

DEMOCRACY WORKS | COUNTRY REPORT | 2014

# Brazil and the Pursuit of Inclusive Growth

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## Introduction

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The international financial crisis of 2008 destroyed banks, companies, and jobs across the world. It also undermined the developing world's faith in Western leadership, in Western models of capitalism, in Western models of progress, even in what economists once called the Washington Consensus on macroeconomics. In the subsequent vacuum, many began looking for an alternative.

Some have turned to the 'Chinese model'—the 'Beijing consensus'—for inspiration, and no wonder. China has grown with phenomenal speed over the past 20 years. Thanks to this growth, some 600 million people have escaped from poverty. At the same time China's size and military prowess have given it an outsized strategic and diplomatic significance. The 'rise of China' is now an inescapable cliché of international political debate, so much so that some believe Chinese-style authoritarianism is a desirable, even a necessary component of economic growth.

But China is not the only developing country which has achieved high levels of growth in the past two decades, and its model is certainly not necessary or even desirable in many parts of the world. Though they do not attract the same kind of attention as China, there are now several large, successful emerging democracies in the developing world, all of which have achieved rapid growth, at least for some periods, without Chinese-style authoritarianism. These include Turkey, Mexico, and Indonesia, as well as the three primary subjects of this series of country papers: India, Brazil and South Africa. Through the exploration of the history, the economics and the politics of these three countries, this series seeks to establish the elements of another possible road to growth and development: the democracy 'model,' or perhaps the 'democracy consensus.'

This report focuses on Brazil, asking what lessons Brazil's experience provides for other countries which want to promote inclusive growth as well as democracy. It is based on four specially commissioned research papers and draws on insights that emerged from a workshop discussion held in Rio de Janeiro on May 20, 2013, attended by Brazilian economists, political scientists and journalists.<sup>1</sup>

The report starts with the history of Brazilian democracy, and a discussion of the strengths and weaknesses of the current system. It then explores in detail how Brazil's democratic institutions (political pacts, elections, parliament, courts, and civil society) have affected the country's attempts to promote growth, reduce poverty, stimulate innovation and keep corruption in check. The final section focuses on the institutional reforms and policies that should be implemented to consolidate recent achievements, and which would allow the country to strengthen the economy, reduce poverty and entrench the political freedoms which have been established in recent decades.



## The Story of Brazil's Democracy

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### THE EMERGENCE OF DEMOCRACY IN BRAZIL

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Brazil has a long history of democracy, interrupted with periods of authoritarianism.<sup>2</sup> In 1964, after a period of political unrest, the country came under a military regime that lasted for twenty years. Transition back to democracy began in the late 1970s, when the military initiated a gradual process of political liberalisation.

This transition was gradual and relatively stable. The Brazilian military regime, alone among its counterparts in Latin America, created its own political party, and began to compete in semi-free elections. Aided by electoral laws that enabled it to appoint one-third of the senators, the pro-military party maintained a majority in the Senate until 1985. During this period the use of torture was gradually curbed. Habeas corpus was restored in 1978. In 1979 a general amnesty took effect and new parties were allowed to form, and in 1982 direct elections for state governorships took place for the first time in nearly two decades. Opposition parties gradually grew stronger but for a long time did not appear to threaten the incumbent regime.<sup>3</sup>

An economic downturn and the political ineptitude of the pro-military regime finally produced a breakthrough to real civilian government in 1984, when an opposition 'campaign for direct elections' produced the largest mobilisation of Brazilians the country had ever experienced. This pressure from below eventually led to the indirect election of the opposition leader Tancredo Neves to the presidency. He fell ill and was replaced by José Sarney, a regional boss and politician who was the civilian vice-president of the last military government.<sup>4</sup> Although the politics of this period

were often convoluted, the gradualness of the liberalisation process may be responsible for the stability of democracy in Brazil today.

## INFLATION AND POLITICS

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The transition to democracy took place under extremely adverse economic conditions. Throughout the 1980s Brazil had triple-digit annual inflation and in the early 1990s, inflation spiralled completely out of control. Public pressure, channelled through new democratic institutions, put pressure on politicians to control inflation and restore economic growth. In February 1986, President Sarney attempted to halt inflation by introducing both a new currency, the cruzado, and a wage-price freeze. Despite some initial success the 'Cruzado Plan' ultimately failed because it left the underlying causes of inflation untouched.<sup>5</sup> Sarney's popularity declined sharply.

In 1988 a new constitution was enacted, with strong emphasis on political and social rights, creating large entitlements and the transfer of resources to states and municipalities. At first, these costs were covered by inflation, implying large transfers of income from the poor and wage earners to the public sector, and, later, as inflation came under control, led to a large increase in the country's tax burden.

Inflation was controlled at last in 1994 and Fernando Henrique Cardoso, the politician responsible, was rewarded with enormous popular support. As finance minister in the government of Itamar Franco, Cardoso designed the 'Real Plan' which promoted fiscal restraint, tight monetary policy and the encouragement of foreign investment. As a result of this policy change, inflation plunged from 5,200 percent to nearly zero. Cardoso was elected president with 54 percent of the popular vote. Throughout his presidency, Cardoso continued to control inflation while preparing Brazil for integration into the world economy.

Cardoso's plan used the exchange rate as an anchor for stabilising prices. A strengthened currency (initially created by pegging the real to the dollar) produced cheaper imports, which dampened inflation and forced domestic producers to lower their prices and become more competitive. To combat the subsequent current-account deficit Cardoso sought to attract foreign capital inflows by keeping interest rates attractively high while promoting movements towards balanced public accounts to mitigate his strategy's impact on internal debt. He consequently fought hard to reduce

government deficits by reforming social security, the civil service, and the tax system. In addition, Cardoso promoted the privatisation of state-owned companies and sought to eliminate deficit spending at all levels of government.

## LULA AND ROUSSEFF

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In 2002 Luiz Inácio Lula da Silva, the leader of the Workers' Party (PT), won the presidential election. He had tried and failed to win the presidency in three previous elections. The success of his fourth attempt can largely be attributed to a combination of three factors: his popular appeal as a working-class person and union leader who opposed the military regime; the unfavourable scenario that had stalled the Brazilian economy since 1999 and eroded the support of the government's party; and the skilful way in which he assured the business sector that he would maintain the macroeconomic arrangements put in place by the Cardoso government. He chose a wealthy businessman, José Alencar Gomes da Silva, as his running mate.<sup>6</sup>

The first challenge Lula faced as president was, predictably, the spectre of inflation. Before Lula even took up his presidency, a sharp depreciation of the Brazilian currency and a spike in inflation led the Central Bank governor, Arminio Fraga, to enter into an agreement with the International Monetary Fund (IMF). The governor called upon all presidential candidates to support the agreement. Lula replied with an open letter in which he pledged to uphold currency stability and fiscal austerity. When he took the reins Lula invited Henrique Meirelles, a top executive at the FleetBoston Corporation, to run the Central Bank, promoted high interest rates, and did not reverse the privatisation of public companies. In 2003, his primary-budget surplus totalled 4.3 percent of GDP.

With economic stability and the world's commodity boom, the Brazilian economy started to grow again in 2005, allowing the government to engineer repeated wage and pension hikes while also channelling modest social spending towards Brazil's poorest families through the Bolsa Família (Family Stipend) programme, which granted monthly cash payments to poor households with children of school-going age. In 2006 Lula was re-elected, and by then it was clear that his voting base had shifted from his traditional stronghold in the urban industrial South and Southeast regions to the impoverished municipalities in the North and Northeast, where Bolsa Família benefitted a large share of households.<sup>7</sup>

Brazil's next president, Dilma Rousseff, attained office on the back of endorsements she received from Lula, and because she promised to protect and extend the legacies of Lula's presidency. In the run-up to the 2010 elections Lula endorsed Rousseff as his "incarnation" in female form, while Rousseff herself promised that if elected she would be "a mother for our people," putting the needier and more fragile first.<sup>8</sup>

The booming export sector and the redistributive policies helped to lift millions of Brazilians out of extreme poverty, helping to ensure the continued dominance of the PT. However, the government was unable to mobilise sufficient investment in infrastructure and could not make the Brazilian economy more competitive beyond the commodities sector. The world-wide economic slowdown hit Brazil hard in 2008, when the economy shrank by 0.2 percent, and again in 2012, when it remained at 0.9 percent growth. Now, inflation and budget deficits are once again creating a major challenge for Brazil's leaders. Generous government spending on pensions or minimum wages, for example, no longer appears to be an option. Under increasing pressure from protestors, the president who is elected in 2014 will have to ensure the higher and more inclusive growth that Brazil needs to survive as a stable democracy.

## Growth and Democracy

Brazil's economic trajectory since the start of the twentieth century has been highly uneven, with periods of strong growth followed by severe economic crises. While growth levels have not been directly linked to the type of political regime in operation, economic crises have often produced social instability, which has itself produced major political changes. Figure 1 (see p8) illustrates the trajectory of Brazilian economic growth from 1902 onwards, as well as indicating the alternations between democracy and dictatorship.

Table 1 shows that after the Second World War, Brazil achieved spectacular annual growth rates of over seven percent on average. These economic improvements were, however, accompanied by rapid population growth, so that per capita GDP expanded at a more moderate rate of just over four percent per year.<sup>9</sup>

TABLE 1<sup>10</sup>

YEAR	GDP	GDP PER CAPITA
1951–1980	7.1%	4.3%
1981–1994	1.9%	-0.1%
1995–2004	2.6%	1.0%
2005–2010	4.2%	3.1%

In 1981–2003, GDP growth became both lower and more irregular, with GDP per capita expanding at a modest 0.7 percent annually. Starting in the mid-2000s, GDP growth accelerated again, reaching an average of 4.2 percent, with per capita growth at a healthy three percent per year.<sup>11</sup>

The economy recovered strongly in 2010, following the severe downturn sparked by the 2008 global financial crisis. But since then growth has been anaemic. During the first

