Brazil: Bright Prospects or Dark Portents?

by Matthew M. Taylor

Brazil is an island on its continent, separated from its neighbors by an ocean of history, culture, and language. And yet whither Brazil, so too Latin America. The country accounts for a sixth of the region's trade, and more than a third of its GDP and its population. In addition to its large share in all cross-regional quantitative measures, Brazil's weight is geopolitical as well, with the country playing a central role among leading emerging markets. The state of affairs in Brazil, then, is of enormous concern to its neighbors, and should be of great concern to the rest of the world as well.

Sadly, the message of this essay is that there is much for both Brazilian and foreign observers to be concerned about when considering the country's medium to long-term prospects. This message runs counter to the ecstatic headlines and rapturous investor reports that have dominated much coverage of Brazil since President Luis Inácio ("Lula") da Silva demonstrated, during his first year in office, that he would not reverse the process of economic stabilization or take a wildly populist policy route.

First, consider the full half of the glass. The country has not been hit by economic crisis for more than half a decade now, and all suggests that in the medium term, current policies will shield Brazil from the full-fledged financial panics of the sort that repeatedly hobbled it in the 1990s. Indeed, despite initial fears about the potential populism of the Workers' Party government that took office in 2003, Brazil has almost achieved investment grade ratings, the debt-to-GDP ratio is at its best place in a generation, Brazil repaid its debts to the IMF well ahead of schedule, foreign currency reserves stand at over $160 billion, hyperinflation remains a distant (but not forgotten) nightmare, the primary fiscal surplus remains above four percent of GDP, and the balance of payments is in remarkable condition. Most importantly, after years in which an uncertain economic tide lifted only the wealthiest ships, inequality has been modestly but continuously shrinking for nearly a decade.

On the political front, as Brazil prepares to celebrate the twentieth anniversary of its 1988 Constitution, almost all naysayers have been proven at least slightly over pessimistic. Early concerns about the instability of multiparty presidentialism were clearly overblown, and despite the existence of twenty-eight officially recognized

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political parties, the political system has proven remarkably stable. The Constitution itself, which worried many because of its enormous breadth and binding constraints on policy, has proven elastic. With fifty-five amendments since its inception, it may be the most rapidly amended national constitution in existence. Granted, a plethora of veto players ensures that policy change is slow, but in retrospect, this resoluteness looks appealing next to the extreme policy volatility of more decisive majoritarian political systems such as Argentina's. Things do not ever happen quickly, but they do happen, and the stability of resulting policies may be some consolation.

Further, although growth over the past five years has been mediocre in comparison to the other members of the BRIC group of leading emerging market economies, Brazil seems a step ahead of Russia, India, and China when it comes to the sustainability of its growth.

Although it is far from perfect, in comparison to these three peers, Brazil has a well-adjusted democratic institutional framework, less dire environmental concerns, and remarkable though it may sound, benefits from a more advanced industrial capitalism, which is far less susceptible to political intervention. The combination of a complete commitment to economic stabilization by all the major political parties, the creation of strong fiscal safeguards over the past decade, and a relatively autonomous Central Bank suggest that Brazil's susceptibility to politically motivated volatility is far less pronounced than in the past. Furthermore, although they will never be completely resolved, the pressures of regionalism are far less jeopardizing than in the other BRICs, and ethnic or nationalist strife of the sort imaginable in any of the other three nations (e.g. Chechnya, Kashmir, Tibet) was long ago resolved. There is even reason to doubt the appropriateness of bundling Brazil together with the BRIC nations, rather than with other recently transitioned, and seemingly stable polities such as Spain, Chile or South Korea.

The sad truth, however, is that all this positive news has shifted attention away from the long-term. Given the many risks Brazil has successfully navigated over the past decade, the country is doing better than many anticipated. Partly as a result, policy discussions have hinged on the short-term, with little thought given to the effectiveness, sustainability or cohesiveness of Brazil's overall policy path. But the recent weakening of US financial markets, and the tremors it caused around the world, were a reminder that if things are not looking wonderful in good times, the picture will be far worse when the current global liquidity bonanza passes.

