ICT represents payments for sub-contractors related to ICT. Wage payments include wages for employees working on strategic IT systems within the judiciary.

Source: CNJ 2019, Justiça em Números.

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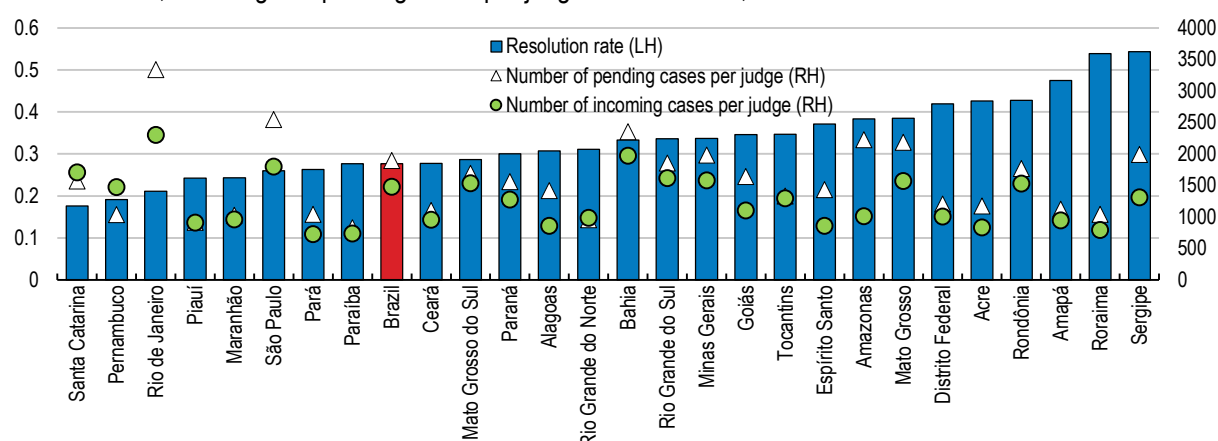
Salaries, benefits and allowances for judges are high, with an average monthly cost per judge of around USD 12 000 per month in 2018, in addition to 70 days of annual leave, part of which is typically paid out rather than taken. At the same time, judges' accountability in case of poor performance or misbehaviour is low (CNJ, 2019^[72]; Romero, 2013^[74]; Mohallem et al., 2018^[75]). Only in the most severe cases can the CNJ force judges into compulsory retirement and disciplining members of the judiciary remains difficult (Lorenzon, 2017^[71]). This suggests scope for increasing the independence of the CNJ and introducing better incentives for judges by linking salaries and promotions to performance assessments.

Brazilian judges typically get tenured positions with only around 3 years of practical experience after graduation. Requiring longer periods for judges to gain court experience before they get tenure could bring benefits. In addition, some have observed that the selection of judges for appeal courts continues to be influenced by political connections, potentially hampering the autonomy of the judiciary and the quality of its decisions (Lorenzon, 2017^[71]). For many positions, a fifth of vacancies is filled with candidates selected by the Brazilian bar association and the Public Prosecutor's Office. One option would be to fill all vacancies through the regular transparent and merit-based public selection procedures. Moreover, introducing more specialisation in the education of judges and court organisation could enhance performance and reduce judicial uncertainty (Palumbo et al., 2013^[60]).

Court congestion differs substantially across states (Figure 23). This is due to differences in court organisation and capacities as well as in litigation demand. However, states with a high number of pending and incoming cases per judge do not necessarily have a low resolution rate, which indicates that the organisation of courts is crucial to explain differences in court congestion. A coordinated effort across states involving the federal government is needed to improve the organisation of state courts. Best practices in human resource and court management should be shared across states and federal transfers to reduce capacity differences across states could be made conditional on progress made.

Figure 23. The regional disparity of judicial efficiency is high

Resolution rate, incoming and pending cases per judge in state courts, 2018



Note: Resolution rate" is defined as the number of resolved cases divided by the cases in stock which equals the sum of the number of pending cases at the end of 2017 and the number of incoming cases in 2018.