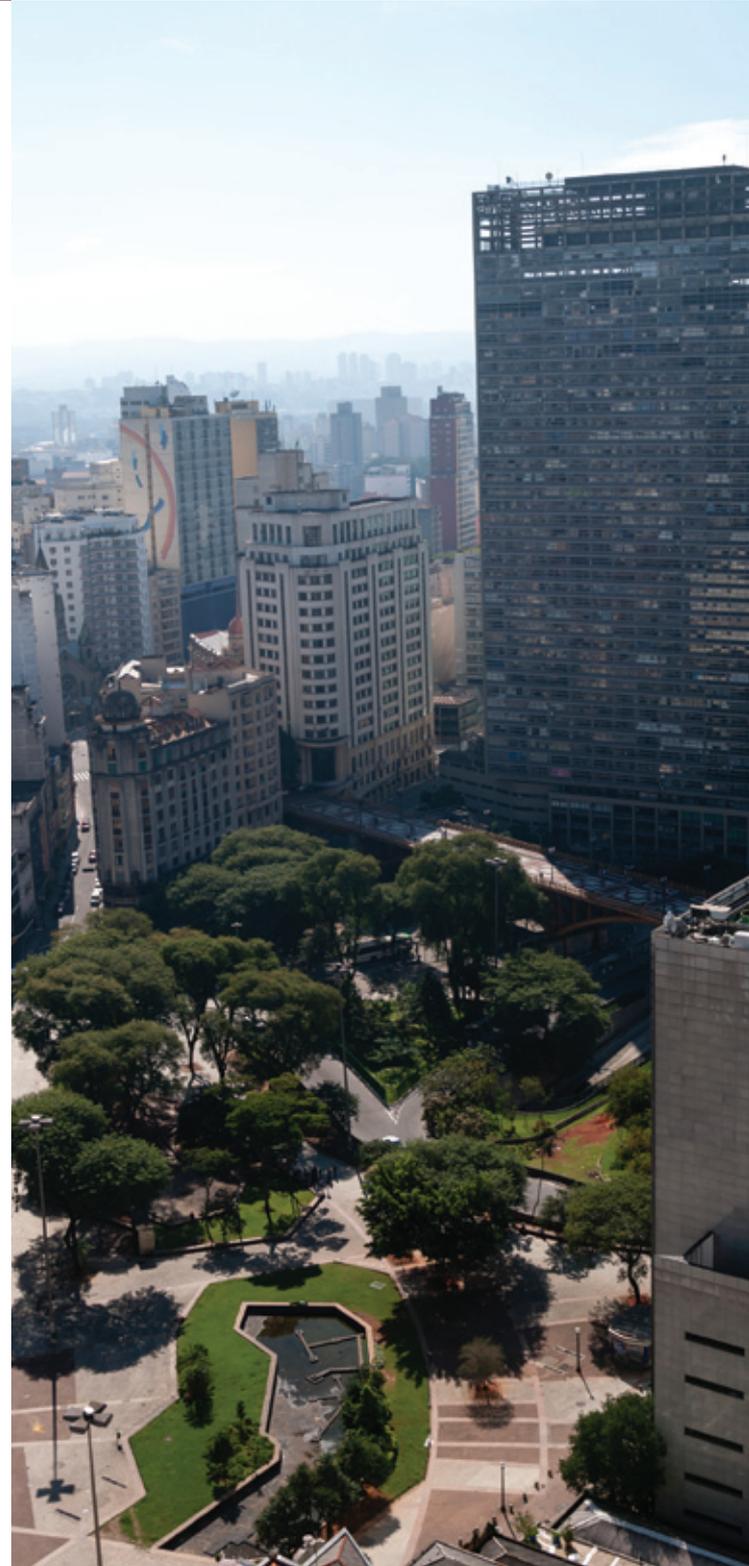
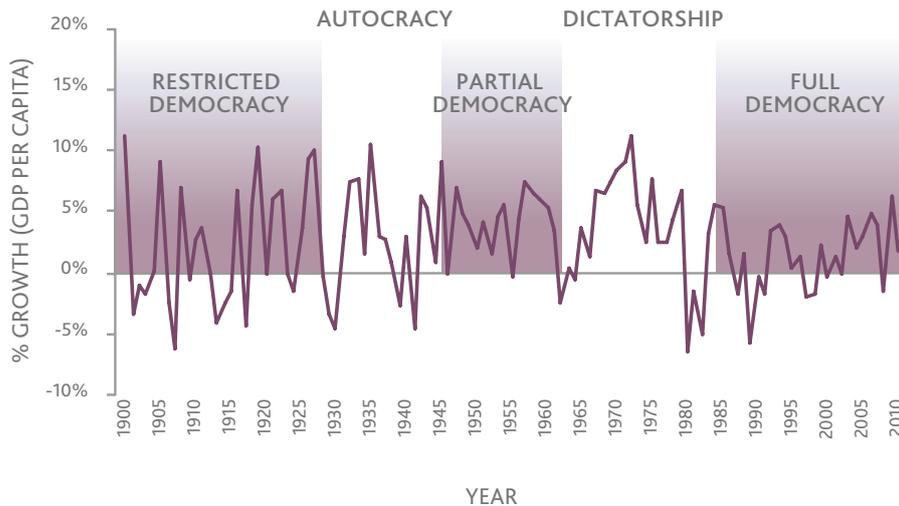


FIGURE 1: BRAZILIAN ECONOMIC GROWTH FROM 1902



quarter of 2013 Brazil's economy grew by just 0.6 percent, which suggests an annual growth rate for 2013 of 2.4 percent.<sup>12</sup>

These numbers were well short of the recovery analysts had expected. For the first time in years the country ran a trade deficit, while government debt rose and inflation edged towards 6.5 percent.<sup>13</sup> The importance of controlling inflation in Brazil once again became evident as rising prices helped to stimulate widespread protests in 2013 and the Central Bank, with the president's full support, raised the base interest rate from 7.5 percent to eight percent, making Brazil the only big economy to tighten monetary policy at a time when the global economy was faltering.<sup>14</sup> By the end of 2013, interest rates were running at ten percent, and the signs were that additional increases were imminent.

## THE FACTORS BEHIND BRAZIL'S GROWTH PERFORMANCE

An assessment of the main contributors to Brazil's post-war growth performance can best be broken down into the following four periods:

1. The golden age of high and relatively stable growth that started in the 1950s and ended in 1980;
2. The high inflation period that began with the 1981 foreign debt crisis and ended with the launch of the Real Plan in 1994;
3. The period of post-price stabilisation and market-friendly reforms from 1995 to 2004; and
4. The most recent boom that began in 2005 and has now run out of steam.<sup>15</sup>

Both rising employment and a substantial increase in productivity contributed to the high growth rates from 1951–1980. The millions of rural people who entered the labour market in cities in this period contributed greatly to this process too. By contrast, improvements to health and education were not significant enough to contribute to this expansion, which came to an end in 1980.<sup>16</sup>

The growth slowdown between 1981–1994 resulted mostly from a decline in labour productivity, which was itself caused by high inflation and excessive regulation. In the reform period after 1994, rises in employment remained the main source of output growth. A noteworthy trend during this period was the significant slowdown in population growth, which allowed per capita GDP to grow more than labour productivity.<sup>17</sup>

This period was one of stabilisation rather than dramatic improvements in incomes. Nevertheless, empirical studies show that privatisation greatly improved productivity at former state-owned enterprises, and there is also evidence that trade liberalisation pushed firms to modernise and to improve managerial practices. Much greater inflows of foreign investment probably had a similar effect. As prices stabilised, firms shifted their focus from cash management to greater operational and sales efficiency.<sup>18</sup>

In 2005, Brazil's fiscal, monetary, and public credit policies became more expansionist, which led to a boom in domestic demand. Between 2006 and 2010, domestic demand grew on average 5.6 percent annually. This strong expansion stemmed from higher public spending and a virtuous cycle linking monetary, product, and labour markets. Looser monetary policy, a substantial increase in lending by public banks, as well as institutional changes and a large influx of foreign capital led to a major expansion in credit, notably to consumers. From 2003 to 2011, total loans expanded at an average 15.6 percent above inflation, while credit to consumers grew 21.8 percent per annum, i.e. four times the growth in the payroll. This, in turn, led to an expansion in investment and hiring. Lower unemployment and rising real wages brought loan delinquency rates down and encouraged banks to lower interest rates and extend the periods in which loans had to be paid back.<sup>19</sup>

Fears surrounding the ascendancy of Lula da Silva and the PT to power did lead to a major devaluation of the currency in 2002. As a result, once inflation pressures stemming from the weak real were controlled, Brazil was left with a very competitive exchange rate, and the currency had room to appreciate. From 2003 to 2011 the real gained 50 percent in value, controlling for inflation, against a basket of currencies of Brazil's main export markets.<sup>20</sup>

Rising export prices were the other, very important, stimuli behind Brazil's boom. Starting in late 2002, export prices started to rise rapidly (commodities and food), more than doubling in US dollar terms over the following decade. As a result the terms of trade improved dramatically, rising 35 percent above their 2005 levels in 2011.<sup>21</sup>

## HOW HAS DEMOCRACY AFFECTED GROWTH?

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Government intervention designed to protect selected economic sectors and to provide specific benefits has historically been widely supported in Brazil, and is seen as a legitimate means of promoting economic development. Over time, several public agencies have been created to stimulate private investment and to co-ordinate economic decisions. Consequently, government and public agencies have come to play an important role in regulating private activities in Brazil.

While democracy has not eradicated this tradition of government intervention and rent seeking, democratic politics have affected its extent and its shape. Under the dictatorship, government regulations helped to ensure that the majority of economic opportunities were available only to powerful interest groups. Under democracy, state resources have been disseminated more widely, and are often used to build support for political decisions.

But private demands for the state's resources frequently exceed the state's capacity to deliver. Examples include the universal, free healthcare system established by the 1988 Constitution, and the assumption that all higher education should be provided for free by public-supported, research-intensive universities. When this happens, the result is either inflation, tax increases or attempts to reform the system, reducing state obligations and allowing the private sector greater leeway.