Although most indicators point to the likelihood that Brazil will continue to merit membership in the club of seemingly stable and consolidated democracies, the sustainability of the gains of the past two decades needs to be analyzed through a longer-term lens. This is especially the case if Brazil continues, by default, to rely on the state as the engine of its transformation.

With a great deal of simplification, we can group the threats to Brazil's long-term development around political, economic, and structural issues. As the first is the cause of many of the problems with the latter two, I focus here primarily on Brazil's political system. But it is worth beginning with a laundry list of the economic and structural issues that seemingly threaten the nation over the next quarter century, before returning to the political system's role.

For all of the very important gains mentioned earlier, of which economic stabilization is undoubtedly the most important and in many ways the lodestone from which all other recent progress has derived, there is no way to hide Brazil's lackluster economic performance under democratic rule. In real terms, the country grew on average 2.9 percent per year during the first decade of democracy (1985–1994), and 2.5 percent in the second (1995–2004). In large part, this lackluster result during the first decade was the outcome of the military regime's dreadful legacy of debt and the exhaustion of import-substituting industrialization, coupled with hyperinflation. Many of these problems were sorted out by the turn of the millennium, but the combination of successive international financial crises, the need to preserve the Real so as to combat inflation, and a strong legacy of statist rule has crippled growth. These economic growth figures are especially disappointing in comparison to many of Brazil's emerging market peers. While many of the problems of external vulnerability have been resolved, not least because of the Partido dos Trabalhadores' (Workers' Party's) turn toward more market-friendly policies, the legacy of statism remains a pernicious force.

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This need not be an impediment to short-term growth, as China has shown so spectacularly. But as political scientist Barry Ames has noted, the tragedy of the Brazilian state is that it primarily benefits itself.[1] Despite hopeful recent improvements, gross public debt accounts for roughly two-thirds of GDP. Government spending is rigid, and seventy percent of revenue is strictly committed to specific programs under the terms of the 1988 Constitution, limiting policy discretion and the government's capacity to invest in infrastructure. Further, the federal government alone spends nearly five percent of GDP in salaries and benefits, with spending on government administration continuing to expand more quickly than the economy as a whole, rising nearly twenty percent in real terms between 2002 and 2006. The pension system is large (nearly twelve percent of GDP), but highly unjust (only 56 percent of the population has pension protection), and heavily biased toward civil servants, who receive far more proportional to their contributions than their private sector peers, despite two significant reforms in the last decade. And that is just within the public sector. The repercussions outside the state are equally frightening. Brazil has a bureaucratic apparatus that puts fear in the spine of all but the most intrepid entrepreneur. According to the World Bank, Brazil is at the bottom of a long list of countries in terms of the amount of time required to open a new business. Starting a business takes three times the world average; incredibly, it can be even more difficult to actually close firms. The formal labor market is so rigid and regulated that only slightly more than half of those working are formally employed; the remainder manage without the protections they might enjoy under a more flexible but universal system.[2]

As a result, even in the past five years, as global liquidity has boomed to record levels, Brazil has grown at mediocre real rates of about 2.7 percent annually. This growth is weak not just in absolute terms, but also in terms of its composition. There is no way to escape the fact that Brazil adds little value to exports; it is primarily a commodity exporter, and can compete in terms of value-added exports in only a few fields, such as aircraft manufacturing, that have benefited from robust government assistance. As China and India push into the global market, with the potential for low-cost production and service-oriented industries, Brazil has yet to vigorously address the shortcomings of its business environment. Indeed, although there are hopeful signs, such as a growing push for tax unification between units of the Brazilian federation, government spending has increased, the tax burden continues to rise (by nearly nine percent of GDP between 1993 and 2003, when the total tax take reached thirty-four percent of GDP)[3], and there is little sign of decreased regulation.

