

Economic Orthodoxy Versus Social Development? The Dilemmas Facing Brazil's Labor Government

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Key Words

Macroeconomic stability; socio-economic policies; discretionary and non-discretionary public expenditures; Latin America

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A recurrent theme in the development literature has been the question of whether increased efficiency can be achieved simultaneously with an increased degree of equity. Many have claimed that society has to choose one or the other. For example, in the case of agriculture it has been suggested that a drastic redistribution of land ownership, though resulting in more equitable distribution of agricultural income, could also diminish productivity. Similar arguments have been presented with respect to the urban industrial sector. Many who have accepted the notion of a trade-off between equity and efficiency have suggested that both might be achieved sequentially. In other words, a period in which equity has been sacrificed for the sake of an efficient allocation of resources resulting in high rates of economic growth, could lay the foundations for a period in which greater emphasis would be placed on a substantial redistribution of assets and income generated from them.

It is the purpose of this article to evaluate the latter proposition as it applies to the recent experience of Brazil where in January 2003 Luiz Inácio Lula da Silva, the former trade union leader and head of Brazil's Workers' Party (PT²) took office. This was

¹ We would like to thank Leonard A. Abbey, Jorge Paulo Lemann and Peri Silva for valuable help and comments.

² Partido dos Trabalhadores or Labor Party

perceived by many Brazilian and foreign observers as portending a dramatic shift to the left in the governance of the country. In the run-up to Lula's victory many harbored hopes that this new government would provide a real radical alternative to the policy profile pursued up to then. At the same time, the prospects of a Lula victory engendered fears among domestic and foreign investors that irresponsibility in macro-economic policies and the erosion of established property rights would become the order of the day. It is ironic that in the third year of President Lula's mandate these early perceptions have been confounded by subsequent developments. Many of the early left-wing supporters were bitterly disappointed in the policies adopted by President Lula, while the domestic and foreign investment communities were not only pleasantly surprised by the actual policies adopted, but gradually became strong admirers of his government.

Examining the record of President Lula's first term, it becomes evident that his strategic thrust was to proceed initially in a cautious way, by first establishing a reputation for economic prudence, thus laying the foundations upon which more radical structural reforms could be carried out. We shall argue that such a sequence, while beguiling, masks some deep contradictions, the nature of which may place in jeopardy the reformist social vision of Lula and his followers.

In this article we shall first describe the socio-economic aims of the PT as it took over the reins of government. This will be followed by a description of the macro-economic policies adopted, their impact on the economy, and the institutional structural reforms launched. Next, bearing in mind the centrality of social reform to Lula and his followers, we shall present a preliminary assessment of the impact of the macro-policies on some key social indicators. Finally, we plan to show how the adopted sequence of

orthodox economic policies followed by drastic social reforms may not be compatible, taking into account the path-dependency which inhibits radical departures from established norms in socio-economic policies.

The socio-economic vision of Lula and the PT in the run-up to power

Prior to the election of October 2002, the presidential candidate's party (the PT) issued a comprehensive manifesto which diagnosed Brazil's major socio-economic failings and outlined a number of policy initiatives designed to remedy them.³ This policy document is distinguished by the fact that social development is considered a vital component, rather than a residual, of economic growth.⁴

The document places a particular emphasis on the tackling of poverty and inequality, both long-term features of the Brazilian economy. For instance, it states that the grinding poverty of Brazil "...is not something transitory, but is the result of a historical legacy in which fundamental flaws were never tackled". Recognizing this, it is argued that there is no substitute for the implementation of thoroughgoing structural reforms. However, there is recognition that such reforms are likely to take a considerable period of time (in fact, many years) to accomplish.⁵

The document states explicitly the need to promote rapid economic growth and international competitiveness as a backdrop to achieve social development. For that purpose six key policy goals were specified: price stability; efficiency of the taxation system; provision of long-term finance; investment in research and development; education of the workforce; and selective investments in infrastructure. To promote

³ *Programa do Governo, 2002*. São Paulo: Partido dos Trabalhadores.

⁴ *Ibid.*, p. 30.

⁵ *Ibid.*, p. 43.

simultaneous social development, the document advances a new strategic vision in which the tackling of poverty and inequality is to be performed in an integrated and coherent fashion.⁶

The social development program proposed by PT contained two key components: a program designed to tackle hunger (called *fome zero*⁷) (p. 43) and a minimum income guarantee (p. 41). Regarding the former, a number of measures were proposed, including direct support for family-based agriculture, the right of all family workers to social security benefits (whether in the formal or informal sector), and complementary income guarantees for all children from poor families, plus incentives for those children to obtain a basic education. In addition, the *fome zero* program proposes yet more direct measures, including “popular restaurants”; food banks; modernization of the food supply chain; the promotion of “urban agriculture”; and support for subsistence farmers. (pp. 43-44)

Perhaps the most publicized aspect of the *fome zero* program was the introduction of a “food card”, a sort of cash card enabling the poorest families to obtain for free a certain quantity of food each month.

Closely allied to the *fome zero* program was the second aspect of the PT’s anti-poverty policy: the minimum income guarantee. The latter was supposed to operate in four ways: 1) To target children in poverty up to the age of 15, transferring payments to families whose income was equal to or less than the minimum wage⁸; 2) the launch of student grants for those between the ages of 16 and 25 coming from a low income

⁶ The document explicitly criticizes previous governments for the fragmented and clientelistic nature of their anti-poverty programs. *Ibid.*, p. 39.

⁷ For more detailed information on *fome zero* see Programa Fome Zero: Balanço de 2003

⁸ A policy which has become known as the “Bolsa-Familia” (family grant). This is supposed to provide R\$50 to each family whose monthly income falls below R\$50 plus R\$15 for each child less than 15 years old. Families whose monthly income lies between R\$50 and R\$100 are simply to receive R\$15 per child under 15. *O Estado de São Paulo*, 21st October 2003

background; 3) a program of minimum income guarantees and professional training for unemployed workers between the ages of 22 to 50; 4) the “New Opportunity” program for unemployed workers between the ages of 51 and 66 offering retraining. (pp. 42-43).