Source: CNJ (2019), database (Justiça em Números).

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Another measure introduced by the CNJ with significant potential for accelerating trials was the establishment of precedent cases through the introduction of the "repetitive cases" clause into civil law (Junquillo and Cerqueira, 2016^[76]). This clause requires courts to align their decisions with similar precedent cases ruled by superior courts. It also alleviates their workload as courts no longer have to deliberate circumstances that have been addressed in the past. The CNJ has created an online platform

to centralise all information related to repetitive cases so that courts can access the information easily and use it as a base for their decisions. The use of precedence cases cannot only be useful to accelerate case resolution, but it also has significant potential to enhance the predictability of court decisions, thus reducing judicial uncertainty.

This potential, however, has not been fully exploited so far. Courts have not implemented the precedence-ruling clause and used the related online platform on a systematic basis. This is related to the lack of an enforcement mechanism. The Supreme Court has no constitutional rights to sanction judges at lower courts if their decisions are not in accordance with the established precedence guidelines (Bottino, 2016^[77]). Looking ahead, improvements in judicial uncertainty, the number of appeals and court congestion will hinge on finding a way to effectively align judges with precedence rulings of superior courts. This will require strengthening the accountability, supervision and training of judges. One solution could be to link promotions and salaries of judges to their alignment with precedence ruling guidelines. Continuing to streamline and consolidate the existing stock of regulations will also help to reduce judicial uncertainty, as contradicting regulations facilitate heterogeneity in judicial decisions (OECD, 2020^[2]).

Two further measures that helped to limit court congestion and the number of appeals were slightly stricter requirements for elevating cases to the Supreme Court and the possibility of sentence execution after the first appeal. However, the mandate of the Supreme Court remains relatively broad and a high share of cases arrives at the Supreme Court. The possibility of sentence execution after the first appeal has also reduced a culture of impunity by which wealthy defendants could postpone their prison sentence until all appeal possibilities were exhausted. The latter has now been repealed by the Supreme Court, thus requiring a constitutional amendment to uphold the possibility of imprisonment as of the second instance of appeal (OECD, 2020^[2]). Passing this amendment would be one possibly quick way to enhance judicial efficiency. Alternatively, reviewing appeal procedures, including by narrowing the mandate of the Supreme Court, would be another potential avenue, although it may take longer to implement.

Reducing the demand for litigation to mitigate court congestion

Litigation is much more frequent in Brazil than in OECD countries, with more than eight incoming civil and commercial cases per 100 inhabitants in 2018 (Figure 24). High demand for litigation can be due to internal or external factors (Palumbo et al., 2013^[60]). Internal factors are related to trial costs and their allocation between parties, incentives for lawyers, the existence of alternative dispute resolution mechanisms, and the degree of certainty and coherence of existing regulations and laws. External factors comprise cultural factors, structural socio-economic factors and business cycle fluctuations.