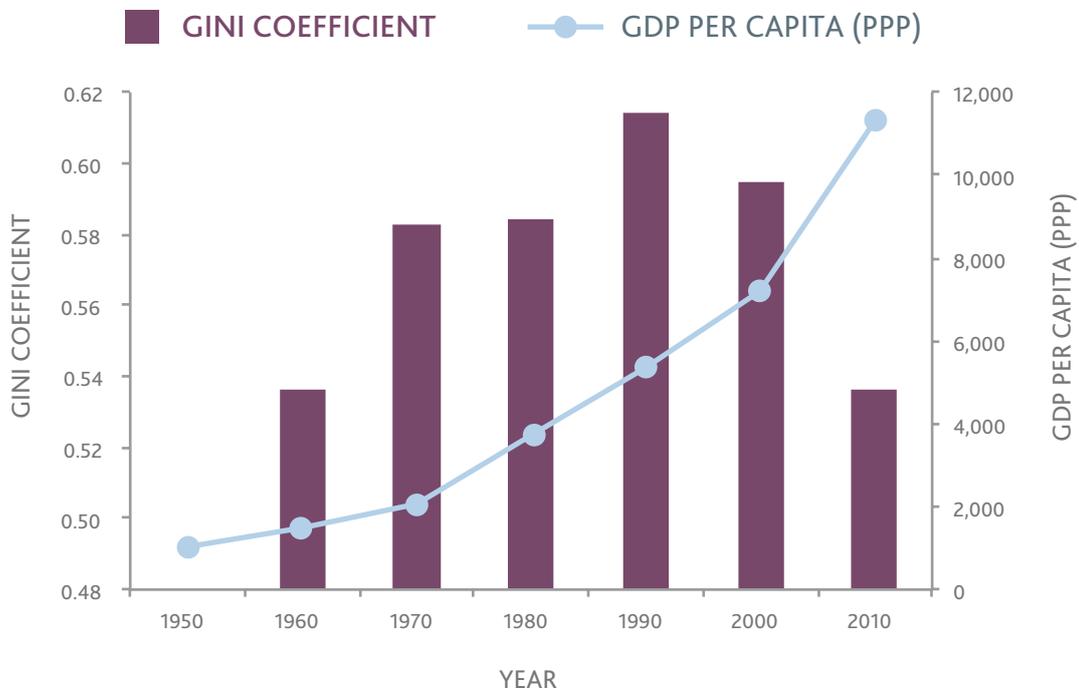
The pattern of reform in this regard has largely been one of 'two steps forward and one step back' for a considerable period of time. In the 1960s, high inflation, low growth, and an external crisis under a fixed exchange rate regime combined with political instability led to the overthrow of the civilian government and the establishment of a military regime that would last until 1984. In its first years, the military government introduced fairly extensive reforms, including government spending controls, the creation of the Central Bank, regulation of capital markets, and the introduction of several credit instruments. In response to these reforms, growth rebounded during the late 1960s, averaging seven percent annually although income inequality remained high and rose even further in the 1980s, because of inflation, while the provision of standard public services such as health and education remained poor.

The economic achievements of the 1970s, plus the availability of cheap international credit, led the government to embark on an ambitious nationalist project of economic and military self-sufficiency. Key policies included import substitution, with particular support for sectors such as the naval industry, and those which produced capital goods and goods for export, as well as infrastructure, managed mostly through the National Development Bank (BNDES); and the nuclear agreement with Germany, which was supposed to provide Brazil with the ability to produce enriched uranium. With increasingly expansionary fiscal policies, inflation accelerated and the current-account deficit rose.<sup>22</sup> Rather than promoting fiscal consolidation to deal with spiralling inflation, the government strengthened economic indexation. By the 1980s, inflation spiralled out of control, and this, combined with the sudden increase in international interest rates and the 1980s world recession, led the ambitious growth model of the military to collapse.<sup>23</sup>

As spiralling inflation was harming growth and increasing income inequality, the focus of the early democratic years was on price stabilisation as well as liberalising reforms. Although this process took the best part of a decade, from 1994 to 2001, important reforms—including the dismantling of some sector-specific protections and benefits—were eventually effective. The 2002 economic crisis, which occurred during Lula’s first administration, was handled with orthodox economic policy, including a focus on macroeconomic stability and additional market-oriented reforms in the credit and capital markets.<sup>24</sup> This process of reform has improved market efficiency in Brazil, while related microeconomic reform has helped to formalise the economy, improving firm access to capital markets and reducing income inequality. Over the longer term, these various reforms have resulted in increased investment, rising productivity, and falling income inequality, as illustrated in Figure 2.

FIGURE 2: INCOME DISTRIBUTION AND GROWTH

SOURCE: M DE BARROS LISBOA AND Z LATIF, ‘DEMOCRACY AND GROWTH IN BRAZIL’, PAPER PREPARED FOR DEMOCRACY CONSENSUS WORKSHOP, RIO DE JANEIRO, MAY 2013



Despite the success achieved by these moves to deregulate the economy, Lula in his second administration gradually began to move back towards old patterns of 'national developmentalism'.<sup>25</sup> This trend gathered strength after 2008, when the state responded to the global crisis with increasing government intervention and the resuscitation of old rent-seeking mechanisms, which the government believed would help Brazil recover from recession. Market distortions, such as tax incentives and protections for selected sectors and a growing range of interest groups, were reintroduced. The results have not been positive. Productivity growth and economic growth have both fallen, and the macroeconomic environment has again become volatile. In this challenging economic environment, government agencies are struggling to attain acceptable levels of public service delivery.<sup>26</sup> The lack of resources, combined with the inability of public agencies to manage the investments required for the economy to grow, led the Rousseff government to invite the private sector to bid for partnerships in road construction, oil production and the administration of ports and airports, in spite of the PT's traditional prejudices against privatisation.

Democracy has, therefore, had a dual effect on Brazil's gradual move away from a state-dominated economy to a private-sector driven economy. On the one hand, a democratic system has reduced elites' exclusive access to state resources, while keeping inflation down and maintaining macroeconomic stability. On the other hand, when growth has been high enough to allow it, democratic governments have used their public resources to secure the votes of poorer Brazilians, as well as the support of powerful private groups that benefited from privileged access to government contracts and subsidised credit. Social programmes have had some positive benefits, as a subsequent section of this paper will argue. But the temptation to extend these programmes beyond budget limitations is strong under democracy, and therefore introduces an added element of instability.

A particularly important outcome of democracy has been the rise in public spending on education, increasing from around 2.7 percent of GDP in 1985, to 5.7 percent in 2009.<sup>27</sup> Although education is now recognised as the single most important explanation for Brazilian inequality during the 1970s, it was largely neglected because Brazil's leaders and intellectuals, focused on industrialisation, failed to appreciate that large numbers of highly skilled people were important for economic growth. A small amount of money was invested in universities and research and development (R&D), but overall government spending on education was low compared to other developing countries. The new focus on education that emerged in the 1990s is not only an important means of closing the inequality gap, but, hopefully, can have a significant impact on increasing the country's productivity, depending on whether Brazil is able to improve the quality of, and better manage, public education.

## Democracy and Poverty Reduction

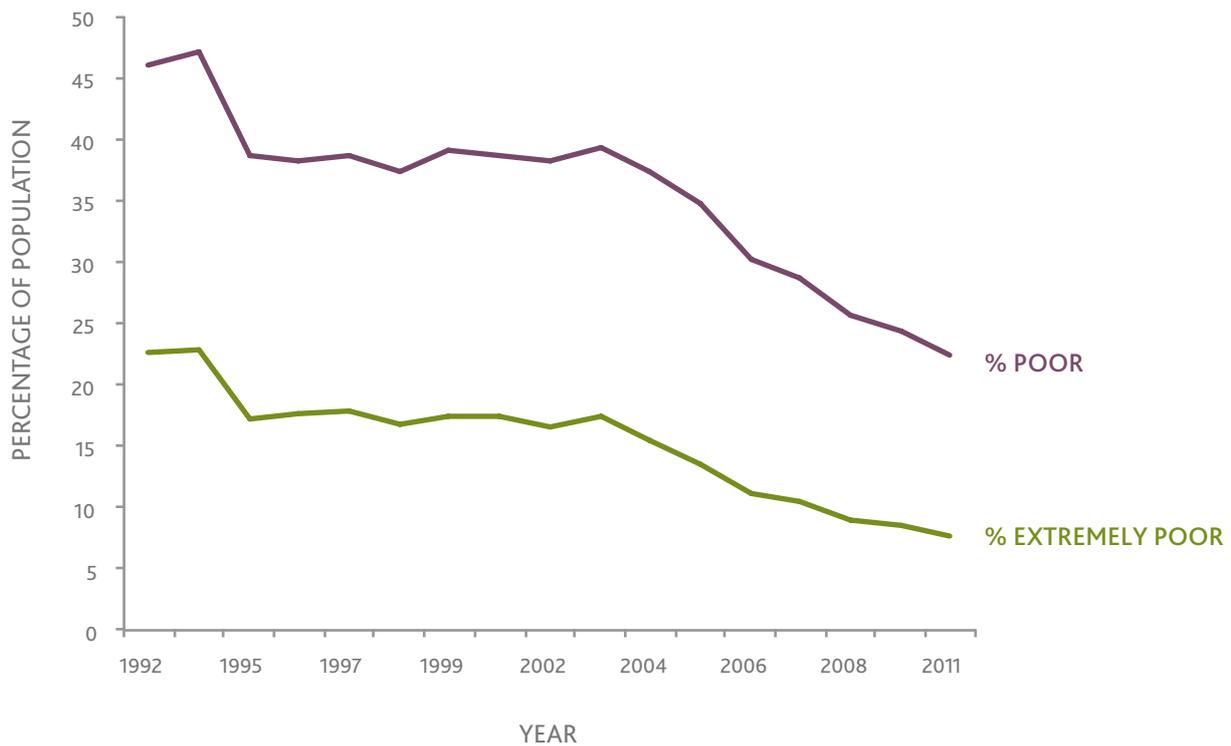
Poverty and income inequality in Brazil have their roots in the slave economy that lasted until 1889. The first policies of social security were introduced in the 1930s, but limited only to civil servants and those in formal employment in the countries' main cities. As urbanisation increased, social security was gradually extended to other sectors of society. A fund for assistance to rural workers was introduced in 1963, and in 1966 a unified National Institute of Social Security was established, bringing together a myriad of institutes that existed for the different sectors of the economy. As the economy modernised and most of the population moved from the impoverished countryside to the expanding urban centres, it was easier to get access to better jobs and public services, including free schooling and healthcare. Urban migration and the demographic expansion of the 1960s and 1970s led to overcrowding, with the creation of large, irregular urban settlements (favelas). Today, 85 percent of the population is urban and fertility rates have fallen dramatically in all social strata. The average rate is now 1.9. Democratisation allowed for the urban and rural poor to get organised and demand better support and living conditions, and politicians realised that they had to respond to these demands if they wanted to attract votes. However, most of the reductions in poverty and income inequality that took place after 1990 are due to broad processes of economic growth and demographic changes, rather than to specific anti-poverty policies. Brazil has no official poverty line, but IPEA, a government think tank, estimated that, according to its criteria, in 2012, Brazil had 6.5 million persons living in extreme poverty and between 15.7 million in poverty, compared with 19.1 and 44 million respectively in 1992.<sup>28</sup>



As illustrated by Figure 3 the first major drop in poverty occurred in 1994, when inflation was curtailed by the 'Real Plan'.<sup>29</sup> Inequality also began to fall at this point. Once inflation had been curtailed, efforts were made to boost economic growth and reorganise the public sector. This period of economic and political stability allowed for the implementation of long-term macroeconomic policies, such as some privatisation and strict fiscal constraints on state and local government. Policy improvements were also made in education access, health and other social sectors.