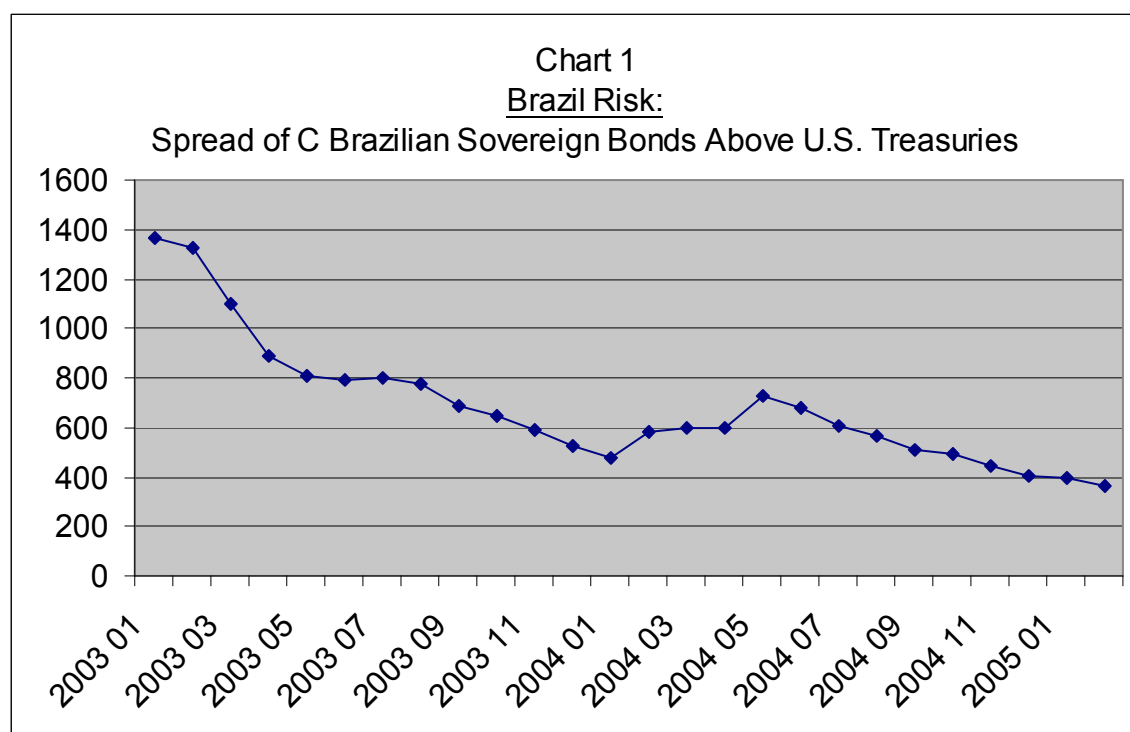
Taken together, these initiatives were supposed to herald a new era in which growth and equity would be promoted simultaneously.

The Lula government’s policies in 2003-5

The domestic and international investment community’s reaction to Lula’s victory in October 2002 was one of nervous expectation. There was the fear that the new government would be tempted to default on part of the debt, that the foreign investor friendliness of the previous government would not be maintained, that there might be a reversal to the privatization program which had prevailed throughout the 1990s and that the fiscal responsibility established under President Fernando Henrique Cardoso would not be sustained. The growing concern of investors in the run-up to the election is well illustrated by the widening of the interest rate spread between Brazilian sovereign bonds and their U.S. equivalents (see Chart 1).

It will be noted in Chart 1 that the interest spread declined right after the election of President Lula. This was the result of reassuring statements made by Lula and his incoming cabinet regarding the above-mentioned fears. Also, conscious of the sensitivities of international financial markets and the danger they held for currency stability, the newly elected government took rapid steps to assuage the anxieties of investors and multilateral institutions. The centerpiece of the government’s strategy in this regard was a reasserting of its predecessor’s commitment to fiscal prudence. In

concrete terms, this took the form of an elevating of the 2003 primary surplus from 3.75% to 4.25% of GDP.⁹ In 2004 the primary surplus attained 4.7 % of GDP in October.¹⁰ Accordingly, the spreads between Brazilian and U.S. treasury bonds continued to decline.



Source: IPEA

Such was the government's determination to pursue tight fiscal policy that it actually succeeded in surpassing the primary fiscal surplus it had pledged to the IMF. This was achieved through tight controls of growth in expenditures, combined with added vigor in generating revenues: in 2003 revenues increased by R\$ 36 billion, while

⁹ Giambiagi (2004), p. 12.

¹⁰ IPEA, *Boletim de Conjuntura*, # 67, Dezembro de 2004.

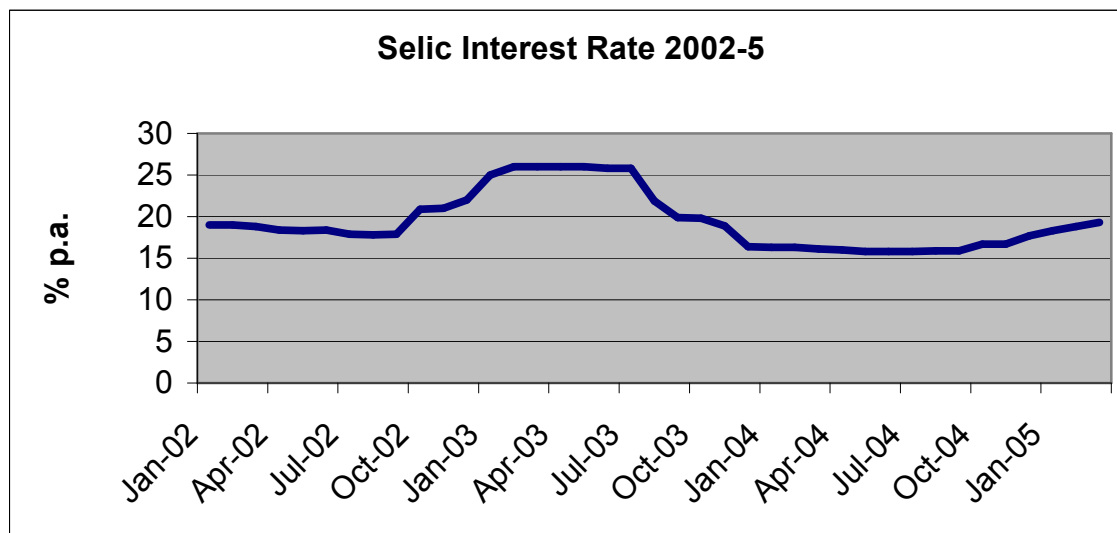
expenditures rose by only R\$ 29 billion, while in 2004 revenues increased by R\$ 64.6 billion while expenditures rose by R\$ 54.3 billion.¹¹

Throughout the first half of 2003 interest rates were kept at very high levels (see Chart 2) as the Lula government continued its policy of reassuring the international community. This policy was underpinned by the maintenance of the inflation-targeting framework established after the January 1999 maxi- devaluation.¹² One should emphasize that the average economic agent needing credit paid much higher interest rates than indicated by the SELIC, which is the country's prime rate. For instance, in 2003 interest rates charged to consumers reached such levels as 74.7% in August, declining slightly to 69.4% in October.¹³ The rates only began to be lowered slightly in the second half of the year, once the *real* began to appreciate in value against the U.S. dollar, a development which stemmed at least in part from a general weakness in the U.S. currency. They continued to decline in the first half of 2004, but from August of that year on the Central Bank began to raise them again, and by March 2005 they had reached 19.25 %.