The effectiveness of government spending is also largely in doubt. The perilous condition of the air traffic control system and the dilapidated and woefully inadequate state of Brazil's airport infrastructure, especially for a nation of continental scale, became evident in the wake of two catastrophic plane crashes in the past year. The problem is not restricted to the air transport sector or to the Lula administration. Five years after blackouts crippled the country during the Cardoso administration, the continued shortage of energy generation illustrates that the lack of attention to infrastructure is a chronic and serious constraint on growth. In addition to air transport and electricity, other key infrastructure projects such as highways and ports badly need long-term investment. But with government spending on infrastructure constrained by other current expenditures, even efforts to increase investment have little promise: the recent Growth Acceleration Program (*Programa de Aceleração do Crescimento, PAC*) announced by President Lula to great fanfare, for example, simply rejiggers many existing programs into new boxes.

The private sector has a hard time providing alternative sources of infrastructure investment, especially in light of the credibility gap surrounding the institutional framework. A sad example emerges from the experience of the federal regulatory agencies. Created in the mid-1990s, these have largely been subverted by old-style political patronage appointments, tight budgets, and the hard-nosed politics of an executive that never had much sympathy for their potential role. As a result, these supposedly autonomous agencies have largely become paper tigers, subservient either to the industries they supposedly control or to the ministries out of whose hands they were intended to take policy. Similarly, despite the party's supposed turn to market-friendly economic policies, members of the ruling Worker's Party recently floated proposals for the re-nationalization of CVRD—the enormous mining concern privatized in 1997. These are not the only examples of a credibility gap, of course, but they illustrate that the prevailing emphasis of many market analysts on legislative progress and other easy metrics of political change obscure the importance of achieving a credible consensus regarding the long-term institutional framework.

Perhaps the most frightening aspect of Brazil's current outlook, however, relates to human capital. Since the return to democracy, Brazil has made significant improvements in the standard of living: between 1990 and 2005, the number of Brazilians living below one purchasing-power-adjusted dollar per day was halved to four percent of the population; infant mortality has dropped from 53.7 deaths per 1,000 to 28.7; and the real minimum wage rose by nearly eighty percent. But these impressive quantitative measures obscure the fact that the provision of social welfare is extraordinarily inadequate. If there is any consensus whatsoever on social policy, it is that spending by governments at all levels of the federation on health and education is inefficient, and both systems have long been teetering at the brink of complete insufficiency. At an international level, Brazil's lackluster educational performance—one estimate places functional illiteracy at nearly seventy-five percent of the working age population[4]—is the key source of competitive disadvantage, especially as well-qualified workforces in China and India come online at much lower cost.

Meanwhile, the pace of social gains has been slow, at best. Even extremely positive improvements in inequality under Lula appear to have resulted largely from direct income transfer programs and a mandated increase in the official minimum wage rather than from any overall structural improvements. The *Bolsa Família* program has been widely and justly praised for providing a minimum wage support to nearly a quarter of Brazil's population, largely in the northern and northeastern regions. But the very success in expanding the program has weakened the effectiveness of incentives that originally were intended to tie the program to school attendance and mandatory health checks. Another victim of the program's success is other social spending. The government predicts that the *Bolsa Família* will account for three of every five *reais* in federal social spending in 2008.[5] Finally, for all the good it has wrought, the program provides many with a fish, without teaching them to fish. It is, in other words, a program that is unlikely to put itself out of business, much less to create lasting gains in terms of sustainable human capital development.

Why the difficulty of effective policymaking, such as health and educational reforms with a long-term view? It is not so much a problem of excess veto players, but rather of the way in which these veto players are incorporated into the political system.

Perhaps the best way to illustrate this is by noting that no matter which candidate or which coalition wins the 2010 presidential election, the *Partido do Movimento Democrático Brasileiro* (PMDB) will likely be the key political powerbroker in the new presidential administration. Indeed, the clearest lesson of the current Lula government is that while presidents of left and right come and go, they all bear the pragmatic, clientelistic PMDB as an incubus. This party, and other centrist but heterogeneous parties like it, hold the votes and the power in Brazil's political system. Without bringing the PMDB on board, no presidential candidate can be elected; without bringing the PMDB and similar parties into the cabinet, it can be impossible to govern.