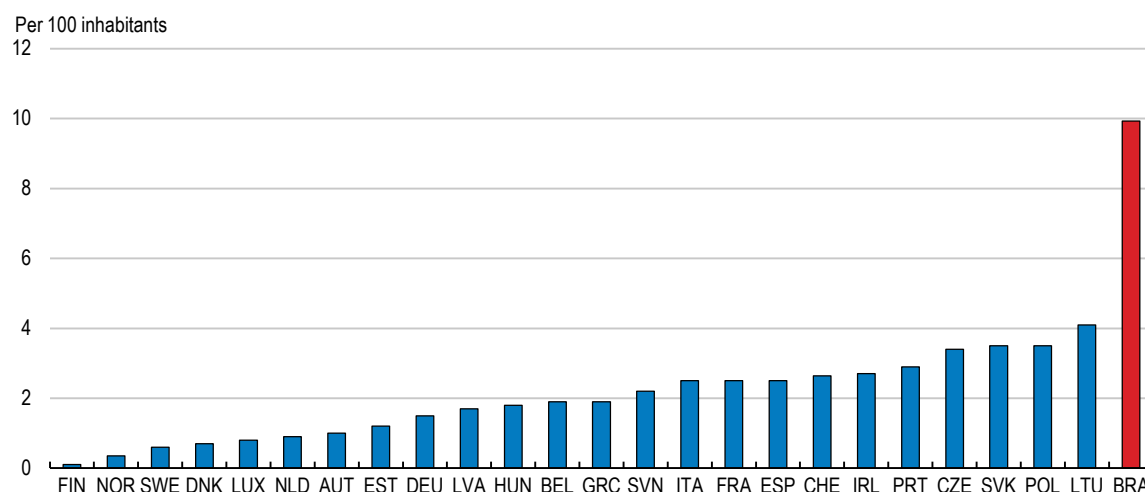
Litigation demand has grown strongly since 1990, as incoming cases rose almost five-fold from about 5 million to 29 million in 2017 (da Ros, 2015^[78]; CNJ, 2019^[72]). This was mainly due to better access to justice for disadvantaged parts of the population. The creation of specialised small claims courts greatly simplified trial procedures for civil and commercial cases involving claims of up to 40 minimum wages. Access to these courts does not require hiring a lawyer and court fees do not exist, except for appeal procedures (Matos and Ramos, 2016^[79]). In addition, the expansion of Public Defender Offices offering free legal aid and litigation for persons without the necessary financial means facilitated access to other court types for poorer parts of the population. The number of public defenders more than doubled since 2004 and their budget increased about tenfold (Matos and Ramos, 2016^[79]; Alves and de Castro, 2018^[80]).

Although it is crucial to guarantee equal access to justice, too low trial costs can induce spurious litigation, congesting courts and crowding out legitimate demand for judicial services (Palumbo et al., 2013^[60]). Free legal aid is not subject to means testing in Brazil and only requires the signature of an affidavit declaring that the individual cannot pay for court fees and lawyers' expenses. Instead, free legal aid could be made dependent on the financial situation of the litigant and the frequency of litigation. The introduction of cost-shifting rules, such as making the losing party liable for the trial costs, can lead to more efficient litigation

decisions, although it might decrease access to justice for more disadvantaged persons (Palumbo et al., 2013^[60]).

Figure 24. The demand for litigation is high

Number of incoming civil and commercial cases per 100 inhabitants, 2018 or latest year available



Source: CNJ (2019), Justiça em Números.2019 CEPEJ (2019), The 2019 EU Justice Scoreboard, European Commission.

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The large increase in incoming cases at small claims courts also reflects the structural change of the economy towards the services sector. In many countries, litigation has strongly increased due to a small number of bulk litigants, typically large companies such as cable television operators, mobile phone companies, insurance companies, banks and consumer credit companies, claiming for small amounts of debt (Gomes, 2011^[81]). The fact that until 2016 sentences could only be executed after all appeal possibilities had been exhausted incited many debtors in these small claims cases to contest court decisions with the sole objective of blocking sentence execution and delaying payment. Judicial uncertainty due to weak alignment of many judges with precedence ruling guidelines has added to high litigation demand in these cases.

Moreover, more transparent, consistent and stable legal and regulatory frameworks would help to rein in legal uncertainty and demand for litigation. In Brazil, the stock of existing laws and subordinate regulations is large and includes many outdated, overlapping and contradicting regulations, which create legal uncertainty. Regulatory changes have been frequent and regulatory agencies have been characterised by heterogeneous degrees of institutional capacities. Consolidating and streamlining the current stock of regulations and updating them to new economic and social circumstances has large potential to reduce the demand for litigation and to increase the efficiency of and the access to the justice system. The recently passed law on economic freedom is a step in the right direction, but more needs to be done to reduce legal uncertainty.