¹¹ *Ibid.*, p. 13 and Banco Central do Brasil, *Boletim*.

¹² For more details on the January 1999 devaluation and its consequences, see Amann and Baer (2003)

¹³ IPEA (Dec. 2003)



Source: IPEA

It should be remembered that the stabilization which occurred with the introduction of the *Real Plan* was not based on inflation targeting but rather on a combination of a more open economy, high interest rates, the covering of government deficits by non-Central Bank borrowing and the maintenance of an “exchange rate anchor”¹⁴. Inflation targeting began with the devaluation of the Real in January 1999 and the price stability maintained since that time has been attributed to this policy. The Lula administration has kept the inflation-targeting framework in place, a policy which has been justified in a lengthy article by Central Bank officials, strongly associated with the previous administration. They concluded that “the inflation-targeting regime of Brazil is relatively new, but has shown to be important in achieving low levels of inflation even in the context of large shocks. The presence of the Central Bank committed to pre-

¹⁴ For more information see Amann & Baer (2003)

announced inflation targets has worked as an important coordinator of expectations and generated a more stable inflation scenario.”¹⁵

The retention of the inflation targeting framework by the Lula administration places it in a dilemma, since such targeting implies that all other policy goals (including social objectives) would be subordinate to the primary goal of achieving a certain level of inflation.

Macro-economic consequences

The macro-economic policy stance of the Lula government was widely praised in international financial markets and multilateral agencies. However, the results in terms of growth were far from impressive in the first year of his administration. It will be noted in Table 1 that the rate of growth of the economy, which had already been weak during the term of the previous government (see Table 1 a)), worsened in 2003. Table 1 b) indicates that during 2003 the GDP grew by only 0.5%, the worst performance since 1992.

Sectorally the poorest performance was exhibited by the industrial sector whose output shrank sharply in the first half of 2003. Although agriculture and services performed more favorably, the anemic growth in the latter¹⁶ was not sufficient to outweigh the decline of industry.

In the second year of the Lula government (2004) the macro-economic performance of Brazil improved dramatically, as real GDP grew by 5.2%, led by an industrial expansion of 6.2%. Viewed on a quarterly basis, the expansion was mainly

¹⁵ André Minella et al. 2003

¹⁶ Services have the largest share in output, approximately 60% of GDP, compared to agriculture (10%), and industry (30 %).

concentrated in the second and third quarters of the year. In Table 1b it can be noted that by the fourth quarter the pace of expansion began to slacken.

The upturn experienced in 2004 can be explained in a number of ways. First, until 2004 the country had experienced relatively low industrial capacity utilization: since the early 1990s this had hovered about the low 80s. It rose substantially only in mid-2004, reaching its highest point in October (86.1%), but falling again by January 2005 to 83.6%¹⁷. Thus, part of the growth upturn in 2004 can be explained by the more extensive utilization of existing capacity. Second, it will also be noted in Table 1a) that the rate of growth of capital formation turned positive in 2004 after two years of contraction; investment as a proportion of GDP rose from 17.8% in 2003 to 19.5% in 2004. However, half of this investment growth is explained by a substantial rise in the price of capital goods and of inputs into the construction industry¹⁸.

Third, growth in consumption (which rose by 8.5% in the first three quarters of the year) also helped underpin the robust GDP growth in 2004. The increase in consumption can partly be attributed to rising industrial real wages and the impact of monetary loosening in the 12 months up to August 2004. It should be stressed that the growth in consumption experienced over the course of 2004 was almost entirely attributable to the effect of private sector decisions: government consumption barely increased as the authorities strove to drive up the primary surplus in their desire to please the international investor community and the IMF. Lastly, Brazilian GDP benefited from the fact that exports surged by 32% over the year based on buoyant international demand

¹⁷ Conjuntura Econômica, February 2005

¹⁸ IPEA, *Boletim de Conjuntura* Março 2005

for commodities and a still competitive valuation for the Real against the Euro and the Japanese Yen.

Table 1

a) Brazil: Yearly Growth Rates of GDP and Component bs

	<u>GDP</u>	<u>Industry</u>	<u>Services</u>	<u>Agriculture</u>	<u>Consumption</u>	<u>Capital Formation</u>
1990	-4.35	-8.73	-1.15	-2.76		
1991	1.03	0.26	0.33	1.37		
1992	-0.54	-4.22	0.30	4.89		
1993	4.92	7.02	1.76	-0.08		
1994	5.85	6.73	1.80	5.45		
1995	4.22	1.91	1.30	4.07		
1996	2.66	3.28	2.27	3.11		
1997	3.27	4.65	2.55	-0.83	2.9	9.3
1998	0.13	-1.03	0.91	1.27	0.1	-0.7
1999	0.79	-2.22	2.01	8.33	-0.3	-7.6
2000	4.36	4.81	3.80	2.15	3.8	4.5
2001	1.42	-0.50	1.86	5.71	0.5	1.1
2002	1.52	2.57	1.61	5.54	-0.4	-4.2
2003	0.50	-0.96	-0.15	5.00	-0.9	-0.9
2004	5.20	6.20	3.70	5.30	8.5*	2.2

*1st 3 quarters year-on-year

b) Brazil: Quarterly Growth Rates of GDP* and Components

	<u>2002</u>	<u>2003</u>	<u>1Q</u> <u>'03</u>	<u>2Q</u> <u>'03</u>	<u>3Q</u> <u>'03</u>	<u>4Q</u> <u>'03</u>	<u>1Q</u> <u>'04</u>	<u>2Q</u> <u>'04</u>	<u>3Q</u> <u>'04</u>	<u>4Q</u> <u>'04</u>
GDP	1.9	-0.1	1.9	-1.1	-1.5	-0.1	4.0	5.3	5.5	4.7
Agriculture	5.5	5.0	10.6	7.3	-2.8	4.8	5.8	6.0	4.9	7.5
Industry	2.6	-1.0	3.3	-3.5	-1.6	-1.7	5.5	6.3	7.0	5.9
Services	1.6	-0.1	0.2	-0.3	-0.8	0.3	2.4	4.2	4.7	5.7
Gross Fixed Investment	-4.2	-6.6	-1.7	-10.5	-9.1	-5.0	1.8	13.4	20.1	13.7

* relative to same period in previous year.

