



# Can Brazil overcome economic malaise and scandal?

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## KEY POINTS

- *Brazil's economic malaise and corruption scandals present significant challenges to President Dilma Rousseff's ability to govern, just four months into her second four-year term.*
- *Latin America's largest economy is rediscovering that stimulating growth and creating jobs requires controlling government spending, increasing trade, and attracting investment by adopting a host of free-market reforms.*
- *The United States and Brazil should jump-start efforts to improve their commercial and diplomatic relations to bolster economic development in a region crucial to both countries.*

**W**hile US policymakers, commentators, and the media have been distracted recently by the “historic” normalization of US-Cuban relations, the rest of Latin America is beset by extraordinary challenges—not the least of which is the economic malaise and governance crisis in Brazil, South America’s most populous country and the world’s sixth-largest economy.

Sworn in for a second four-year term just over three months ago, Brazilian President Dilma Rousseff is confronting the worst economic conditions in decades and a spiraling public corruption scandal involving the state-owned oil company Petrobras. Even before her narrow victory last October, most Brazilians questioned whether her policies could jump-start economic growth and address the nation’s social and economic challenges.<sup>1</sup> Today, her popularity has plummeted: according to Brazilian polling institute Datafolha, 62 percent of those interviewed rated Rousseff’s government as “bad”

or “terrible,” while only 13 percent considered the government “great” or “good.”<sup>2</sup>

In the last two months, a series of protests in Brazil’s main cities have drawn millions of people to the streets demanding Rousseff’s impeachment. Although the dissatisfaction appears to be rooted in middle-class anxiety about a flagging economy, the protests have intensified because of allegations that contractors working for Petrobras paid \$800 million in kickbacks to politicians—the vast majority of whom are from the president’s left-wing Workers’ Party (PT). (Unless investigators are able to prove Rousseff’s direct knowledge of the kickback schemes, however, few experts expect the matter to escalate to her impeachment.) Government supporters also have taken to the streets to defend labor rights and demand an increase in teachers’ salaries.

Combined with the potential of Brazil’s vast natural resources, a regimen of overdue reforms

should eventually get the economy growing again. Rousseff appointed a new economic team at the beginning of the year that has proposed new measures to restore economic confidence and growth. And in the wake of demonstrations in March, her attorney general announced stiffer penalties for political corruption.<sup>3</sup> However, scandal-ridden politics, a fractious National Congress, and the president's plummeting approval ratings may make it difficult for her new team to get traction in a second term.

## Mixed Legacy of the Workers' Party

When longtime labor leader Luiz Inácio da Silva (popularly known as "Lula") assumed the presidency of Brazil in 2003, his predecessor, Fernando Henrique Cardoso, had established the underpinnings of a strong and prosperous economy. Keeping most of Cardoso's macroeconomic policies, Lula enjoyed the benefits of an economy that was flourishing, with record commodities exports to China and high oil prices. Moreover, the 2007 discovery of vast oil deposits in Brazil's territorial waters appeared to ensure the country's economic security for decades.

While credited for reducing poverty by 30 percent, Lula's administration neither secured the prosperity of the new middle class nor laid the foundation for a Brazilian economy capable of competing in the 21st century.<sup>4</sup> A year ago, in a research paper for the American Enterprise Institute, we explained that Lula failed to push through essential reforms for "improving government efficiency and accountability, simplifying the labyrinthine federal and state tax systems, and removing arbitrary obstacles to doing business."<sup>5</sup>

Despite leaving behind important unfinished business, Lula's personal popularity allowed him to name his successor, Dilma Rousseff, who had served as minister of energy and presidential chief of staff. After she was elected to the presidency in 2008, Rousseff maintained most of

Lula's populist policies and continued to ignore a reform agenda.

But unfortunately for Rousseff, the end of the China commodity boom and the failure of leaders to retool the Brazilian economy have taken their toll. During Rousseff's first term as president, the economy of Brazil went from expanding an average of 4 percent per year between 2002 and 2008 to averaging just 1.3 percent growth in the last four years.<sup>6</sup> This year, the trend is expected to deteriorate even further with a contraction of 0.5 percent.<sup>7</sup>

In hindsight, Rousseff's undoing may have been relying on social programs that produced record deficits and rising expectations while failing to create sustainable jobs. For example, an estimated 50 million people in Brazil have benefited from government social welfare program Bolsa Família, which provides conditional cash transfers to very poor families to reward school attendance and vaccinations. However, 12 years after Lula expanded the program, only 12 percent of the beneficiaries have been able to improve their economic situation to rise into the middle class.<sup>8</sup> And the demand of that burgeoning middle class for greater opportunity, first manifested in spontaneous demonstrations in 2013, is at the heart of the crisis Rousseff is facing today.