FIGURE 3: POVERTY LEVELS IN BRAZIL, 1992–2011

SOURCE: THE BRAZILIAN INSTITUTE FOR GEOGRAPHY AND STATISTICS, NATIONAL HOUSEHOLD SURVEYS



Lula was elected in 2002 promising to end poverty altogether. The first anti-poverty programme, 'Hunger Zero', was ill-conceived, and was later replaced by Bolsa Família, a conditional cash transfer programme which became the government's flagship.<sup>30</sup> As the economy started to recover, and after the programme was introduced in 2003, poverty levels started to decline and inequality fell, with the Gini index reaching 0.53—lower than South Africa, though still high by global standards.<sup>31</sup>

Other social indicators have been improving regularly since at least the early 1990s, such as infant mortality, life expectancy and access to education, services and consumer goods. Average education levels have risen from 4.8 years in 1992 to 7.4 years in 2011, and access to school for children under 12 years of age has been close to 100 percent since 2000.<sup>32</sup> Most households now have access to running water and garbage collection, although sanitation remains a challenge. Cell phones are becoming universal, and computer access is close to 45 percent.<sup>33</sup> Poverty remains regionally distributed, and is particularly intense in the North-East and the Amazon. It has decreased in regions which have experienced more recent migration and economic development.

## GOVERNMENT INTERVENTIONS AND POVERTY REDUCTION

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### Labour market policies

A major concern in Brazil has been the high cost associated with formal employment, as well as the size and persistence of the informal sector of the economy. In 2011, 58 percent of Brazil's labour force were formally employed, while the remainder were either self-employed (21 percent), worked in informal jobs (15 percent) or earned no monetary income.<sup>34</sup> Formal employment comes with many costs to the employer—mandatory employment benefits including an annual 13th cheque and 30 days of paid vacation, social security contributions of roughly 20 percent of salary, and an additional eight percent to a special employees' fund. These costs, along with several other smaller taxes, result in formal employment costing employers about twice the monthly salary. In order to meet all legal requirements, firms must also hire a professional accountant, and submit themselves to regular inspection by government labour and tax officials.<sup>35</sup> In addition, the costs and bureaucratic challenges of starting a business are high, placing Brazil 130 out of 185 in the World Bank's 2013 *Doing Business* index. These costs are a particular barrier for small firms, and have resulted in a very large informal sector. The Organisation for Economic Co-operation and Development (OECD) estimates that Brazil's informal sector is equal to about 15 to 20 percent of the country's GDP.<sup>36</sup>

Recently, a number of efforts have been made to reduce the cost of employment and of starting and running a formal business. Legislation adopted during the 1990s, and developed subsequently, offers small firms a simplified registration process. Over 5 million firms had benefitted from these changes by 2011. Recent legislation also allows small-scale entrepreneurs to register and enrol in the social security system at no cost—meaning they can obtain a stipend equivalent to the minimum wage in the event of illness or retirement. By 2011, some 1.5 million people had taken advantage

of this policy.<sup>37</sup> In 2011, the shoe, garment, furniture, and software sectors were exempted from the 20 percent social security contributions—to be replaced by a revenue tax. This was intended to improve the international competitiveness of these sectors, although it is not clear yet whether firms will hire more people or not.

Over time, the size of the informal sector has been falling. In 1991, only 44 percent of the workforce was in formal employment—by 2011 this had risen to 58 percent. In part, this is due to the reduction in agricultural jobs, which are predominantly informal.<sup>38</sup> In principle, formal employment should rise further if the minimum wage were abolished or reduced, as this would lower the costs of employment, particularly for those with few skills. However, the legal minimum wage has increased regularly, in real terms, during the last few years, without increasing informality. In January 2012 the minimum wage increased by 14 percent although the economy had grown just 2.7 percent in 2011, threatening to trigger inflation and increase the public deficit.<sup>39</sup> The effects of these increases on employment levels have not been as great as many economists feared—the estimation is that a ten percent increase in the minimum wage in Brazil reduces employment by at most 0.05 percent.<sup>40</sup> One explanation for this paradox is that the minimum wage works mostly by reducing the variation in salaries at the bottom in the formal sector, rather than by increasing its overall costs. The impact on public finances, however, is considerable, particularly because the automatic wage rise also determines levels of retirement and other public benefits.

## Welfare and social security

Brazil's social security system, including retirement benefits and healthcare services, dates back to the 1930s. Initially it was limited to those in urban formal employment. Despite limits on political participation and freedom of expression, Brazil's military government did expand the social security system from 1964 to 1970. But only after the new democratic constitution of 1988 were social security, healthcare, and education extended to the whole population.<sup>41</sup>

Retirement benefits and pensions comprise the most expensive and complex part of Brazil's social security system. Today, the cost of Brazil's public social security system (except health) amounts to 11.2 percent of national GDP. Although the workers and employees contribute 20 percent of their salaries to social security, in 2013 alone the public deficit on this item was about US\$20 billion, and likely to increase.

In addition to benefits for the formally employed and civil servants, current legislation provides a monthly pension valued at the minimum wage to those aged 65 who worked in the informal sector, and are considered poor, as well as to those who worked for over 15 years in agriculture. These non-contributory benefits are currently estimated at 2.1 percent of GDP.<sup>43</sup> Given the aging population, increasing life expectancy, and slowing economic growth, this approach is unlikely to be sustainable. Legislation introduced in the late 1990s varied retirement benefits according to years of contribution, incentivising workers to delay retirement, but this only partially mitigated the problems in the system. The high level of retirement benefits paid to civil servants—more than double that of other workers—is another challenge. While legislation was introduced to limit this

discrepancy in 2012, it only applies to new civil servants, limiting its impact in the short term.

In general, retirement benefits are larger for persons from higher income brackets. Programmes directed at poor people of retirement age have a significant impact on the reduction of poverty for this segment, but poverty in Brazil is higher among children living with younger parents, who do not benefit from this support. Finally, the growing deficit within Brazil's social security system and associated demographic changes, means that a growing part of the current cost of this system will be transferred to the younger generation.<sup>44</sup>

### Cash transfer programme

The Bolsa Família conditional cash transfer programme was started in a few municipalities in the 1990s, and by 2003 developed into the flagship national programme of Lula's government. Initially focused on incentivising poor families to send their children to school, its aims have since expanded. The value of cash transfers is small—averaging US\$80 per month—and they are only available to poor families with small children. Currently, although approximately 13 million families—representing just over a quarter of Brazil's population—benefit from the programme, it costs only about 0.5 percent of GDP. Beneficiaries are identified and monitored by municipalities, while funds are transferred by federal government directly to beneficiaries' accounts. Targeting is reasonable, in 2006, 70 percent of beneficiaries were genuinely poor—although 43.7 percent of eligible people weren't benefiting from the programme.<sup>45</sup>

The programme has been effective in reducing extreme poverty, but has had only a modest impact on reducing overall poverty and income inequality. The effects of its conditionalities are not easily observed: it has only slightly increased school enrolment and hasn't significantly influenced the use of healthcare services by poor children or pregnant women. The programme fails to provide beneficiaries with a genuine exit strategy out of poverty via improved qualifications or better jobs.

One of the programme's main virtues is that, unlike other social policies, spending is focused on the poorest. Its targeted design and intelligent use of technology have also been important in ensuring that funds do reach the intended beneficiaries.

Despite its limitations, it has been a great political and electoral success. As a result, it has sparked a series of other similar programmes in Brazil, such as Rio de Janeiro's Cartão Família Carioca (CFC), launched in 2010, which provides additional incentives for children who perform well in school—boosting parental engagement. Another programme, Rouseff's Brasil Carinhoso, launched in 2012, aims to lift families with children younger than six years of age out of extreme poverty by combining additional cash transfers with enhanced access to nursery schools, vitamins, and asthma medication.<sup>46</sup>

## Public health

The 1988 Constitution established healthcare as a universal right, and an obligation of the state, and instituted a unified healthcare system that entitled everyone, in principle, to free, high-quality medical care. This ambitious goal seems elusive, but Brazil has made significant progress in preventative public health, such as inoculations and primary healthcare services. For example, Programa Saúde da Família (PSF) was created in 1994, and with a 95 percent coverage in urban areas has reduced infant and child mortality through its family-focused health education and disease prevention programmes.<sup>47</sup> Brazil also has one of the world's most effective and extensive HIV/AIDS prevention and treatment programmes.

The constitutional obligation to provide everyone with healthcare places strain on the country's resources without necessarily benefitting the poor in an efficient way. Brazil spent about 8.8 percent of GDP on health in 2006, but only 43 percent of this spending was in the public sector.<sup>48</sup> Brazilians who can afford it tend to avoid the public health sector due to the long queues and waiting periods that are common features in underfunded public facilities. While this ensures that the poor find it difficult to get quality care when they need it, the constitutional principle allows those with uncovered conditions who can afford lawyers to take the state to court, with the result that complex and costly treatments for this small, better-off group are eventually funded by the state. The public health sector is also affected by mismanagement and corrupt procurement processes. Proposals to improve the health system include replacing the principle of universal coverage with an assurance of standard healthcare, combined with cost sharing for those who can pay; better management of public hospitals and healthcare services; and proper rules to support the provision of public health services through private providers.

## Education

Brazil now spends about 5.7 percent of GDP on public education, and families spend an additional two percent on private education. Illiteracy fell from 17.2 percent in 1992, to 8.4 percent in 2011, and is now largely limited to older people in rural areas. However, functional illiteracy is widespread, because of the low quality of public schools. Education is compulsory from ages four to 17, and most children attend free, public schools, with about 60 percent completing secondary school. Schools are managed at the municipal and state level, with the federal government providing additional support.<sup>49</sup>

Brazil has the largest postgraduate and research sector in Latin America, and its main universities produce 13,000 PhDs and 40,000 MAs annually.<sup>50</sup> There are about 7 million students in higher education, the majority of whom attend private institutions. Public universities tend to be highly selective, and until recently, primarily served students from fairly advantaged households—most of whom attended private schools. Postgraduate education and research remains concentrated in a few public universities, which are free and highly subsidised.

Despite progress, the large number of young people who are neither studying nor working (17.2 percent in 2010) is a concern.<sup>52</sup> The large majority of these come from

relatively poor households. Their parents have themselves stopped studying at an early age—suggesting they are caught in a poverty trap. Brazilian students perform poorly in international assessments such as OCED's PISA. In 2009, 73 percent of 15-year-olds in schools were below the minimum expected for their grades in mathematics. There were also very few high performers<sup>53</sup> The major reasons for poor educational performance include the low status of teaching as a profession, the poor quality of teacher training, the bureaucratic nature of public schools, which provide little incentive for performance, and shallow curricula with no clear standards. Students also have little choice over subjects at secondary school, and vocational education has not been well developed. Efforts have been made to improve schooling through stricter curricula, performance bonuses for teachers, extended teaching hours, use of Information Communication Technology (ICT) and partnerships with private companies and philanthropic organisations. Some progress is being made but not nearly enough.