Source: IBGE; IPEA, Boletim de Conjuntura; Conjuntura Econômica

One of the achievements of the previous government during its eight years in power was the thwarting of hyperinflation and the subsequent maintenance of relative price stability. Despite these accomplishments, the price level still remained sensitive to exchange rate movements.¹⁹ In the two quarters preceding the October 2002 election, the *real* came under sustained downward pressure as a result of investor nervousness. As a consequence, tradable prices spiked sharply upward, causing a rise in inflation (see Table 2 b)). This forced the authorities to tighten monetary policy. (see Chart 2).

Table 2

a) Brazil: Price Changes
(yearly % change)

	<u>Consumer Prices (IPCA)</u>	<u>General Prices (IGP-DI)</u>
1993	1,927.38	2,103.40
1994	2,075.89	2,406.87
1995	66.01	67.46
1996	15.76	11.10
1997	6.93	7.91
1998	3.20	3.89
1999	4.86	11.32
2000	7.04	13.77
2001	6.84	10.36
2002	12.53	26.41
2003	9.30	7.66
2004	6.70	12.13

Source: FGV, Conjuntura Economica; Banco Central.

¹⁹ For a more detailed discussion, see Amann and Baer (2003).

b) Brazil: Monthly Consumer Price Changes

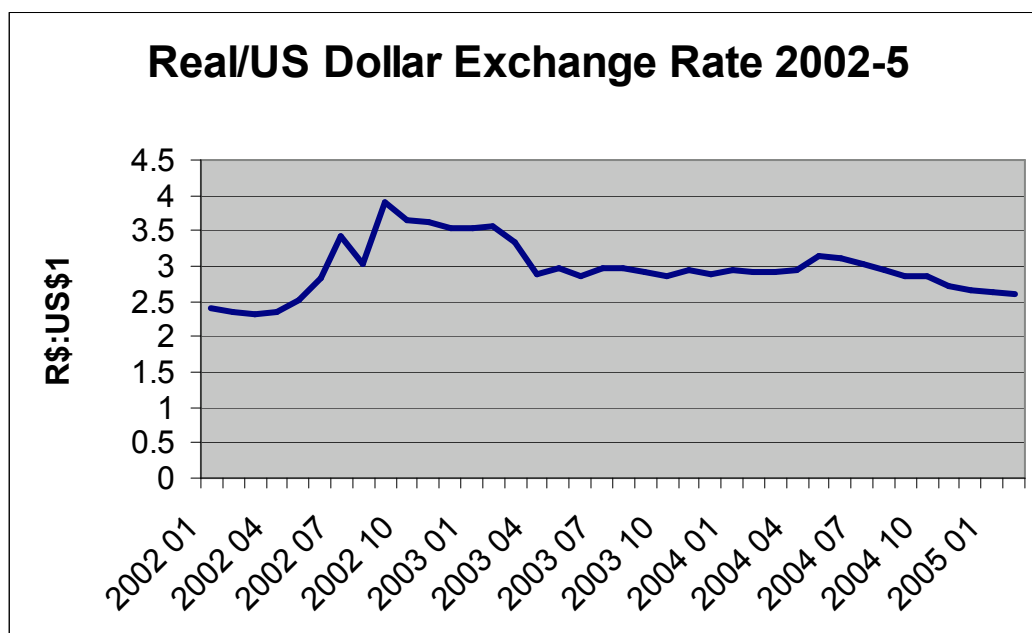
<u>Month</u>		<u>Month</u>		<u>Month</u>		<u>Month</u>	
2002 01	1.07	2003 01	1.47	2004 01	0.76	2005 01	0.58
02	0.31	02	1.57	02	0.61	02	0.59
03	0.62	03	1.23	03	0.47		
04	0.68	04	0.97	04	0.37		
05	0.09	05	0.61	05	0.51		
06	0.61	06	-0.15	06	0.71		
07	1.15	07	0.20	07	0.91		
08	0.86	08	0.34	08	0.69		
09	0.83	09	0.78	09	0.33		
10	1.57	10	0.29	10	0.44		
11	3.39	11	0.34	11	0.69		
12	2.70	12	0.52	12	0.86		

Source: IPEA.

By the time Lula assumed office in January 2003, the worst of the inflationary resurgence had passed and the *real* began to recover some of the ground it had lost in the previous year (see Chart 3). As will be noted in Chart 3 the *real* actually began to appreciate vis-à-vis the US Dollar throughout 2004. While this appreciation may be viewed as a positive in terms of contributing to price stability, nonetheless there are worries over its impact on the country's continued long-term rapid growth of exports.

One of the more positive consequences of the tight fiscal and monetary policies which the Lula government inherited from its predecessor (and continued to carry out) was the solid performance of the balance of payments. It will be noted in Table 3 that the

Chart 3



Source: IPEA

trade balance, which had become positive in 2001, continued to grow (rising from a surplus of US\$ 2.6 billion in 2002 to US\$ 34 billion in 2004). This improvement was due, in part, to the continued growth of exports, but also to the decline of imports in 2003, which reflected weak domestic demand. However, by 2004, Brazil's superior balance of trade performance rested exclusively on accelerated export performance. It will also be noted that the current account emerged from a long period of deficit when, in 2003, it turned positive moving to a surplus of US\$11.7 billion in 2004.

Table 3

External Sector
(US\$ billions)

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Exports	51.1	48.0	55.1	58.2	60.4	73.1	96.5
Imports	57.7	49.2	55.8	55.6	47.2	48.3	62.8
Trade Balance	-6.6	-1.2	-0.7	2.6	13.2	24.8	34.0
Interest	-11.4	-14.9	-14.6	-14.9	-13.1	-13.0	-13.4
Profit Remittances	-6.8	-4.1	-3.3	-5.0	-5.2	-5.6	-7.3
Current Account	-33.4	-25.3	24.2	-23.2	-7.7	4.2	11.7
Portfolio Investment	18.4	3.5	8.6	0.9	-4.7	5.1	-4.0
Direct Investment	28.9	28.6	32.8	22.5	16.6	10.1	18.2
Amortization			25.8	35.2	38.9	45.1	48.7
Foreign Debt	223	226	217	210	211	216	220*
Foreign Exchange Reserves	44.6	36.3	33.0	35.9	37.8	49.3	52.9

* 3rd quarter

Source: Banco Central do Brasil.