With commodity prices beginning to fall in 2013, economic growth slowing, and government spending climbing, Rousseff doubled down on costly government solutions to ensure her reelection. In particular, she expanded social programs to shore up support in underdeveloped regions and with demographic groups that rely on government subsidies. Indeed, Rousseff managed to win reelection in October 2014 in large measure because of the dependence of poor voters on the social safety net. As *Investor's Business Daily* reported, "Every state that [voted] for Rousseff had at least 25% of the population dependent on Brazil's Bolsa Família . . . [whereas] states with less than 25% of the population on Bolsa Família overwhelmingly went for [opposing candidate Aécio] Neves and his policies of growth."<sup>9</sup>

# Mismanagement and Scandal at Petrobras

It would be fair to expect that Brazil's elected leaders also would derive political benefits from a state-owned oil company. Naturally, Petrobras's infrastructure and access to vast new petroleum deposits would attract foreign investment, modernize the nation's industrial capacity, and generate substantial revenue. However, the mismanagement and manipulation of Petrobras have become a liability for Brazil and its ruling party.

The inefficient management of Petrobras stems from politicians' reliance on oil revenue to sustain government spending and protectionist policies have driven away foreign capital and technology. This has all led to the company's failure to generate the expected revenue from new vast oil deposits.

After discovering pre-salt deposits in 2007, Lula's relentless cheerleading raised expectations that the country's oil wealth would attract foreign capital and technology that would transform the country's industrial base and that boundless revenue would sustain substantial and indefinite increases in government spending.<sup>10</sup> Petrobras initiated one of the largest corporate capital expenditure programs in the world (approximately \$237 billion).<sup>11</sup> However, the Brazilian government also imposed "a nationalistic mandate to buy oil platforms and other equipment from Brazilian companies, which has triggered a soaring debt, major project delays, and fields that are yielding less oil."<sup>12</sup> The hopes that were raised by Lula were dashed under Rousseff.

The Petrobras scandal that has seized the nation's attention today has been traced back to 2005, when important engineering and construction firms in Brazil allegedly began bribing government officials with the proceeds of inflated contracts. In a larger sense, this scheme is rooted in the corruption that has plagued Brazil for decades. In terms of perceived corruption, Brazil is ranked 69th out of 175 countries, according to Transparency International.<sup>13</sup> According to the Federation of Industries in São Paulo, corruption costs the country between 1.4 percent and 2.3

percent of its GDP, which translates into \$34–56 billion annually.<sup>14</sup> As *Forbes* reported, "Petrobras has not been able to say exactly how much money it lost to corruption. But new CEO Aldemir Bendine hinted it could be as much as \$30 billion. As of March 6, Petrobras' market cap was \$39.7 billion."<sup>15</sup>

Investigators in the Petrobras case have released a list of 54 politicians who are being investigated for possible involvement in the scheme. The list includes 34 congressmen and 5 former ministers of Rousseff's administration. While Rousseff and Lula are not included in the list, Alberto Yousseff, a whistleblower cooperating with the investigation, has testified that the two presidents knew of the kickback system.<sup>16</sup>

## The mismanagement and manipulation of Petrobras have become a liability for Brazil and its ruling party.

Among those on the list released by prosecutors are Speaker of the House Eduardo Cunha and President of the Senate Renan Calheiros, both members of the Brazilian Democratic Movement Party (PMDB). Although Cunha is fiercely independent from Rousseff, his PMDB is the party that she will depend on to pass badly needed economic reforms. After his inclusion on the list of targets, Calheiros scuttled a presidential austerity decree for what he called "procedural reasons."<sup>17</sup> Many viewed his action as retaliation for the government's failure to protect him.<sup>18</sup> And earlier in April, investigators arrested João Vaccari Neto, who resigned as treasurer of the ruling Workers' Party after being interrogated for soliciting campaign donations from Petrobras contractors and laundering this money to fund PT campaigns.<sup>19</sup>

While Rousseff chaired the Petrobras board of directors during much of the period of the kickbacks, the ongoing government investigation has yet to uncover evidence implicating her directly in the scheme. However, the fact that the word "impeachment" is being raised in the media

and at massive demonstrations is a serious challenge for a president in the early months of her second term.