### Agrarian reform

Social movements, particularly the militant landless movement, have played a strong role in pressing for agrarian reform. In the context of large rural properties, which are often uncultivated, the government has, since the 1990s, pursued a policy of impounding 'unproductive' land, and redistributing it to the landless. About 1 million families are now estimated to have been placed in these settlements.<sup>54</sup> However, this has not been a successful tool to improve social inclusion. Far more people have migrated out of rural areas than have benefitted from this programme, and the growth of large, technology-intensive agribusiness, combined with small, highly-productive family-run farms has made these settlements uncompetitive. Most settlements therefore remain dependent on state subsidies.

### Affirmative action and race

Slavery has left Brazil with a legacy of a large mixed-race population, and descendants of slaves and indigenous populations are significantly poorer than other groups, even though there was never a system of legal, race-based discrimination since the end of slavery in the nineteenth century. Data on race in Brazil is collected on the basis of self-identification of skin colour, and the major categories used in the 2012 national household survey are, white (46 percent), black (eight percent), brown (45 percent) and yellow (0.5 percent, mostly descendants of Japanese migrants) and indigenous (0.3 percent).<sup>55</sup> Although the boundaries between these categories are fuzzy—it is relatively easy for the population to move between them—the differences in income and education levels remain extremely clear.

Racial discrimination is severely punished, and affirmative action is actively pursued through a ministerial-level Secretary for Policies to Promote Racial Equality. Race-based affirmative action policies have been implemented in response to the demands of very active social organisations, many of them benefitting from international support and government subsidies. In 2010 a Statute for Racial Equality outlining affirmative action requirements in various sectors was enacted as law.<sup>56</sup> Affirmative action has been implemented particularly

strongly in public higher education institutions, with recent legislation requiring a certain proportion of students to be 'non-white'. There are also proposals to introduce race quotas in the civil service and for congressional elections.

Since poverty and dark skin colour are highly correlated, and in the absence of marked race boundaries similar to those found in the US or South Africa, it is an open question whether poverty, rather than race, should be the main target for social policies. However, there is clear evidence that the job market discriminates against blacks, just as it discriminates against women, requiring specific policies to deal with these issues.<sup>57</sup>

### Urban violence

Urban violence has become one of Brazil's major social problems over the last few decades. Although homicide rates have fallen slightly over the past ten years, they remain high at 26.2 per 100,000 (2010).<sup>58</sup> While this is still lower than South Africa's rate of 31.8 per 100,000, it remains far higher than that in most other middle-income countries. The main victims of urban violence are males aged 15 to 29, with black people being disproportionately affected. The roots of urban violence are deep, and compounded by Brazil's lack of effective local policing in many cities and towns.

While the situation is worsening in poorer parts of the country, major cities like São Paulo and Rio de Janeiro have seen improvements. In São Paulo, improvements are attributed to reductions in numbers of firearms, new policing and intelligence structures, a well-organised police force, and an aging population. However, the police force is also extremely violent, and large numbers of alleged criminals are killed in police operations. In Rio de Janeiro, Police Pacifying Units in the city's informal settlements have played an important role in this violence. Reforms that have accompanied the setting up of these units include requiring new police recruits to develop co-operative roles with communities and clamping down on inefficient and corrupt officers.

## POVERTY AND DEMOCRACY IN BRAZIL

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There are several aspects of Brazilian democracy particularly relevant to understanding the fight against poverty. The nature and complexity of the electoral system is one of these. It is relatively easy to form a political party in Brazil, and parties receive free time on radio and TV. But due to an electoral system of proportional representation by state, the most populated regions are underrepresented, and the relationship between elected officials and constituencies is obscured. To the layman, there is no clear link between voting choices, who is elected, and what mandate is pursued. For instance, if a popular candidate to Congress in a state gets three times more votes than required to be elected in his state, he will carry with him two other candidates from his party who received fewer votes than, say, another candidate from another party who did not meet the minimum requirement.

The nature of Brazil's most important political institutions also hampers the state's ability to make consistent policy. While Congress is powerful enough to distribute benefits to constituencies, it is too weak to shape policy more broadly. The judiciary remains autonomous, but it is overwhelmed by excessive demands and cumbersome procedures, and is not immune from corrupt practices.

Brazilian public services, at the national level and in some states, have reached significant levels of professionalisation. This includes organisations such as the National Revenue Service and the Federal Police, and also large areas of the public sector related to statistics and the military, science and technology, justice, and foreign relations as well as in government-owned agencies such as Petrobrás, the National Development Bank and Banco do Brasil. Other sectors and branches of government are often used as bargain currency to assure the government congressional support. There are 40 ministries and ministerial-level secretaries, several of which are controlled by specific parties and particularly subject to corrupt practices. The number of federal employees is 1.1 million, and the government is free to appoint about 20,000 employees, including practically all the top management positions, which are regularly replaced when the government changes or needs to shift people for political reasons. Recent surveys by IBGE, the government's statistical office, identify 3.1 million people employed by state governments and 6.3 million municipal employees. Together, they represent about 12 percent of the country's labour force, or 20 percent of those with formal employment. The number of local public employees has been growing steadily since the 1988 Constitution, and they are mostly supported by transfers from the federal government, since very few states and municipalities generate enough taxes to pay their administrative costs.

It is difficult to say how much of this expansion is wasteful and how much is an appropriate response to the growing demands for services by the population. The country certainly does not need all of the more than 5,000 municipalities, most of which are insolvent, but are paying good salaries and perks to their mayors, vice-mayors, municipal secretaries and local legislators out of federal transfers; nor does the country need 40 ministries. Most of the municipal expenditure goes to education, health and urban issues, and most of the state's expenditure goes to education, health, social benefits and security. With economic growth, the percentage of GDP spent on public services by the federal government has not grown in the last decade in relative terms. In 2012, 40 percent of the federal government's direct expenditure (excluding transfers and the payment of the public debt service) went to social security, 23 percent for personnel, seven percent for other administrative expenditure, 12 percent for health, education and other social expenditure, and six percent for investments. The growing costs of social expenditure is one of the main reasons why the country's tax burden has been growing steadily, reaching 36 percent of GDP.

A third important feature is 'Coalition Presidentialism'.<sup>60</sup> Because the Brazilian system of proportional representation leads to the election of many small parties, the president's party seldom holds the majority in Congress. As a result, coalitions across both houses of Congress are required in order to pass legislation, approve

the budget and make key appointments. But the creation of such coalitions inevitably involves federal approval for special-interest bills, cabinet jobs for the leaders of small parties and tolerance for high levels of corruption. The president is also empowered to issue 'provisional acts', which become law pending congressional approval. State governments are meanwhile dependent on transfers from central government, some of which are linked to promises of political loyalty.

In sum, the way democracy works in Brazil has led, on one hand, to the continuous expansion of social benefits and services, and on the other to costly practices of rent seeking, that together make the public sector much more expensive and inefficient than it should be. With economic growth, these two features can coexist, and provide the government with broad support coming from most sectors of society. In the last few years, however, with the changes in the international scenario, the government has been pressed to cut expenditure and to increase the efficiency of the public sector, which may affect entrenched interest groups and the government's popularity. These issues will, almost certainly, come up in the political debates preceding the next presidential election in October 2014.

## Democracy and Innovation

Brazil's transition to democracy has had a positive effect on social and policy innovation. But despite a range of supportive policies and programmes, the current Brazilian regime has been less effective in encouraging industrial and technological innovation.

Innovation had a fairly slow and late start in Brazil. During the 1800s and early 1900s, Brazil developed a few professionally oriented institutions of higher education, but it was not until 1934 that the first comprehensive research university, the University of São Paulo, was established. In the 1950s many previously state and privately run universities were made into federal institutions, and the National Research Council was established. A number of states also developed their own research funding organisations—most notably the São Paulo Research Foundation (FAPESP) in São Paulo state. FAPESP is funded by a one percent share of all state sales taxes. Today, almost all states have research funding bodies based on similar principles.

Another federal research funding agency, the Studies and Projects Funding Agency (FINEP), was established in 1967, specifically to fund technology research and development projects. Financed by BNDES, it reflected the military-driven, state-oriented 'big science' approach to research and innovation that characterised the government of President Ernesto Geisel. As well as retaining Brazil's import substitution industrialisation policy, the military government invested extensively in the development of transportation, electrical and communications infrastructure, as well as in some military projects such as the development of a nuclear submarine, a space programme and a protected national computer industry. Over time, policy began to shift gradually away from big science towards commercial innovations, and by the late 1990s there was a growing awareness of the



need to translate science and technology into innovative products and processes. Democratic governments have also begun to appreciate that very poor basic education undermines innovation and technological progress.

## RECENT TRENDS IN SCIENCE AND TECHNOLOGY INNOVATION

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Since the 1980s, Brazil's basic scientific indicators have performed well thanks to strong public universities and research centres, as well as steady public investment in science and technology. In 2009, Brazilian authors published 32,100 papers in indexed publications internationally, 54 percent of all those from Latin America and 2.7 percent of the world total, up from 0.2 percent in 1981. In terms of the impact of these publications, as measured by citations, Brazil has performed similarly to other emerging economies.<sup>61</sup>

Spending on R&D in Brazil has consistently hovered around one percent of GDP over the past decade, and is fairly evenly split between the public and private sectors. Brazil ranks 29th in the world in numbers of patents registered at the US Patents and Trademark Office. But the absolute numbers of patents filed—about 20,000 annually—have not changed in the past decade, and Brazil now lags behind both China and India.<sup>62</sup> Most local patents are filed by branches of international corporations—reaching 74 percent in 2011. For example, while Brazil is the source of the majority of international patents relating to components of ethanol engines, most of these are actually developed by Bosch and other international companies, albeit in their Brazilian plants. Patents filed by Brazilians in fact only dominate in agriculture, food machinery and construction. In high-tech sectors, over 80 percent of patents are filed by international companies. Brazilians usually file patents through public universities and research organisations.<sup>63</sup>

Brazil's federal government launched the Science Without Borders (SWB) programme in 2011, which aims to send 100,000 students and scholars abroad by 2015, to study or develop research, as well as to bring scholars from other countries into Brazil. But the private sector has been insufficiently involved in this scheme, and most of the students are undergraduates, going abroad for an academic year or less. The number of people travelling abroad to obtain advanced degrees is not high; neither is the number of foreigners coming to Brazil as visiting scholars. The programme's impact is so far fairly limited.

## RECENT TRENDS IN PRIVATE SECTOR INNOVATION

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Eleven funds designed to support innovation in specific strategic sectors of the economy were established by the federal government in 1999, along with two broader funds focusing on university-business collaboration and on infrastructure. The 2004 Innovation Law established a framework for collaboration between industry and academia, along with incentives for scientific and technological research and innovation, and a number of states have also now developed their own innovation initiatives.<sup>64</sup> With these laws and initiatives, public-private collaboration and state support for business innovation have both risen, but not to the levels anticipated.