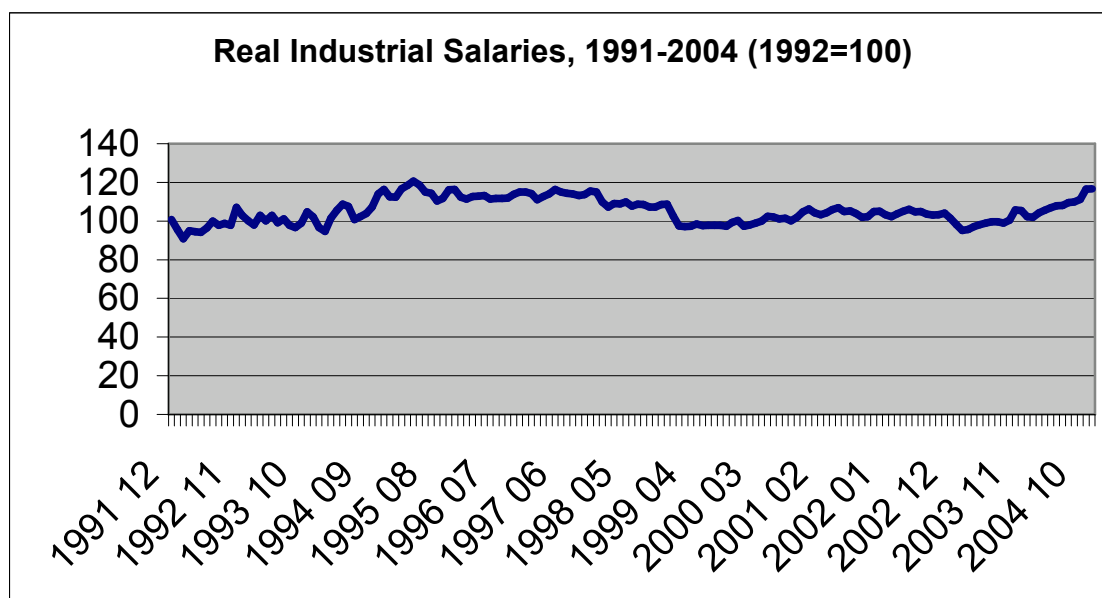
The improvement in the current account balance came at a propitious time in that foreign direct investment had declined substantially between 2000 and 2003; it rose again in 2004 but not to the levels of the late 1990s. Portfolio investment as will be noted turned negative once more in 2004. In spite of the generally favorable balance of payments developments, the net foreign debt increased slightly, reflecting the effects of higher interest rate premia on the cost of external debt rollover. By the third quarter of 2004 the total external debt amounted to US\$M 220,317. Of this 10% was short term while the remainder was long and medium term. Of total debt (including short term debt)

over 60% will become due for payment in the next three years. This implies average annual amortization payments of US\$ 43bn over the next three years necessitating appropriately large surpluses on the current and capital accounts of the balance of payments. However, the likelihood of such surpluses being generated by FDI and portfolio investment seems highly improbable, considering that only US\$10bn in FDI occurred in 2003 and US\$18.4bn were received in 2004 while portfolio investment in the latter year was negative.

Social impacts of Lula's macro-economic policies

It should be stressed at the outset that structural policies aimed at improving social indicators operate with very long lags. Therefore we would not expect to see dramatic improvements in these indicators over such a short time period (the first 2 1/2 years of Lula's government). Nevertheless, it cannot be denied that the tight fiscal and monetary policies which have been maintained in place have had short-term social impacts, not least through their effects on income levels and employment.

Chart 4



As Chart 4 reveals, the period between 1995 and the beginning of the Lula administration witnessed a protracted decline in real industrial wages. Against this background, given its social objectives, it was clearly of priority to the new administration to reverse this trend. However, as can be seen in Table 4 a), the first two years of the Lula government proved a period in which real industrial wages failed to register a sustained increase. Another source (DIEESE, which is the research arm of the trade unions) reveals the failure of real wages to in the metropolitan areas of São Paulo and Belo Horizonte to regain levels of the 1990s (see Table 4 b)). There are indications that the decline in real wages is continuing. As will be noted in Table 4b) real wages in São Paulo in 2004 were lower than those attained in December 2003 throughout the entire year.

Table 4

a) Brazil: Monthly Real Wages

(September 2001 = 100)

	<u>2002</u>	<u>2003</u>	<u>2004</u>
January		92.6	85.9
February		89.3	87.0
March	95.3	89.3	86.2
April	100.9	86.8	85.5
May	100.6	86.8	87.1
June	103.5	85.6	88.0
July	101.1	86.8	86.5
August	99.6	85.4	87.7
September	100.4	84.5	86.7
October	99.9	85.0	86.9
November	100.5	87.4	90.6
December	111.1	106.9	

Source: Conjuntura Economica.

b) Average Real Income of two Major Urban Areas
(Monthly Wage in Reais of January 2003_)

	<u>São Paulo</u>	<u>Belo Horizonte</u>
1998	1264	776
1999	1193	733
2000	1121	718
2001	1022	720
2002	937	724
December 2002	897	712
January 2003	873	703
February	871	697
March	836	663
April	855	654
May	861	654
June	876	650
July	862	668
August	874	657
September	867	648
October	890	622
November	902	627
December	998	684
January 2004	987	700
February	955	702
March	941	698
April	937	693
May	966	699
June	979	710
July	975	698
August	965	691
September	950	687
October	973	691
November	958	702

Source: DIEESE.

c) Unemployment
(% of labor force)

	<u>2002</u>	<u>2003</u>	<u>2004</u>
January	11.1	11.2	11.7
February	12.5	11.6	12.0
March	12.9	12.1	12.8
April	12.5	12.4	13.1
May	11.9	12.8	12.2
June	11.6	13.0	11.7
July	11.9	12.8	11.2
August	11.7	13.0	11.4
September	11.5	12.9	10.9
October	11.2	12.9	10.5
November	10.9	12.2	10.6
December	10.5	10.9	9.6

Source: IBGE.

d) Open Unemployment in São Paulo.
(% of work force)

	Open Unemployment	Hidden Unemployment*	Total Unemployment
1998	11.7	6.5	18.2
1999	12.1	7.2	19.3
2000	11.0	6.7	17.7
2001	11.2	6.3	17.5
2002	12.1	6.9	19.0
2003	12.7	7.2	19.9
January 2004	11.9	7.2	19.1
February	12.6	7.2	19.8
March	13.3	7.3	20.6
April	13.2	7.5	20.7
May	12.3	7.4	19.7
June	11.8	7.3	19.1
July	11.7	6.8	18.5
August	11.7	6.6	18.3
September	11.4	6.5	17.9
October	10.8	6.8	17.6
November	10.4	7.0	17.4
December	10.0	7.1	17.1

*persons who were looking for work in the last 12 months while pursuing some type of economic activity considered precarious

Source: DIEESE.