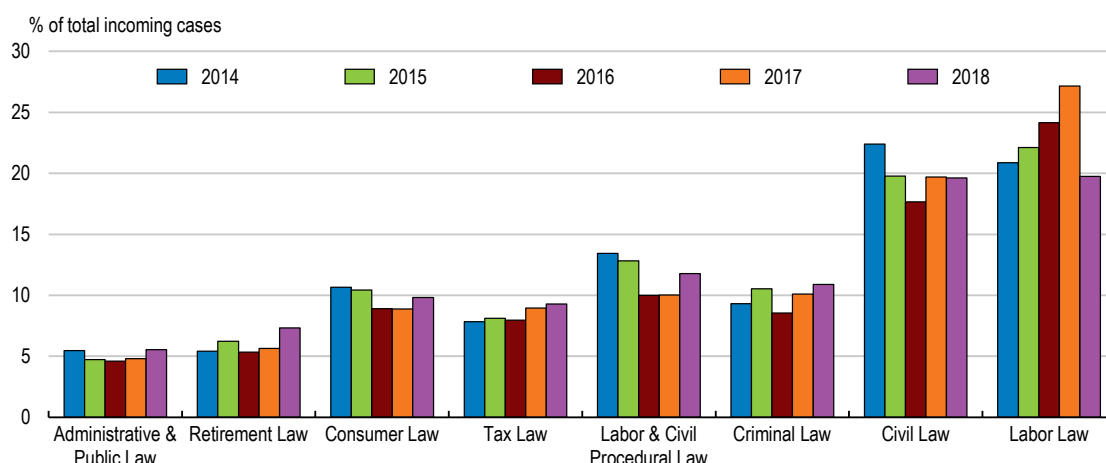
Litigation demand strongly varies across different law areas

Litigation is particularly high in the field of labour law (Figure 25). The current labour code was implemented in 1943 and contains many regulations that are not adequately reflecting contemporary employment relationships, particularly regarding safety standards, work time arrangements and worker compensation. Alternative firm-level agreements on labour issues are frequent, but have in the past often not been

recognised by labour courts when contested. Brazil's labour justice alone costs 0.3% of GDP, more than twice as much as the whole justice system in Argentina (CNJ, 2019^[72]) (da Ros, 2015^[78]).

Figure 25. Labour law is responsible for a high share of incoming cases

Incoming cases by law area (1st and 2nd instances)



Source: CNJ, Painéis CNJ (Justiça em Números, demandas por classe e assunto). <http://cnj.jus.br/pesquisas-judiciarias/paineis>

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A labour market reform passed in 2017 has significantly reduced incoming cases in labour courts. The reform has provided the basis for firm-level agreements to gain prevalence of the labour code on issues such as annual leave organisation, working hours, incentive pay and other issues of internal flexibility. At the same time, core worker rights have been preserved and cannot be subject to contractual arrangements. In the area of employment protection for open-ended contracts, the introduction of a new form of separation by mutual agreement has the potential to reduce previously high litigation related to contract rescission and the definition of 'dismissal without just cause'. Trial costs, which used to be free for employees, are now charged to the losing party and free legal aid has been restricted to poor workers (Silva and Esteves, 2018^[82]).

However, issues related to the accountability of judges and adherence to precedence case guidelines to align judicial decisions with Supreme Court rulings also affect labour courts. Cases related to dismissal without just cause still accounted for 12% of all incoming cases across law areas in 2018, which could be solved by a clearer legal definition of a "just cause". Changes to the current system of unemployment insurance could also reduce demand for litigation, as these incentivise litigation. Italy, for example, reformed its labour code in 2014 simplifying the regulatory language, including the definition of dismissal for causes other than just cause. This has reduced the scope for ambiguity and thus litigation demand (Silva, Almeida and Strokova, 2015^[83]). France also implemented a successful reform of dismissal case procedures under the Prud'hommes regime in 2016.

Outdated labour safety and health standards are still a large obstacle for investments in physical and human capital. Vocational training for high school students in firms or on machines implies significant legal risks to firms and training providers, which explains why vocational training is almost non-existent in secondary education (Grundke et al., 2021^[23]). Cases related to safety and health standards and compensation due to moral damage are among the categories with most incoming cases in labour courts and deter investment of firms into new machinery and technology. The government has recently revised some of the related regulations, in particular related to the import of new machinery, to avoid the need for Brazilian safety approvals of machines that have already undergone similar testing abroad. At the same

time, a task force has been created between members of the executive and the judiciary to update labour regulations and reduce congestion in labour courts.