Brazilian innovation is particularly strong in areas such as polymers, pharmaceuticals, agricultural chemicals, food, detergents, general chemicals, textiles, printing, petroleum, mechanical engineering, and metallurgy. It is weaker in electronics, communications, and information technology (IT). Innovation in information technology was inhibited by the Informatics Act, passed during the last year of military rule, which restricted IT imports and barred foreign investment in the sector. These restrictions were only lifted in 1991, after which five more years were required to privatise Brazil's telecommunications sector, and for the IT sector to begin to take off. A new IT law passed in 2004 retained incentives for national content, and requires that five percent of revenues are committed to R&D.<sup>65</sup>

## BUSINESS INNOVATION: CASE STUDIES

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Although private sector innovation in Brazil has been constrained, the country is home to a number of particularly innovative businesses. Most of these success stories relate to companies engaged in commodities or products for other businesses, rather than direct sales to consumers. State involvement in these companies, as well as their use to achieve political aims, has also been a consistent theme—and has often hampered their performance.

- Embraer was created in 1969 by the military government, as a state company in the aircraft industry. The company struggled to perform in the challenging economic conditions of the 1980s, and was privatised in 1994. With strong initial support from government, including subsidies for export, it has since become a world leader in small to mid-sized jets. Additionally, the area surrounding its base in São José dos Campos in the state of São Paulo has attracted other industries which provide products and services to Embraer.<sup>66</sup>
- Vale, one of the world's largest mining corporations, was founded in 1942, just as Brazil was starting its programme of industrialisation. It was privatised in 1997, and has since expanded to over 30 countries around the world, benefitting strongly from rising commodities prices. Vale's large port and logistics complex on the coast of the Espírito Santo state, which has developed many innovative environmental initiatives, is an example of how its future performance might be driven by innovation.
- Petrobrás, founded as a state oil company in 1953, plays a huge role in Brazil's economy, as well as in Brazilian politics. Now a semi-public corporation, with shares traded both in Brazil and in New York, it operates in 18 countries with assets of over US\$130 billion. The company has developed competitive technology in deep sea drilling, and production in this area has grown steadily. The discovery of new, ultra-deep sea oil reserves was used to build support for Lula's re-election, and subsequently also for Rousseff's campaign. In late 2013, Libra oil field, the largest identified in Brazil so far, was sold to a consortium led by Petrobrás, and including France's Total, Anglo-Dutch Shell and China's state-owned CNOOC and CNPC. Libra's estimated 8–12 billion barrels of recoverable oil make it the biggest oil prospect in the world auctioned in 2013. Once it reaches peak production, some time in the next decade, it should

increase Brazil's output from 2.1 million to about 3.5 million barrels per day.<sup>67</sup> Legislation requires that the field should be operated by Petrobrás, requiring huge investments. In the last several years Petrobrás has suffered from problems stemming from political interference, and is being forced to import oil at higher prices than it is allowed to sell in the Brazilian internal market. As a result, its share price has plummeted by about 70 percent.<sup>68</sup>

- Natura, launched in 1969, has become a market leader in the cosmetics and personal care sector, with offices across South America as well as in the UK, US, and Australia. Natura has a reputation for environmental responsibility, and supports a number of programmes related to sustainability. Forbes ranked it as the eighth most innovative company in the world in 2011.

## SOCIAL AND POLICY INNOVATION

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Democracy has had a much more clear-cut impact on social and policy innovation. The most well-known and effective example is the Bolsa Família programme, discussed previously. Because of its relatively low cost, this programme has been widely lauded by international specialists as a model for poverty reduction in developing countries, and has inspired a number of other related schemes at state and municipal levels and around the world.

The public sector has also supported the private sector in innovative ways, such as the National Programme of Popular Cooperative Incubators, which brings management expertise to small co-operatives. Another programme called Habitare develops technology to modernise construction systems and reduce the housing deficit, while the São Paulo state Research, Innovation, and Diffusion Centres programme supports policy and technology R&D through partnerships between universities, research institutions, public bodies and businesses.

Education is an area in which Brazil has developed a number of innovative initiatives during the past two decades. Many of the problems with Brazilian basic education stem from the first years of primary school, as many children reach fifth grade without being able to read or write. Over time, information on poor educational performance on international tests has begun to reach parents, as has data from the Ministry of Education, which has developed a score for each school, based on student test results and other criteria. As a result, education has become a more important political issue. So, for example, recent legislation proposes that 75 percent of revenues from new ultra-deep oil reserves should go to education, and there is debate over a law that would require ten percent of GDP to be invested in education.<sup>69</sup>

However, education quality is not improving rapidly, and there is growing evidence that additional spending will not generate sufficient improvements. Brazil needs to introduce profound changes in teacher education, school management, and in the implementation of national standards—all of which are controversial and are often resisted by teacher unions and bureaucracies.

## RELATIONSHIP BETWEEN DEMOCRACY AND INNOVATION

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There are a number of reasons for Brazil's difficulty in generating higher levels of technological innovation, particularly in the private sector. The fairly closed economy and uncompetitive business environment mean that businesses often simply do not need to innovate. The long history of protectionist policies has created an inward-looking entrepreneurial culture. While some protectionist policies were lifted during the democratic years, this process has not been completed, and in response to recent competition from China, some new barriers have been created. The experience of Asian economies suggest that R&D would develop more rapidly in a more competitive, export-oriented environment. With a few exceptions such as Embraer, this emphasis on competitiveness is missing in Brazil.

Brazil's industrial structure also works to discourage private sector R&D: the technology-intensive sectors that are most likely to innovate play only a small role in Brazil's industrial output. The complex tax system also discourages innovation, both by making compliance difficult for businesses; and by dampening the ambition to innovate and expand. Finally, high taxes and the complexity of starting and running a business in Brazil discourages innovators from launching new firms and products.

Certain aspects of Brazilian democracy have nevertheless been beneficial for innovation. The greater emphasis on social inclusion, supported by wage growth among low-income groups, has meant rapid growth in consumption. As historically poor states have begun to experience higher growth rates, they have also begun to invest in innovation themselves.

Democracy has also strengthened the public university system, which suffered extensively under military rule. Especially in the years between 1964 and 1970, the regime forced many scientists to retire, leading many researchers to flee the country. The improved climate at Brazilian research universities under democracy is related to the growing number of scientific papers published and graduate degrees granted. Education has become a far more salient theme in Brazilian politics under democracy. It has been a central issue in campaigns and political advertising, and was a deciding factor in the 2012 São Paulo city elections.<sup>70</sup>

Some aspects of democracy have discouraged innovation, however, most notably state intervention in business, driven by short-term pressures. For example, in late 2012 changes were made to the contracts for generating electrical power, in order to bring down electricity prices.<sup>71</sup> As a result share prices of electricity companies nosedived—compromising investment and innovation in the sector. Similarly, various fiscal waivers and subsidies instituted to protect particular sectors of the economy—again to reduce prices and boost consumption—are also clear examples of short-term thinking, with long-term costs. As long-term commitments to boosting innovation are unlikely to prove as electorally popular as policies that reduce prices in the short term, they have lost traction under democracy.

While democracy has strengthened the university system in Brazil, there are concerns that certain aspects of democracy may now be starting to weaken it. Extremely popular programmes were launched to expand undergraduate

programmes at public universities, and to provide poor students with scholarships for study at private universities. While these have been valuable electoral tools, the undergraduate programmes are now struggling with insufficient budgets, and the scholarship programme has resulted in a boom in institutions providing qualifications of questionable quality. Questions are now being raised as to whether these were really appropriate tools to use in expanding higher education. Other popular, but potentially harmful, changes in the higher education system have included a relaxation of the academic requirements for faculty member career progression, as well as the direct election of leadership positions in universities.

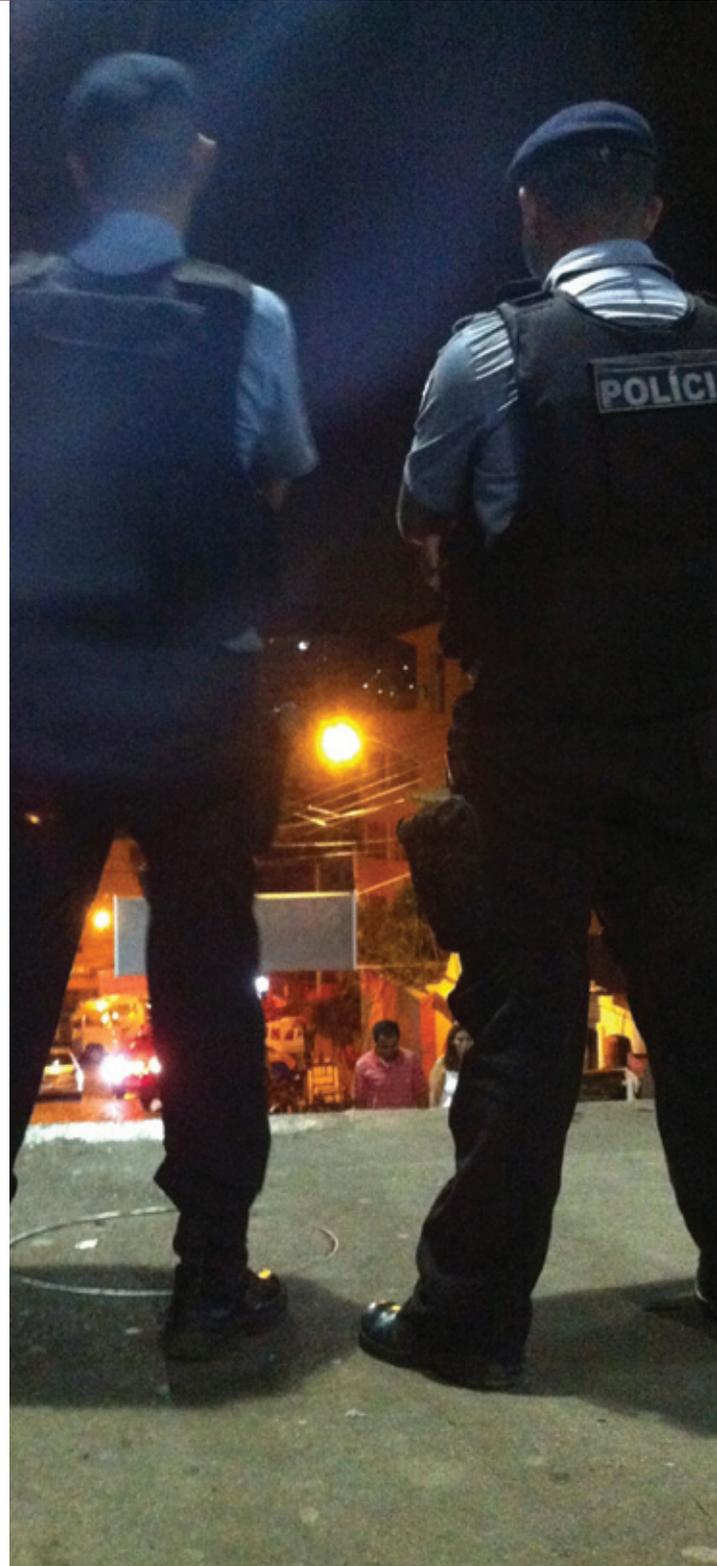
## Democracy and the Fight Against Corruption

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Since Brazil's return to democracy in 1985, corruption has been a frequent topic of national debate. Scandals involving prominent politicians and government officials have had serious consequences, including the impeachment of a president and the indictment of prominent government officials. The strengthening of the rule of law since the Constitution of 1988 and improvements to accountability institutions have made these anti-corruption measures possible. The intensification of political competition as well as the independent media and popular activism have also strengthened the fight against corruption. But most of the press reporting, and the activism, have been triggered by scandals, and progress towards cleaner government has been uneven.