In addition to declining real wages, slack labor market conditions contributed to a continued high unemployment level when the Lula government began its mandate.

Unfortunately, in the second half of 2003, matters even worsened (Table 4 c)). During 2004, however, the DIEESE unemployment statistics reveal a modest improvement.

The growth trend of Brazil's Gini coefficient, showing a continued rise in the country's income distribution concentration seems to have continued into the Lula administration. Between the 1960s and the 1995-2003 the average for the coefficient rose from 0.50 to 0.61. An early estimate for the first half of 2004 indicates that this trend may be continuing²⁰.

Lula's explicit social policies

As was mentioned above, President Lula began his mandate with "*fome zero*", whose aim it was to directly tackle the problem of hunger. In subsequent months the implementation of this program fell into disarray. As one observer commented "...it sowed bureaucratic confusion by creating extra ministries to tackle social problems (one for hunger and another for social assistance)." In addition, according to the same source, the *fome zero* program has been viewed by many observers as "fuzzy and outmoded".²¹ A key difficulty faced by the *fome zero* program has been that in its multifaceted and loose-bound approach, the authorities have set themselves an enormous organizational challenge. On a practical level, these difficulties made themselves felt on the ground: "Efforts to provide initial food relief to the 4 million poorest Brazilians ran into a logjam of problems, ranging from finding that many of them were illiterate and had no ID (and

²⁰ The 2004 estimate stands at 0.63 (European Union online)

²¹ *The Economist*, 14th August 2003

thus could not find out about or register for the aid) to local corruption and huge logistical snafus involved in delivering aid to people who live without roads, electricity, phones, or often fixed addresses.”²²

Whatever the organizational imperfections of Lula’s new social programs, their effectiveness was always going to be limited by available resources. Unfortunately, the budget allocation for social programs proved not to be as generous as the government had originally anticipated. This was a direct result of the fiscal pressures placed on Brazil by multilateral institutions (in particular the IMF). It will be recalled that the IMF agreed to a new more stringent primary budget surplus target of 4.25 % of GDP (the old target having been 3.75%). To achieve this, an extra cut of R\$ 14 billion was required in the federal budget, of which R\$ 5 billion had been destined for social expenditures. Of the latter sum, reductions in education spending contributed R\$ 341 million, health R\$ 1.6 billion, and social security R\$ 247 million. Most surprising of all, given its profile, was the application of a R\$ 34 million cut to the *fome zero* program.²³

Lula’s reforms

One major political and economic success of Lula in the first year of his mandate was the passage of a reform of the social security system. Such a reform was desperately needed. This becomes clear by the scale of social security spending in comparison with other social expenditures. According to Rands²⁴ during 2002 the state had to allocate no less than R\$ 39bn to provide for the benefits of civil servants. This compares with total federal spending on health of R\$ 30bn. The important point to bear in mind is that these

²² Steffen (2003).

²³ Cruz (2004)

²⁴ Rands (2003) p.4-5

social security expenditures are targeted at a very restricted section of population, that is, 3.5m public servants and their dependents. In other words, although public expenditure on social security in Brazil may be extensive, its benefits are extremely concentrated. This may be seen in Tables 5a) and b) which show that the top decile of the income distribution received over half of the pension benefit in 2002. In contrast, the government-run social security system for private sector workers (the Instituto Nacional de Seguridade Social – INSS) targets fewer resources (R\$ 17bn) at a much larger client group (19m people) (ibid.). Thus, a reform was crucial if resources were to be conserved, but also more equitably distributed.

Table 5
a) Brazil: Distribution of Government Monetary Benefits by Income Groups
(Deciles - %)

	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>Total</u>
<u>Total Benefits</u>	2	3	3	3	5	7	7	9	15	46	100
<u>Pensions</u>	0	1	2	3	4	7	7	9	16	51	100
<u>Unempl. Insurance</u>	6	6	8	12	12	9	13	11	14	9	100
<u>Family Support*</u>	2	8	11	13	13	12	10	10	9	12	100
<u>Old Age Support**</u>	7	12	28	14	39	0	0	0	0	0	100
<u>Children Support***</u>	35	38	19	7	1	0	0	0	0	0	100

*Abono salarial de salario-familia; ** Amparo ao idoso ***Bolsas-escola, alimentação e criança cidadã

b) Brazil: Distribution of Non-Monetary Benefits by Income Groups
(deciles - %)

	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>Total</u>
Health	17	16	14	12	11	9	7	6	5	3	100
Education	6	6	6	6	5	5	10	12	17	27	100

Source: Rezende and Cunha (2002), p. 95

In December 2003 the Lula government succeeded in having its social security reform bill passed by both Brazil's Senate and Chamber of Deputies. The reform increased the minimum retirement age for all civil servants; it required retired civil servants to contribute to the social security system if their monthly income exceeded R\$ 1,440 per month; it limited the amount of pensions paid to widows and orphans of civil servants; it placed caps on civil servants' wages and retirement earnings; it placed a maximum cap for the whole civil service and it set a cap on pensions paid to private sector retirees. In addition, numerous other measures were introduced to control spiraling social security costs²⁵.

Over the longer term, these reforms are expected to deliver substantial savings, perhaps as much as R\$ 50bn in twenty years' time²⁶. In this sense, the reforms should have the ability to free up resources for alternative social expenditures while at the same time curbing the deficit-generating properties of the social security system. However, the reforms will take some time to have full effect and in this interregnum, the government will find itself under continuing and stringent budgetary constraints. Unfortunately, for the Lula government, its progress in limiting the growth of the social security deficit will

²⁵ *Banco Central do Brasil Focus*, 'Social Security Reform' December 18th, 2003

²⁶ Rands (2003)

be hampered – at least in the short term – by its pledge to raise the minimum wage²⁷.

Under Brazilian law, increases in the minimum wage will automatically generate a rise in social security payments, since the latter are in effect indexed to the former. Thus, we have a typical recurrence of the efficiency vs. equity dilemma. Attempts to rationalize the social security system are constantly being confronted by the equity-based demand for higher minimum wages. A practical consequence of this dilemma is that the government – despite the reforms – is forecasting continued rises in the social security deficit at least over the short term²⁸.

Another major thrust in the government's attempt to achieve structural change consisted of a tax reform package introduced in the first half of 2003. Among the main items were: a unification of the ICMS tax²⁹ across states (with a reduction in the number of rates from 44 to 5), with a gradual shift from a production-based to a consumption-based tax; the cessation of state tax breaks to inward investors; the transformation of the financial transactions tax (CPMF)³⁰ from a temporary into a permanent tax; the federal compensation of states which issue tax credits to exporters; the reform of the method of collecting the Cofins³¹ social security tax by switching the basis of its collection from wages to employers' value-added revenues, and finally, the promotion of capital goods

²⁷ In June 2004 the Lula government used all of its political power to force through Congress an increase in the minimum wage of only R\$ 260 in opposition to substantial pressure from across the political spectrum for an increase to R\$ 275.