Other domains causing high demand for litigation relate to debt enforcement, in particular tax foreclosures. After failed administrative attempts to recover tax payments, the law requires prosecutors of the treasury to file tax foreclosure cases and to prosecute every outstanding tax liability until the last appeal. The judiciary has to repeat the same investigation that the tax administration concluded without success, such as locating the debtor and his property. Tax foreclosure cases represent 39% of all pending cases and 73% of cases pending sentence execution (CNJ, 2019^[72]). Although the recent law on economic freedom enables tax authorities to evaluate the chances of legal prosecution and abolishes legal sanctions for prosecutors of the treasury, more is needed to decongest courts. Debt enforcement procedures of tax administration and the judiciary should be better coordinated to reduce duplication. Moreover, judicial debt enforcement procedures should be directly linked to judgements, to reduce procedural possibilities for debtors to delay debt enforcement.

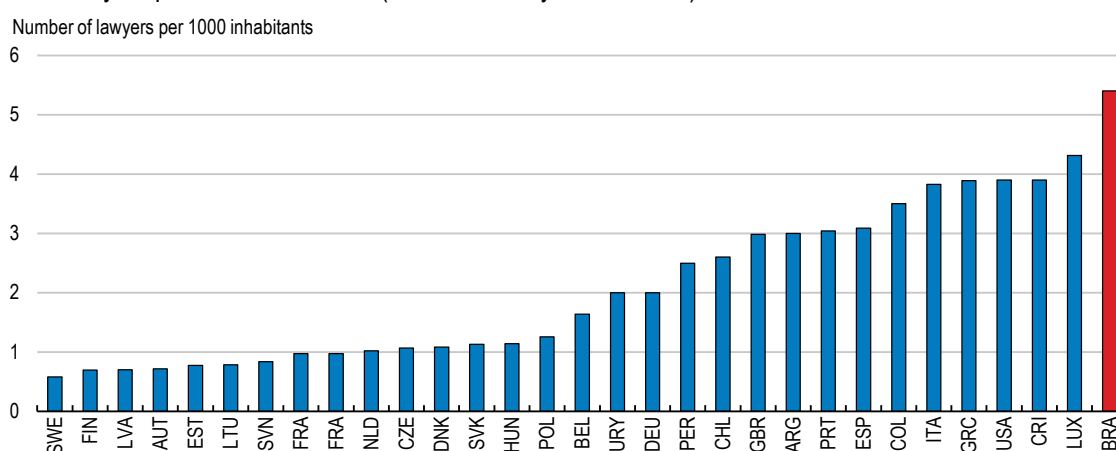
In addition, debt enforcement cases related to insolvency procedures are congesting courts, and reforms to speed up these enforcement procedures are needed. Providing information on debtor assets to the creditor to inform the decision whether to pursue enforcement would help to reduce cases with a low probability of success. Trial length could be reduced by introducing time lines for enforcement procedures to be terminated if no assets are found as well as electronic platforms for auctioning seized assets that facilitate their liquidation. Encouraging the use of secured fiduciary sale clauses in contracts would enable asset seizure in case of debtors default without recurring to the judiciary. A 2019 law has decreased legal uncertainty related to the seizure of private assets of the firm owner, which has the potential to reduce the length of debt enforcement cases.

The legal industry has strongly expanded in recent years and is highly protected

Another driver for the rising demand for litigation has been the strong expansion of the legal industry since the 1990's. The number of lawyers per 1000 inhabitants has expanded four-fold since 1991 (FGV, 2014^[84]), and it is superior to that of other countries (Figure 26). The number of law schools has strongly increased and is much higher than in other countries (da Ros, 2015^[78]). This strong supply of legal experts is related to the increasing demand for litigation, but also to the attractiveness of the profession due to high privileges.