The international Bribe Payers' Index, Corruption Perception Index (CPI), and the Global Corruption Barometer all provide fairly similar results, indicating that corruption is less pervasive in Brazil than it is in many other middle-income countries. Brazil scores 43 on the CPI, placing it on a par with South Africa.<sup>72</sup> According to the Global Corruption Barometer, the number of people who report paying a bribe is in line with the OECD average. The majority of concerns relate to the police force. Low levels of reported experiences of corruption are surprising, given the extent of regulation and public intervention in the economy in Brazil, all of which provide ample opportunity for corruption, and are strongly correlated to corruption in other countries.

Although major transparency laws were only passed in 2011, Brazil also has some of the highest levels of transparency in Latin America. The 2012 Open Budget Index's score of 73 places Brazil's federal government in its second best category, alongside Norway and Sweden, and ahead of all Latin American countries and all non-OECD countries (except South Africa).<sup>73</sup>



But there are differences between levels of government. Federal public servants, particularly those in the more professionalised branches of the civil service, are viewed quite positively. By contrast, corruption is seen as more pervasive in other sectors of the federal government and in subnational government—although, importantly, it is not encountered much by citizens when they interact with these regional bureaucrats.

Evidence from indirect indicators of corruption, such as the cost of political campaigns, is less encouraging. Brazil's political campaigns are the second most costly in the world, after those in the US. Corporate donors provide most of the funding, accounting for 98 percent of President Rousseff's campaign budget, and 95 percent of that of her opponent in 2008/09.<sup>74</sup> Donations tend to come from a relatively small group of large donors, who expect something in return. There is clear evidence, for example, that public works contractors gain a substantial boost in contracts when donating to the candidate that wins office. The Global Corruption Barometer has accordingly found that Brazilians believe political parties and parliament to be the most corrupt institutions in their country.<sup>75</sup>

This negative perception is supported by the criminal records of Brazilian politicians: in 2008, roughly a third of members of parliament faced charges in criminal and audit courts. In 2011, a fifth of members of the Brazilian parliament were defendants in criminal cases in the Supreme Court.<sup>76</sup> To date, nine ministers in Rousseff's administration have been dismissed because of corruption scandals. Politicians facing criminal charges enjoy privileges in Brazil, such as facing trial in higher courts, where they have a greater chance of influencing outcomes, and benefiting from immunity unless this is revoked by a majority parliamentary vote. This has made holding office attractive for individuals with a criminal record.

In short, corruption in Brazil is intimately linked to campaign finance and public contracts, and bears a closer resemblance to corruption in industrial economies with ineffective checks and balances than to the corruption surrounding the delivery of services that is found in most developing countries.

## DEVELOPMENT IMPLICATIONS OF CORRUPTION

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The estimation is that corruption costs Brazil between 1.5 and 5 percent of GDP, and 70 percent of the country's firms identify the issue as a major constraint on integration in world markets. Corruption also affects developmental outcomes—particularly in education and health—in significant ways. Between a quarter and a third of local governments are thought to have misused educational and health funds.<sup>77</sup>

Corruption may help to explain why educational spending in Brazil has had a limited impact on improving the quality of schooling. Although there is evidence that increased monitoring of spending is beginning to reduce the problem, between 13 and 55 percent of federal transfers to education are thought to be irregular, and in a study of municipalities, 35 percent showed evidence of corruption.<sup>78</sup> The number of irregularities in health spending is even higher, and often includes serious irregularities, such as the purchase of vehicles and computers which subsequently disappear.

Predictably, given this diversion of resources, corruption affects the quality of educational provision. Corrupt municipalities are much more likely to have inadequate school infrastructure, or insufficient teacher training. Test scores are 0.35 standard deviations lower in corrupt municipalities, while failure and dropout rates are higher.<sup>79</sup>

## ACCOUNTABILITY INSTITUTIONS

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Brazil's anti-corruption institutions have become much stronger in the democratic era. The first reforms were put in place by the 1988 Constitution, which gave the Public Prosecutors Office and the audit courts powers to investigate official misconduct. The Constitution also guaranteed press freedom, which made investigative reporting possible. Attempts to reduce some of these powers, particularly under the Lula regime, have not succeeded. On the contrary, the institutions set up to combat corruption in Brazil are considered to be highly professional and meritocratic. They offer competitive salaries to employees, and have adequate funding. Nevertheless, lack of co-ordination, inter-agency rivalries and some political constraints make them less effective than they could be.

These institutions have evolved since 1988, largely in response to scandals. Parliamentary and press investigations into a racketeering scheme set up by President Collor (in office 1990–1992) led to his impeachment and resignation. Congress suspended Collor's political rights for eight years, even though the Supreme Court eventually acquitted him. But changes were made to party financing laws following the scandal, and a number of new laws to combat corruption were put in place.

In the wake of the impeachment, the ban on corporate funding for party financing was lifted (on the premise that legal private funding would be easier to monitor than the illegal funding that had flowed into party coffers despite the ban). The Brazilian legislature put in place a new legal framework designed to create more transparency and to enable oversight of campaign donations. Public party funding also increased considerably in the wake of the scandal. In addition new laws were approved: the Law of Administrative Probity, which stipulates rules for the Civil Service (Law 8429); the Law on Public Bidding Procedures (Law 8666); and the law creating the Council for the Oversight of Financial Activities (COAF) (Law 9613).<sup>80</sup>

The second important contemporary scandal—the 'dwarves' scandal of 1993, named for the height of the legislators involved, highlighted problems with the national budgeting system, which was at that time extremely centralised and not transparent. A legacy of the authoritarian regime, the system rendered the budgetary process incomprehensible and very difficult to monitor, but easy to manipulate by insiders in Congress. The scandal involved the allocation of funds to 'phantom' non-profit institutions created solely for this purpose by members of budget committees, and triggered significant budgetary reforms such as new procedural and reporting requirements, and some decentralisation of power.<sup>81</sup>

The third and largest scandal, the *Mensalão* scandal, unfolded during Lula's first administration after the discovery of an illegal scheme designed to funnel

public and private funds to members of the PT political alliance. Congressional deputies were receiving some US\$12,000 every month in return for approving legislation favoured by the government. The funds originated from state-owned companies' advertising budgets, funnelled through an advertising agency owned by a well-known businessman. The political opposition succeeded in establishing a parliamentary inquiry commission, and the Supreme Court opened criminal proceedings against 40 individuals. In 2007, all 40 of the accused were indicted, 25 were convicted in October 2012. Several prominent politicians—José Dirceu (leader of the Workers' Party in São Paulo), José Genoino (president of the Workers' Party), and Delúbio Soares (treasurer of the Workers' Party)—were found guilty of bribery and at last arrested in late 2013, while some minor appeals still remain to be decided by the Supreme Court.

This outcome was surprising, as the PT had substantial control over the Parliamentary Investigatory Committee at the time, and President's Lula and Rousseff had appointed the majority of the Supreme Court judges. One of them, Joaquim Barbosa, occupying the presidency of the Supreme Court, played a central role in bringing the judgement to a conclusion. A black judge, his appointment by President Lula was widely considered a manifestation of the government's commitment to affirmative action, and the government was clearly surprised by his independence and commitment to the rule of law. The judgement was transmitted in full by TV networks and became a symbol of the maturity of Brazilian institutions, setting an important precedent: even popular politicians could face sanctions and be sent to jail. As a result of the scandal, an online registry for campaign contributions was created along with stricter penalties for off-the-books campaign finance.<sup>82</sup> It is worth noting, however, the time it took for the courts to proceed with the judgement—eight years—due to the almost endless appeals brought to postpone or revise the Court's decisions. Additionally the special treatment the defendants received once arrested show that the Brazilian legal system still does not provide the general population with the same attention and protection it provides for those who have political clout and can pay.

### The judicial system

Although a few judges have been found to be corrupt, and although there is great regional variation in the quality of judicial institutions, Brazil's courts, particularly at the higher levels, are viewed as autonomous and professional. Along with Chile, Brazil is thought to have the most independent and professional judicial institutions in Latin America.<sup>83</sup>

The Supreme Court rules against the preferences of the executive fairly frequently, ruling legislation advocated by both Cardoso and Lula unconstitutional. There is no evidence of presidential influence or meddling in Supreme Court decision-making. Although the president appoints the majority of Supreme Court judges, which have to be approved by the Senate, presidential interests have regularly been defeated, most notably during the *Mensalão* trial.

By contrast, the state courts are both less autonomous and less efficient than federal courts. Local politicians are in some cases able to exercise substantial influence over courts, especially in poorer states where oversight by the media,

civil society and accountability institutions is more limited. Although a Judicial Council has now been established to oversee the work of the lower courts, much remains to be done. The arcane legal framework contains loopholes which allow public officials facing corruption charges to extend trials and avoid imprisonment. The judicial system's slow pace, especially on issues relating to political corruption, is a major issue, and contributes to a sense of political impunity and reduced confidence not just in the court system, but also in other accountability institutions.

### The National Audit Court

The National Audit Court (TCU) is another strong and important accountability institution. Two-thirds of TCU members (six judges) are appointed by the national Congress and the balance (three judges) by the President—although two of these must be drawn from a pool of senior civil servants. While fairly autonomous from the executive branch, this pattern of appointments still leaves it vulnerable to politicisation.<sup>84</sup>

The TCU is not a judicial institution, even though it operates in a quasi-judicial way. Instead, it is an ancillary organ designed to assist the legislative branch in monitoring public expenditure. The TCU's rulings on the legality and regularity of budgetary, tax, and spending decisions have the status of administrative decisions, and are amenable to appeals in the judicial system. But it can issue fines, bar politicians from running for office and nullify ongoing tenders and auctions.