The irony, however, is that the determining factor in the success of the new government will likely be the president's ability to undertake independent policymaking despite the PMDB. As noted earlier, Brazil's multiparty presidentialism has proven less unwieldy than many expected. As Fernando Limongi and Argelina Figueiredo have convincingly proven, the president has strong tools at his disposal to corral and direct a governing coalition in Congress.[6] Almost every presidential administration (except, not by coincidence, the doomed Collor administration), has managed to patch together a fairly stable congressional coalition that enabled them to govern, and in fact permitted significant policy reforms, such as the Real Plan, the privatizations of the 1990s, and the social security reforms of the past decade.

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But while a rudimentary governability is possible, hazards permeate the process of coalition formation. Coalitions are pulled together on the basis not of policy preferences, but primarily through pork. Congressional representatives are brought into the governing coalition in return for patronage appointments or the funding of budgetary line items, while campaign contributors give money not to advance particular policy preferences, but to buy personal access to government services. Too often over the past two decades it has become clear that this system makes policy change incredibly slow. Any policy change requires significant advanced planning and executive commitment, as well as constant negotiation and recurrent horse -trading, without which determined policy opponents are handed a veto over policy. Few policy changes are approved without being sponsored and actively pushed by the executive, meaning that reform requires constant oversight and energetic cheerleading by the president. Even the most successful politicians are tarnished by their association with the horse-trading and pork barrel politics at the heart of the negotiations, leading to the perception of political corruption.

These perceptions are especially damaging because there is little sense of a functioning accountability process that can condemn the corrupt and exonerate the innocent. Over the past two decades, few politicians have been held accountable for corruption, even in the face of overwhelming evidence presented to the public. President Collor was famously impeached in response to widespread public protests, but then absolved of criminal conduct by the high court. In the recent *mensalão* scandal that toppled most of Lula's inner circle, the high court recently indicted the key culprits two years after the scandal erupted, but appears unlikely to reach a decision on either conviction or absolution until after Lula leaves office. It is worth noting that the *mensalão*—a "big monthly allowance" used to encourage ideologically disparate congressional representatives to tow the government line—was itself part of the process of coalition formation.

Endemic corruption is a serious concern at the state and municipal levels of the federation as well. By way of illustration, the euphoria of police when they recently captured Colombian drug kingpin Juan Carlos Ramirez Abadía was undercut by revelations that one of the reasons he had been on the lam for so long in São Paulo state was that local police forces saw handsome profits to be made from milking this billionaire and his lieutenants of protection rents. This is but one of many possible examples of the endemic corruption of key accountability institutions, ranging from police to courts.

Indeed, perhaps the two most destructive threats to Brazil in the medium term lie in the intertwined issues of corruption and public security. While most market analysts and political consultants focus overwhelmingly on macroeconomics and macro-politics, these two threats are increasingly eroding the foundations of Brazilian democracy. There is the same disconnect in public discourse as well. In the recent *mensalão* trials, for example, the high court was widely praised for the indictments it handed down, as though these were sufficient to temper corruption and move the country to a new level of the rule of law. Undoubtedly, the indictments were important, in part because of the novelty of the high court actually moving to try politicians. But a host of other politicians have also been found to have acted corruptly in recent years, and few have even been removed from office, much less convicted. Almost none have actually been sent to jail and it is doubtful any of the kingpins in the current scandal will be either. This constant impunity has a pervasive and corrosive effect on public sentiment.

Public security is a related theme. In part because of the widespread corruption of police forces and the ossification of the judiciary, Brazil is a dangerous place. More importantly, one of the few licit remedies widely adopted to deal with crime has been the packing of prisons, which has the perverse effect of turning these into breeding grounds for criminal gangs. The wave of well-orchestrated attacks that paralyzed São Paulo last year illustrated the sophistication and serious threat posed by such prison-based gangs, especially as they enter into overt conflict with state police forces.