Figure 26. The number of lawyers is high

Number of lawyers per 1000 inhabitants (2017 or latest year available)



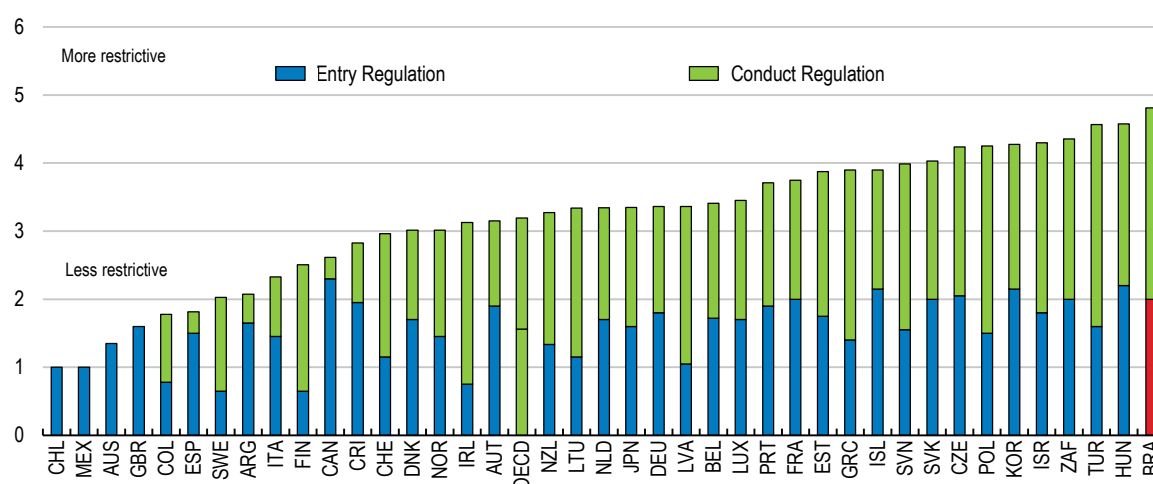
Source: (CEPEJ, 2018^[85]), (da Ros, 2015^[78]), (Venegas, 2013^[86]), (IBGE, 2019^[87]), (OAB Nacional, 2019^[88]), (Bilardi, 2017^[89]).

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Lawyers play a central role in determining the pattern of demand for judicial services, as they often decide on behalf of their client whether to file a case in court or resolve the issue in alternative ways. Empirical analysis has shown that the number of lawyers affects litigation demand in many countries (Pereira and Wemans, 2017^[90]; Mora-Sanguinetti and Garoupa, 2015^[91]). Given the asymmetry of information, lawyers may have incentives to go to court and receive service fees even when it is not in the best interests of their clients, due to low claim value or low probability of winning (Carmignani and Giacomelli, 2010^[92]; Palumbo et al., 2013^[60]).

Stronger competition in the legal profession can help to reduce spurious litigation induced by lawyers (Figure 27). Legal contracts between lawyers and clients including fees could be made more transparent so that clients understand the prices and quality of the services provided (Carmignani and Giacomelli, 2010^[92]). The authority to deal with disputes regarding lawyer-client contracts is currently given to the Bar Association, the association of the law profession, which creates significant conflicts of interest. Transferring the regulation of the profession to an independent body within the judiciary, for example the national council of justice, could lead to a more impartial judgment and improve transparency and competition.

Figure 27. The law profession is highly regulated



Source: OECD 2018 Product Market Regulation Indicators database.