²⁸ *IPEA Boletim de Conjuntura*, 2004 (March), p.58

²⁹ ICMS (Imposto sobre Operações Relativas à Circulação de Mercadorias e sobre Serviços – Tax on Goods and Services). This is a state-based sales tax

³⁰ CPMF (Contribuição Provisória nos Movimentos Financeiros – Provisional Tax on Financial Movements). This is a federal tax on financial transactions popularly known as the “check tax”

³¹ Cofins (Contribuição para o Financiamento da Seguridade Social – Tax for Financing Social Security)

sales and exports by reductions in the incidence of the ICMS sales tax and the industrial products tax (IPI)³².

While reform of the indirect taxation system was certainly needed in order to boost revenues and promote competitiveness (especially of exports), doubt remains as to whether the current measures are sufficiently extensive or thoroughgoing (Giambiagi, 2004). In addition, there remains the question as to whether aspects of the reforms will actually function in practice, not least the provision granting state tax exemptions for exports³³. In another important area- bankruptcy law – progress has been more favorable with the bill receiving final congressional approval in December 2004. The old law gave first priority to workers, second to the tax authorities and thirdly to creditors. The new legislation gives priority to creditors while limiting payments to workers. In enhancing the rights of banks as creditors, the new law has the potential to assist in the expansion of credit, a development urgently required for accelerated growth³⁴.

By the time the Lula government reached office, Brazil's privatization program had slowed down considerably and continued to stagnate into 2003-5. What is of greater interest, however, is the changed attitude of the government with respect to the regulatory agencies, which were established as public utilities were privatized in the late 1990s. Whereas under the previous government, regulatory agencies set out to generate tariff conditions favorable to various private, domestic and foreign concessionaires, the Lula administration adopted a posture which was much less favorably disposed to the claims of privatized firms. This may be most clearly seen in the New Energy Model, passed by

³² For greater detail see Gustavo Rangel, *Barclays Capital Research*, August 15th 2003

³³ The key problem here being the lack of appropriate inter-governmental transfer mechanisms to compensate states for lost revenues.

³⁴ Latin Trade December 2004. Lula defended these reforms, arguing that Brazil's bank lending margins were among the highest in the world and were damaging the economy.

Congress in March 2004. The model explicitly favors the award of future public utility concessions on the basis of the setting tariffs to benefit lower income groups³⁵.

Another change in the government's regulatory stance can be seen in its approach to the independence of its regulatory agencies. In early 2004 pressure from within the Lula administration led to the replacement of the head of Anatel, the regulatory agency concerned with telecommunications and hitherto regarded as the most successful among its peers. This development seems to highlight a different vision of who controls regulatory agencies and even the Central Bank. Implicitly in its actions the government appears to be advancing a core precept of the PT: that the levers of policymaking power should be in hands of those directly accountable to the electorate rather than independent and perhaps unaccountable bodies.

The core dilemma of the Lula government

President Lula came to office with two major goals: the pursuit of a macroeconomic policy orthodox enough to win the approval of the international financial community and the achievement of a greater degree of socio-economic equity. It seems that this was to be done in a sequential fashion, emphasizing initially the former to be followed by the latter. Unfortunately, such sequencing may prove to be unfeasible. An initial period of economic orthodoxy might make it very difficult to allow for a subsequent large dose of policies aimed at greater socio-economic equity. That is to say, embarking initially on a program of an orthodox policy path can determine subsequent sets of policies.

³⁵ Economist Intelligence Unit *Brazil Country Report*, 1st Quarter 2004

Thus, the Lula government may find that the cost of more extensive socio-economic policies will be the partial or total abandonment of orthodoxy and the loss of support of the international financial community.

Our argument is illustrated in Chart 5. In the center of the chart the shaded box indicates total resources available to the government, the allocation of which can be divided between discretionary and non-discretionary expenditures. The non-discretionary expenditures comprise contractually determined items over which the federal government has no control. The most important of these are debt servicing and the constitutionally determined transfers to sub-national governments. Discretionary spending would include social programs aimed at improving equity. The key point to note is that the balance of discretionary versus non-discretionary expenditures will be determined by the macroeconomic policy stance adopted and the success encountered in implementing structural reforms.

To be specific, it will be noted that a growing debt coupled with low domestic savings in an open economy (key features of the Brazilian case) makes the economy more vulnerable to currency volatility. Of course, we would not wish to pretend that the presence of an open economy or a low domestic savings rate – and the consequent need to draw in foreign capital - automatically results in a damaging currency weakness. In the case of the United States, for example, prior to 2004 the dollar had been able to avoid dramatic falls despite the existence of a chronic current account deficit. The reason for this is that the US, benefiting from liquid financial markets and the possession of a key reserve currency, remained an attractive destination for international portfolio capital.

Brazil, unfortunately, possesses neither attributes and thus the cost of capturing international resources is higher while capital inflows are subject to greater volatility.

Thus, the Brazilian authorities are obliged to maintain high interest rates³⁶ and to achieve a large primary surplus, both policy choices deemed necessary to attract international capital inflows. One result of these high interest rates, is a tendency for debt servicing costs to rise and growth to falter. Thus, discretionary expenditures suffer as the result of a pincer movement comprising of weak revenue generation (the result of low growth) and rising debt servicing obligations.

The only forces that might increase growth and allow a breakout from the trap described above are structural reforms (especially social security and taxation reform), which eventually might be expected to lead to higher growth and accelerated revenue generation for the government. Unfortunately, so far progress on the structural reform agenda has been very limited, thus impeding enhanced growth performance. On the other hand, given the experience of the Lula administration to date it would seem that the orthodox policies have substantially increased non-discretionary spending. This was reinforced in 2003 by the low growth resulting from a combination of high interest rates and orthodox fiscal policies. Although growth rebounded in 2004, as we saw the continuing presence of structural constraints has subsequently forced the authorities to adopt growth-dampening tighter monetary policy. Thus, the ability of the Lula government to develop a broad program leading to the improvement of socio-economic conditions in the country remains constrained. This is likely to have unfavorable long-term consequences for growth since investment in social spending, infrastructure and

³⁶ It will be recalled that the inflation-targeting framework severely limits the discretion of the authorities to pursue a laxer monetary policy in the event that inflationary pressures are rising. Such a scenario may well (and has) come to pass after an episode of currency weakness.

human capital is needed to raise growth potential. It is entirely possible that the greater social emphasis in the government's policies will require greater expenditures, lower interest rates and the adoption of regulatory policies, which do not favor domestic and foreign concessionaires. All this may further compromise the country's ability to attract foreign financing and FDI.