Aside from the clear concerns both gang—and police-related violence should spark about individual rights and the rule of law, they also have a more quantifiable cost in terms of lost lives, risks to investors, and the overall business climate. For reasons that are not entirely clear, murder rates have been declining from record levels in some major cities such as São Paulo. But homicide rates remain significantly above the world average, and kidnappings and violent robberies are widespread and probably rising (although data is sparse). These crimes inevitably have a cost, most dramatically in the case of tourism, but increasingly in other economic fields. As Fiona Macaulay notes in her masterful recent survey on public security in Latin America, the economic cost of crime in Latin America has been estimated by multilateral development agencies at fourteen percent of GDP, with a lower but still highly significantly cost of three to five percent of GDP in Brazil.[7] If the cost of exchange rate policy to the economy were this high, surely a coalition of business and civil society groups would begin to pressure Congress for change. So far, however, the pressures for public security reform have been too fragmented to generate a common framework that can overcome the strong mutual distrust and jealousy between the powerful professional lobbies of Brazil's many different police forces, prosecutors and judges.

Despite these many long-term risks, it is very unlikely that there will be any explosive denouement to Brazil's current predicament. For all its failures, the political system is well institutionalized, procedurally democratic, and highly adaptable. There is no race between order and disorder; the two seem to coexist in comfortable harmony within the political system. This, to some extent, is both the tragedy and the paradox that confront any observer. Democratic Brazil is the country of muddling through, neither advancing in grand spurts nor imploding in self-destructive fury. The question is whether this is a sustainable or desirable outcome.

My message here has been a cautious one. Brazil appears to be teetering on the brink of greater things. It is far better off than its supposed counterparts in the BRICs, and indeed, it would probably be a mistake to set the country's sights as low as the association with the other three BRIC nations suggests, when the real quest is to pull alongside the consolidated OECD democracies. Although achieving meteoric Chinese-style growth does not seem to be in the cards, neither do the associated political, social and environmental convulsions this may trigger. Rather, the long-term outlook for Brazil must go beyond economic growth alone, deepening the social and political foundations of Brazilian democracy.

In light of recent improvements, there is much to be hopeful about. But if Brazil is to achieve its potential, the consensus regarding economic stabilization needs to be expanded to include three central themes for reform: 1) human capital development, including basic health, education and public security provision; 2) electoral and judicial reform, aimed at curbing both corruption and the pork-centered process of coalition formation; and 3) fiscal and tax reforms aimed at increasing the flexibility and decreasing the weight of the Brazilian state. Although all three are increasingly on the minds of many observers, momentum has not yet built to generate the significant societal pressure required to seriously advance these reforms.

Notes

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[1] Barry Ames, *The Deadlock of Democracy* (Ann Arbor, MI: University of Michigan Press, 2001), 3.

[2] Paulo Tafner, "Brasil: O Estado de uma Nação: Mercado de trabalho, emprego e informalidade (Brazil: The State of a Nation: the labor market, employment and informality)," *Instituto de Pesquisa Econômica Aplicada (IPEA)*, 2006, 266. Available at: http://www.ipea.gov.br/Destaques/brasil2/Resumo_MercadodeTrabalho.pdf (accessed January 31, 2008).

[3] Data courtesy of Tendências Consultoria Integrada.

4 The population between fifteen to sixty-four years of age; "5º Indicador de Alfabetismo Funcional: Um diagnóstico para a inclusão social pela educação," *Instituto Paulo Montenegro*, São Paulo, September 2005. Available at: http://www.ipm.org.br/ipmb_pagina.php?mpg=4.02.00.02.00&oin=5&idn=1&ver=por (accessed January, 31, 2008).

[5] The category "social spending" in the federal government's budget does not include health, education, and social security spending. When all of these forms of discretionary spending are summed, the Bolsa Família accounts for about one in six reais of total spending.

[6] A. C. Figueiredo and F. Limongi, *Executivo e Legislativo na nova ordem constitucional,* (Rio de Janeiro, Brazil: Editora FGV, 1999).

[7] Fiona Macaulay, "Knowledge Production, Framing and Criminal Justice Reform in Latin America," *Journal of Latin American Studies* 39, no.3 (2007): 627-651.