Under democracy, the TCU has become a highly sophisticated and professionalised institution, characterised by meritocratic recruitment, large budgets and sophisticated infrastructure. Boasting a budget of \$700 million and counting on a staff of 2,400, the TCU is one of the most highly ranked institutions of its kind outside the OECD—and is ranked as better than its Spanish and Italian counterparts.<sup>85</sup>

However, it struggles with effectiveness. It may take the TCU several years to hear and close a case, after which the decision can be appealed in the courts, further extending the process. Secondly, as audits tend to focus on the legality of spending, rather than on its content, serious irregularities remain undiscovered. The TCU's internal incentive structure is also problematic, with a disconnect between the professional work of auditors and its top decision-making body, which includes a number of political appointees who are able to block politically sensitive issues and decisions. Finally, because it lacks the capacity to sanction corruption, the TCU's effectiveness depends primarily on the extent to which other actors—such as the media or opposition legislators—can publicise its audits.

### The Office of the Comptroller-General (CGU)

The CGU was created in 2002, and acts as an anti-corruption agency and internal comptroller. Since 2003, the CGU has carried out municipal audits at a rate of 60 per month. These are randomly selected from the 5,600 Brazilian municipalities, and multidisciplinary teams of federal auditors spend one to two weeks in the municipality.<sup>86</sup> The federal government is motivated to protect this programme, as it gains popular approval from voters by fighting corruption at the local

government level without threatening national politicians. There is clear evidence that this approach has proved an effective deterrent against corruption, and has reduced corruption levels in the delivery of education and health.

### The media and civil society

Brazilian citizens regularly name the media as the most trusted institution in the fight against corruption. Brazil's investigative journalists regularly work to uncover corruption and criminality. Four major national newspapers, three weekly news magazines, several radio stations, and a competitive television market have all played important roles in providing information to the country, and maintain a high level of autonomy from the state. Strong competition in the media market and the fact that the media companies are not controlled by industrial or financial companies help prevent significant media bias towards specific industrial groups or corporations.

A key example of media autonomy is the episode leading to the resignation in 2010 of Rousseff's chief of staff, Antonio Palocci. Despite strong support from Lula, Palocci was forced to resign following press announcements of allegations of illicit enrichment. The media also played a crucial role in denouncing corruption in the Ministry of Transport, where bribes were being paid to have contracts approved. Following this, 17 top officials, including the minister, were fired.<sup>87</sup>

Civil society mobilisation has also led to important institutional reform initiatives in Brazil. The first of these developments is the Law Against Vote Buying, approved in 1999, which was the result of the collection of over a million signatures in its support. The law closed most of the loopholes in the existing election legislation and resulted in the impeachment of 660 politicians between 2000 and 2008.

Similarly, the Clean Slate Law was also passed after 1.3 million signatures were collected. The law bans candidates who have been impeached or who have criminal records from holding electoral office. The Clean Slate Law of 2010 counteracted important failures in accountability: the inefficiency of elections in preventing corrupt politicians from gaining power, and the slowness of the judicial system in addressing issues of corruption. The movement that originated this law was an initiative of the Brazilian National Conference of Catholic Bishops (CNBB), and is an example of religious involvement on issues related to poverty, justice and human rights.

### The Public Ministry

The Public Ministry is the central component in Brazil's set of accountability institutes, playing a role similar to that of an ombudsman's office, and by international standards it is very strong. Established by the Constitution of 1988, this prosecutorial body is formally independent of the other three branches of government, enjoys great autonomy over its budgets and is able to recruit on a highly meritocratic basis. It has played a major role in selecting cases to investigate and prosecute. In addition to the federal level institution, each state also has its own Public Ministry, which is also able to operate with great autonomy.

Unlike the judiciary, the Public Ministry is a proactive institution, and has played an important role in almost every major corruption scandal in Brazil. Its biggest challenge is its relationship with the Federal Police, relating to both investigative work and access to courts for trials. Ongoing rivalries over the ministry's powers of investigation are currently a controversial topic.

## REGIONAL VARIATIONS

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The quality of anti-corruption institutions varies substantially across Brazilian states. Corruption is particularly high in states in the North and Centre West regions. For example, in Tocantins state, 75 percent of federal deputies face criminal charges, while the national average is around 30 percent. In the north of the country, 28 out of 65 members of the lower house of Congress face accusations in the judicial system.<sup>88</sup>

At the state level, the most important institutions for corruption control are the state audit courts. Their effectiveness varies widely across states. In states that experience the regular alternation of power, court activism is much higher, and state audit courts are more likely to institute special audits. Where there is integration between the Public Ministry and state audit courts, audits are more effective and have higher sanctioning rates. Where state audit courts are stronger and the judicial system better there is less corruption, even controlling for human development and per capita income. By contrast, in states with weak anti-corruption institutions, wealth accumulation by political elites is much higher.

Media independence shows great variation across the states—about eight percent of all state-level media is controlled by state political elites in Rio Grande do Sul, compared to 100 percent in Roraima.<sup>89</sup> In addition, the more independent the media, the lower the degree of wealth accumulation by state elites. Interestingly, the national media has proven to be one of the most important remedies to curb corruption at the state and local government levels—state and local elites typically have very little influence over local media. Over the past years, power abuse and corruption at the state level has received a good deal of coverage, prompting the Federal Public Ministry to intervene in numerous cases across the country.

## Concluding Remarks

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In 2013, Brazil experienced a series of street protests that were unprecedented in their size and their suddenness. Though initially organised to protest increases in bus, train, and metro ticket prices in some Brazilian cities, demonstrators soon focused their outrage on corruption and the provision of social services. Over the month of June, the movement grew into the largest in Brazil since 1992.<sup>90</sup>

Demonstrations started in São Paulo when the municipal and state governments announced that the price of bus tickets would rise from R\$3.00 to R\$3.20.<sup>91</sup> In other cities, protests targeted corruption and the use of state money to pay for FIFA World Cup soccer stadiums and other showy sports projects instead of public services. Most of the demonstrators were young, coming together through social networks on the internet, and often rejecting the presence of organised political movements. Some radical groups were involved in starting the demonstrations, but the number of participants vastly surpassed their reach. The protests were mostly non-violent, but often attracted small, organised masked groups that came prepared with gas masks, sticks and Molotov cocktails used to invade bank agencies and public buildings. They were prepared to confront the police, who, in turn, did not always react with restraint, generating further demonstrations and confrontations. Without an identifiable leadership and a multiplicity of demands, it was left to different sectors in government and the public to interpret the meaning of the movement and the lessons to be drawn from it. No political party or local government was spared, and some of the more vocal demonstrators expressed a radical opposition to capitalism, liberal democracy and representative institutions in general.

A common interpretation was that the movement was related to the recent slowdown of the economy, which affected mostly the new, struggling lower middle classes, and, more generally, to the sense of frustration of the urban youth who are frustrated by their limited education opportunities and restricted work prospects. In addition, discontentment also comes from average Brazilian citizens, who pay about 40.5 percent of their income in taxes yet infrastructure is often inadequate, public safety is a constant cause for concern, health services are in short supply and often function poorly, and public education fails, on the whole, to deliver the quality that would allow tax payers' children to access good public schools and universities.<sup>92</sup> Rising inflation and increases in the prices of basic consumer goods, including food, which is heavily taxed (at 27 percent), also created discontent.<sup>93</sup>

Initially, the protestors met with success. Following the demonstrations against the bus fare hike in São Paulo, the local government withdrew the proposed rate increase. In Rio de Janeiro and São Paulo, local governments were forced to open their books and reveal what subsidies they provide to private bus companies.

To keep inflation down, the federal government stopped Petrobrás from raising petrol prices. At the end of June, Rousseff announced that an additional \$23 billion would be dedicated to public transportation.<sup>94</sup> She renewed the government's commitment to improving public services and announced a five-point proposal to reform the political system through changes to campaign finance law and the electoral system. In August 2013, she proposed a law that would reserve all of Brazil's oil royalties for healthcare and education.

By the end of 2013, as the demonstrations receded, it became clear that, although the protests helped the government become more sensitive to popular demands, only deep and long-lasting political and economic reforms could satisfy these demands in the longer term. Inflation cannot be controlled by decree, municipal governments do not have resources to pay for the increasing costs of public transportation, and Petrobrás is suffering because it is being forced to sell oil and petrol for less than it costs to buy in the international market. The political reforms proposed by Rousseff are not supported by all and were diluted by the Congress. The promises of the federal government to provide additional resources to local governments could not overcome chronic problems with the delivery of services and clashed with the need to limit the public deficit.

Beyond the political divide that is unavoidable in any democracy, there is a growing consensus in Brazil about the reforms needed to be introduced in the forthcoming years, to make the democratic system more resilient, allow the economy to continue to grow and bring the benefits of this growth to the population, thereby reducing poverty and social inequality.

In brief, Brazilians need to face the fact that the country cannot continue distributing more and more benefits and power to whoever brings votes or political support to the government, hoping that the economy will continue to grow and that the tax burden can continue to increase indefinitely. It will have to move from the distribution of expanding resources to reallocation and rationalisation in the use of the limited resources it has.

As stated by Lisboa and Letif, "Brazil has been experiencing a democratisation of privileges. In recent decades, specific benefits and discriminatory policies have been progressively extended to several groups. Benefits from such policies are understood very well, but their broader economic impact is not... Ending the centrality of rent-seeking in Brazil is essential for increasing investments and growth potential."<sup>95</sup> The public sector cannot and should not be dismantled, but should become leaner, more efficient, and less susceptible to pork-barrel politics. Large funds that are supported and controlled by the government but remain outside the budget—including those of the public banks, public companies and their pension funds, many of which derive from labour taxes such as FGTS, FAS, the Union Tax and the subsidies to 'S' system—should be exposed, made transparent and open to public scrutiny by increasing the oversight of the public accounting offices.

These reforms are difficult to implement. Successful changes will require political institutions with enough legitimacy to be able to confront strong vested interests at all levels. But Brazil's democratic institutions will help make the need for these changes more apparent, and can also ensure that reforms will last. There are many specific actions that need to be implemented. Among the most important: adjust social security benefits to budgetary and demographic realities; reduce the subsidies to protected sectors of the economy; make the country more open to international investment and competition; improve the quality of the public sector in areas such as education and environment protection; reassess the current systems of transfers of resources to insolvent states and municipalities, and deepen institutions of accountability across different levels of government.

Priorities will need to be set and agreed as changes across such a broad spectrum of policies will not be possible all at once. A broad vision as to the direction in which Brazil should develop will be needed and a sequenced programme of reforms adopted and implemented. Effective leadership will be an essential ingredient in this mix.

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