In early April, the scandal widened when investigators alleged publicly that kickbacks were also paid to politicians from the proceeds of inflated contracts issued by the Ministry of Health and by Caixa Econômica Federal, a government bank that is the country's largest mortgage lender. The revelation was particularly troubling because it came just days after Rousseff's new finance minister, Joaquim Levy, announced a joint venture with Caixa Econômica. A senior official of the Federal Police who is investigating the kickbacks stated ominously, "We're facing a business model that is repeated in contracts around Brazil's public sector."<sup>20</sup>

## **Nearly 70 percent of the population of Brazil believe that their president is responsible for one of the greatest corruption scandals in its history.**

The anticorruption measures Rousseff's team announced in March include criminalizing campaign slush funds, seizing assets of people found guilty of corruption, and requiring that government officials have no criminal records. "This is a decisive step to expand the government's capacity and power to prevent and combat corruption and impunity," Rousseff noted during a broadcast speech in March.<sup>21</sup>

Although Rousseff's impeachment might be unlikely, a poll published on March 23 by polling firm MDA showed that 59.7 percent of respondents favored impeaching her, and 69.9 percent said they believe she is responsible for the corruption in Petrobras.<sup>22</sup> When nearly 70 percent of the population of Brazil believe that their president is responsible for one of the greatest corruption scandals in its history, it is unlikely that mere changes in the law will restore public confidence in her government. The

creation of an independent agency to oversee government contracts and investigate corruption claims is a concrete measure that might quell public outrage. Fortunately, unlike in other South American countries facing corruption crises today, such as Venezuela or Argentina, Brazil's judiciary is respected for its rigor and independence.

## **The Economic State and Rousseff's New Team**

The Petrobras scandal and the country's broader economic doldrums nearly derailed Rousseff's reelection bid last October. Today, the expanding investigation poses a growing threat to Rousseff's ability to govern, and perhaps her political survival. If the president's new economic team fails to arrest the decline of an economy already in recession, she may lose support within her political base.

These scandals are taking place against the backdrop of the worst economic crisis in Brazil since the early 1990s. Inflation stands above 7 percent; gross public debt is at 66 percent of GDP; industrial production is expected to contract by 0.72 percent; investment is down 8 percent from a year ago; unemployment stands at 5.9 percent; and Brazil's currency, the real, has fallen 30 percent against the dollar since 2013.<sup>23</sup> It is also estimated that prices of goods have increased by 8 percent from last year, which represents the biggest change in more than a decade.<sup>24</sup>

Brazil is the world's largest producer of sugar, soybeans, and coffee and a significant exporter of oil and iron ore. Unfortunately for the country, commodity prices have declined drastically with shrinking international demand. For example, CNN reported the price of sugar is down by 24 percent, coffee has lost 29 percent of its value and soybeans have dropped 32 percent.<sup>25</sup>

In a television address on March 8, Rousseff noted, "The government has decided to courageously change its methods and seek solutions that are more appropriate to this moment, even if it means temporary sacrifices for everybody and unfair and exaggerated criticism

against the government.”<sup>26</sup> Rousseff has also blamed the economic problems on international conditions, including “the most serious international crisis since the great depression of 1929 and the worst drought in history.”<sup>27</sup> Nevertheless, while international factors are to blame for less money in the coffers, her economic policies have worsened an already fragile situation.

In response to the economic crisis, Rousseff changed her economic team. Joaquim Levy, a US-trained economist, was appointed as finance minister. Levy is known in Brazil as “Joaquim Scissorhands” because of his record of cutting government programs.<sup>28</sup> After taking office last November, Levy sought to reassure international capital markets by describing a plan to control spending, increase revenue, produce a surplus, and decrease public debt. Levy pledged fiscal measures that he says would generate 2 percent more revenue for the government this year. Removing electricity subsidies and imposing a fuel duty are part of his strategy to control government spending and increase revenue.<sup>29</sup> “[T]he immediate objective is to establish a target for the primary fiscal surplus for the next three years that is compatible with the stabilization and decline of gross public debt in relation to GDP,” he said.<sup>30</sup>

Rousseff also appointed former Treasury secretary Nelson Barbosa as planning minister to oversee infrastructure projects. Barbosa has underscored the importance of ensuring that investors are offered higher returns and decreasing government intervention.<sup>31</sup>

In a move to slow inflation and appreciate the real, the Brazilian central bank’s monetary policy committee raised interest rates to 12.75 percent—a change that roiled the waters. As one analyst told CNBC, “Yes, inflation is a big problem and they have been working very hard to clamp down price pressures, but by raising interest rates, they seriously risk tossing the economy into deeper recession.”<sup>32</sup>