Table 6

Brazil: Federal Government Expenditures
(% distribution)

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Current Expenditures	50.0	55.2	53.0	43.8	40.2	38.4	40.6	48.8	50.2	44.1	48.4
Wages and benefits	12.9	16.2	14.2	11.5	9.6	8.8	9.4	10.8	11.1	9.1	9.8
Public debt service	7.1	7.1	6.6	5.4	6.2	7.5	6.3	8.8	8.2	7.6	8.2
Transfers to states and local govts	8.6	9.1	9.0	7.7	7.6	7.1	8.4	10.0	10.8	9.2	10.1
Social Security	12.1	13.7	14.2	11.8	10.8	9.8	10.5	12.4	12.9	12.4	13.5
Other Current Exp.	9.3	10.0	9.0	7.4	6.0	5.2	6.0	6.8	7.2	5.8	6.8
Capital Expenditures	25.7	8.7	9.0	21.7	20.6	15.6	10.5	14.9	14.8	12.5	11.5
Investments	2.9	.2.1	2.0	2.0	1.6	1.2	1.6	2.5	1.5	0.7	1.2
Financial investments	4.4	2.9	4.2	16.4	14.2	9.8	1.8	3.3	3.1	2.6	2.4
Amortization of debt	18.6	3.7	2.8	3.3	4.8	4.6	7.1	9.1	10.2	9.2	7.9
Amortization refinancing	24.3	36.1	38.0	34.5	39.2	46.0	48.9	36.3	35.0	43.4	40.1
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministerio da Fazenda, Tesouro Nacional.

The dilemma discussed above is represented in concrete terms in Table 6. The table gives a summary view of Brazil's federal government expenditures. It will be noted that expenditures on amortization and amortization refinancing in 2004 amounted to no less than 48% of total government spending. The data also reveal the limited extent to which amortization prevails relative to amortization refinancing. The burden of amortization refinancing (at 40.1% of total government spending) is, of course, highly sensitive to movements in interest rates. For this reason, it is clearly to the government's advantage to embark on a path of lower interest rates. However, given the need to adhere to the inflation-targeting framework and to maintain the external valuation of the currency, such an attractive policy option may not be feasible.

Turning to current expenditures, it will be noted that public sector debt service, social security spending, transfers to state and local governments are classified as constituting non-discretionary categories of expenditures. Taken together, these spending categories account for 31.8% of total public spending. Combining the relevant items from current and capital expenditures, it will be observed that total non-discretionary spending in 2004 accounted for 79.8% of total expenditure. By contrast, in 1995 (the year after the *Real* was launched) non-discretionary expenditures stood at just 69.7% of the total. Thus, it becomes clear that the government's relative scope for discretionary expenditures has narrowed sharply over a relatively short period. Against this background, the constraints which shackle much needed investment in social programs become all the clearer.

Having analyzed the nature of the government's macroeconomic strategy, that is, the imposition of strict orthodox measures, which would win approval of the international

financial community and multilateral agencies, it becomes clear that, at least in the short-term, that there is a very limited scope for combining orthodoxy with social development. During this initial phase, we saw that the workers endured one of the largest reductions in earnings in Brazil's economic history³⁷, unemployment grew and many firms fell into bankruptcy, the government was forced to drastically cut infrastructure investments, while the only sector which benefited was banking, where a combination of high interest rates and restricted competition resulted in record profits³⁸.

Conclusions: the continuing dilemma

In January 2003 President Lula came to power with two goals: the pursuit of social justice and a commitment to economic orthodoxy. Over the course of this article we have argued that so far, at least, these two objectives have not proved compatible. While the government has done a credible job of continuing the market-based policies it inherited from the previous administration, and thus earned high marks with the international financial community, this has been at the cost of achieving key social objectives, such as lower unemployment, higher incomes, and greater equity in the distribution of income and assets. Of course, it may be argued that the adoption of an orthodox macroeconomic stance forms a necessary foundation upon which future attempts to tackle Brazil's deep-rooted social problems can be based.

However, we have shown that the impact of tight fiscal and monetary policy in practical terms is to constrain the authorities' scope to expand discretionary expenditures. While structural reforms have the potential to counter this tendency, thus far they have

³⁷ Jorge Luiz Bachtold (2004)

³⁸ Bachtold indicates that the profit of Bradesco in 2003 grew by 14%, of Itaú by 26.5% and of the Banco do Brasil by 17.4%

been limited in scale and, even according to their proponents, are expected only to have a limited – and delayed – effect. More fundamentally, it should be recognized that fiscal and monetary orthodoxy – by restricting investment in infrastructure and human capital – will inevitably limit the growth potential of the economy³⁹. Thus, the notion that orthodoxy in macroeconomic policy represents a necessary precondition for accelerated growth in some future period, needs at least some critical re-evaluation. In other words, Brazil runs the risk of being caught in a trap in which social problems remain unaddressed despite ostensibly sound macroeconomic performance.

Therefore, as the Lula government advances towards the conclusion of its mandate, it remains faced with a fundamental dilemma: the need to simultaneously maintain economic respectability within a globalized international financial system, while attempting to remedy the country's grave socio-economic disparities.

The recent experience of Brazil suggests that the simultaneous achievement of macroeconomic stability and socio-economic change are not necessarily compatible. An alternative possibility of adopting a sequential approach in which a period of economic orthodoxy precedes a period of socio-economic structural progress - which may appear a reasonable path - was shown in the case of Brazil to be strewn with path-dependent

³⁹ Many structural bottlenecks will have to be overcome: 80% of Brazil's highways were classified as "deficient", "bad" or "terrible" by a government commission; railroads, which carry only 24% of Brazil's cargo with 28,000km of tracks, needed dramatic improvements in infrastructure. Seaports are also notoriously expensive and inefficient compared to their East Asian counterparts. Average port costs are estimated for Brazil at US\$41 per ton versus US\$18 for the US. In Santos, Latin America's largest port, 30 containers can be loaded in one hour versus 100 in Singapore. To deal with such deficiencies, the government in December 2004 instituted a public private partnership (PPP) program. This allows for the private provision of infrastructure services under contract to the government, which guarantees in turn the purchase of such services for a specific time period and for a specific price. The advantage of this arrangement is that investment can take place (financed by the private sector) without the need to resort to scarce public sector capital investment funds (*Latin Finance*, October 2004).

obstacles. It remains to be seen whether Brazil proves to be an exception or the rule to these dilemmas.

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