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Alternative dispute resolution mechanisms

Alternative mechanisms for dispute resolution, such as arbitration, mediation or online dispute resolution, have large potential to reduce litigation demand (OECD, 2018^[93]). In Brazil, arbitration has gained a lot of traction, as its outcomes are legally binding and directly enforceable. A recent amendment to the Arbitration Act provides the legal framework for public entities to engage in out-of-court arbitration procedures. These are already applied, for example, in the context of rebidding procedures related to public infrastructure projects. Moreover, a new legal framework for mediation has facilitated and incentivised mediation between private parties inside and outside of courts. The new civil procedure code has made a conciliation or mediation hearing mandatory in the early stage of most lawsuits (Alves and de Castro, 2018^[80]). This resulted in an increase in the number of cases resolved through court-annexed conciliation from 11.1% of cases in 2015 to 12.1% in 2017 (CNJ, 2019^[72]). Particularly labour disputes have seen increasing use of alternative dispute resolution, which is partly related to extended scope for firm-level dispute resolution introduced by the 2017 labour reform (CNJ, 2019^[72]). But there is scope for further progress. For example,

South Africa has strongly reduced litigation demand related to dismissals by introducing centralised out-of-court conciliation and arbitration procedures (Silva, Almeida and Strokova, 2015^[83]).

Regarding debt enforcement and insolvency procedures, alternative dispute resolution for firm restructuring or liquidation have strong potential to facilitate creditor coordination, speed up insolvency procedures and reduce court congestion (OECD, 2019^[94]). In Portugal, the introduction of legal frameworks for court-annexed conciliation as well as out-of-court mediation for firm restructuring has facilitated creditor coordination and reduced litigation demand related to insolvency procedures and debt enforcement. Introducing similar legal vehicles in Brazil and extending them to non-viable firms to include firm liquidation could significantly reduce court congestion and the duration of insolvency procedures. Japan has recently introduced a legal framework for out-of-court firm liquidation, which encourages debt resolution proceedings at early stages to avoid the devaluation or hiding of firm assets. Firm owners or debtors are allowed to keep more assets than in case of a personal bankruptcy, which incentivises their cooperation (OECD, 2017^[95]).

Online dispute resolution mechanisms can contribute to reduce court congestion, in particular in the field of consumer law. A large share of incoming cases in small claims courts relate to consumer compensation for moral and material damage (CNJ, 2019^[72]). Online dispute resolution that connects consumers directly with firms to facilitate out-of-court conciliation has potential to reduce the demand for litigation, as many cases are similar and bulk-litigation is frequent in this area. It can also contribute to the development of e-commerce, as it reduces the costs of enforcing sales contracts signed through the internet and increases trust of consumers. The national justice council (CNJ) has recently introduced such an online platform, which links incoming cases directly to the concerned company to facilitate out-of-court dispute resolution. A thorough evaluation of this online tool could inform the introduction and design of online dispute resolution in other law areas.

Box 3. Policy recommendations for raising productivity

Key recommendations

- Further simplify license requirements and apply silence-is-consent rules and one-stop shops wherever possible.
- Reduce tariff and non-tariff barriers, starting with capital goods and intermediate inputs.
- Consolidate consumption taxes into one value added tax.
- Ensure the alignment of court decisions with precedence rulings of superior courts by linking judges' promotions and salaries to compliance with the rules.

Other recommendations

- Continue the ongoing comprehensive review of the competition impact of regulations and administrative burdens.
- Eliminate requirement to seeking approval for company registration from local authorities.
- Reduce the role of professional associations in regulation.
- Avoid price floors in professional services and non-prescription medicines.
- Limit the possibilities to take public officials involved in licensing processes to court over their decisions to cases of abuse or bad faith.
- Publish all tender documents for public procurement online, allow bids to be submitted online and avoid providing reference prices in the tender documentation.
- Continue improving the governance of state-owned enterprises and consider privatisations on a case-by-case basis based on thorough cost-benefit analysis.

- Phase out remaining interest subsidies in directed credit for rural or housing projects.
- Reduce restrictions on cabotage shipping by allowing foreign shipping companies and reducing bureaucratic requirements.
- Improve the ICT system for judicial case-flow management.
- Use information on judges' workload and performance to improve resource allocation across courts.
- Make wider use of specialised courts and judges.
- Reduce demand for litigation by simplifying labour, tax and insolvency laws and related enforcement procedures.
- Strengthen competition in the legal profession by separating regulatory functions from the Bar association.

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