Rousseff’s new economic team is talking tough on fiscal discipline. It remains to be seen if the president is prepared to risk her dwindling popularity by allowing a currency devaluation and lowering interest rates, as experts say is necessary. The margin for maneuvering on

budget cuts is limited, particularly because Rousseff’s own party and restless political base continue to oppose austerity measures, such as cutting pensions and unemployment benefits.<sup>33</sup>

In March, Brazil announced a February trade deficit of \$2.8 billion, its worst monthly performance since 1980.<sup>34</sup> Although much of this slowdown can be attributed to the country’s overdependence on the China-driven commodity boom, Brazil’s exports to every region in the world also have suffered serious setbacks. An important exception is Brazil’s trade with the United States, which continues to purchase Brazilian aircraft in significant numbers. In fact, according to the Census Bureau, trade between the two nations increased by 8.9 percent, with the United States enjoying a \$12.1 billion trade surplus with Brazil in 2014.<sup>35</sup>

## **Cumbersome, complex, and time-consuming rules for conducting business in Brazil are a drag on its competitiveness.**

Recently, Finance Minister Levy and Trade Minister Armando Monteiro visited the United States to promote further commercial engagement between the two countries. This is a significant shift from Rousseff’s first term in office and an ideal opportunity for both nations to revamp economic relations. In an interview with the *Wall Street Journal* a Brazilian official noted, “It is a material fact: Brazil needs to export more, so it needs stronger links with the United States.”<sup>36</sup>

Cumbersome, complex, and time-consuming rules for conducting business in Brazil are a drag on its competitiveness. The term “custo Brazil” is used to describe the added time and costs of investing and operating in the country. For example, excessive labor costs and one of the world’s most convoluted tax systems discourage investors, both foreign and domestic, from doing business in Brazil. In fact, according to Deloitte,

“Brazil’s complicated legal system, and other benefits drive up a company’s payroll as much as 80%.”<sup>37</sup> Reducing these barriers is key to attracting greater foreign investment.

Brazil’s byzantine tax code—the federal laws compounded by a layer of 26 different state codes—imposes a prohibitive cost on normal business practices. Brazil’s tax regime is ranked as one of the most time-consuming in the world; according to the World Bank, companies must spend about 1,200 hours a year to prepare their taxes.<sup>38</sup> Even after a company’s accounting team completes the required paperwork, the tax authorities’ delay in reviewing the documentation is another bureaucratic burden.

Additionally, Brazil does not follow Organisation for Economic Co-operation and Development guidelines for transfer pricing. As the United Nations Tax Committee describes, “Transfer pricing’ refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of a multinational enterprises group.”<sup>39</sup>

Multinational companies implement their transfer pricing procedures based on a harmonized policy for all the countries in which the company has operations. However, Brazil has a completely different method. Consequently, this practice generates uncertainty for new investors seeking to comply with Brazil’s transfer pricing and to limit the risks of economic double taxation. This is one of the most difficult challenges for tax accountants and lawyers representing foreign entities in Brazil when dealing with the country’s fiscal system.

The economic crisis may force the hand of Brazil’s leadership to adopt more free-market solutions. Fiscal discipline, anticorruption reforms, and expanded trade with stable world economies can help revive Brazil’s aspirations of becoming an economic powerhouse. With less interventionist economic policies and a more robust private sector, recent arrivals to Brazil’s middle class could become the motor that drives the economy to reach its potential.

## Seizing Mutual Benefits

With a population of 200 million and a \$2.5 trillion economy (the world’s sixth largest), Brazil has the potential to become one of the United States’ most important economic partners. Maximizing mutual benefits for both countries will require the political will to move beyond the prejudices of Brazil’s political establishment, which tends to see the United States as a rival.

Strengthening and expanding relations with Brazil should be a US presidential priority. Despite their ideological differences, former US President George W. Bush and his counterpart Lula da Silva enjoyed an open, candid, and constructive relationship, precisely because both leaders cultivated a personal rapport. Although the two current heads of state have very different personalities from their predecessors, regular and informal communication can avoid the pitfalls of two great countries pursuing their own agendas. Harmonizing those agendas to the extent possible, requires intense, high-level, and mutually respectful diplomacy. In a promising move, Rousseff accepted President Barack Obama’s invitation to visit Washington in late June—rescheduling the planned October 2013 meeting that the Brazilians canceled because of allegations of US spying.<sup>40</sup>

With Venezuela’s economic collapse, the waning *chavista* petro-diplomacy will leave behind a financial and diplomatic void that should be filled by a constructive partnership formed by the United States, Brazil, and other regional governments whose leaders recognize that communication, cooperation, and coordination are in everyone’s interest.

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# Notes

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