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CHALLENGES FOR THE NEW ADMINISTRATION

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Brazil: Challenges for the New Administration

Brazil's president, Luís Inácio Lula da Silva, was elected in October 2002 with more than 60% of the vote. After three unsuccessful attempts to win the Presidency (1989, 1994 and 1998), when Mr da Silva and his Worker's Party (PT) advocated a platform of 'radical change' (democratic-socialism), in 2002 they ran on a somewhat more moderate version of the typical left-wing discourse in Latin America. Despite the moderate style, they won with the promise to replace the 'neo-liberal' leaning of the two Cardoso administrations (1994-2002) with another in which the state would engage in strategic planning initiatives to foster high levels of economic growth. 'Political will shall substitute for the will of the market in the setting of governing priorities', was the motto insistently repeated throughout the electoral campaign.

After its inauguration, though, Brazilians were surprised to see that the biggest change in the country would be that of the PT and other left-wing parties. Accustomed to spelling out in inflamed discourses the reasons why the focus on macroeconomic stability, emphasized by the Cardoso administration, was bad for the country, the new administration announced from the beginning that it would pursue a very conservative strategy –one based on fiscal responsibility and neo-liberal structural reforms. The new strategy would include: the continuity in the path of fiscal tightening, the engagement of the Executive in political negotiations with Congress and state governors to cut the massive deficits of the public sector workers' pension regime, and the promotion of an even greater loosening of labour laws than that attempted in the Cardoso era.

The purpose of this chapter is to discuss the key challenges faced by the Worker's Party administration in Brazil, in social and economic terms given the constraints imposed by the workings of the political system. What I attempt to do here is, first, to call in some of the crucial issues in the agenda for generating the conditions to attain sustainable growth in Brazil and, second, to try to evaluate how the administration would tend to deal with those issues. In answering those questions it is vital to understand how important such issues tend to be seen by the ruling elite, how the present administration will tend to address them, and how successful it might be in getting them fixed.

The broad subject areas to be discussed here are macroeconomic stability, microeconomic regulation, and social policy, each of them tending to evolve into various issues. For example, macroeconomic stability implies: (i) devising a long-term strategy to balance the government budget out; reforming the tax system in order to make it more efficient, transparent and fair; (ii) increasing the efficiency of the state so that a greater part of its existing resources is used to promote collective goals; (iii) cutting current public spending levels and programmes so that a sustainable tax reduction path can be followed in the future; and, (iv) changing the structure of government fiscal priorities in order to deal more efficiently with scarce funds and pressing needs.

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Microeconomic regulation, on the other hand, deals with creating and maintaining a business environment which incentives production over speculation, increasing productivity rates and formal hiring, as well as risk taking and positive externalities. It has a lot to do with matters of: (i) eliminating political or ideological (ie, particularistic) influences over the policy making process and the setting of laws/regulations for different industries which could distort incentives for investments; (ii) provisioning of collective or public goods necessary for risk taking initiatives, like the establishment of fair and stable rules of the game (eg, an adequate structure for protecting property rights and competition policies), efficient infrastructure, education & training policies, and a strategy of trade liberalization; and (iii) focusing state intervention on the improvement of the well-being of the consumer (and not the supplier).

Finally, social policy must deal adequately with setting policies to protect individuals and communities in hard times and, more importantly, offering basic skills to those less capable of providing for themselves in order to allow them to do so in the future. Social policy reform in Brazil should necessarily deal with (i) restructuring the social budget in order to divert social spending to the real poor; (ii) conditioning the concession of social policy benefits to some sort of human capital gain for the beneficiaries; and (iii) eliminating any mechanisms that makes possible for political groups (parties, unions, associations) to gain from the distribution of social benefits.

It is obvious that, everywhere, the ability of a government to deal with such issues depends directly on the political support it is capable to gather and maintain. So, the first section of this chapter will be devoted to analyzing the current support base of the PT administration in the political system, as well as in society at large. I will speculate on how that political support base tends to be affected by the decisions taken by the administration both in strictly political terms and in terms of the content of its policy agenda. Section two discusses the issue of macroeconomic stability and fiscal reform, section three addresses microeconomic regulation, and section four deals with social policy. Conclusions will be presented on section five.

1. The Political Support Base of the PT Administration: Past, Present and Future Prospects

PT was created in 1980, a time when Brazil was still under authoritarian rule, as the political branch of the (new) union's movement of Sao Paulo metal workers (1). Since then, PT has grown stronger in every election. In its first years, the party was very small, holding only a few executive positions until very recently: the first state governor from the party was elected in 1994 and it was only in 1996 that it started to govern major cities, like Porto Alegre and Brasília. Now it runs four small states and some major capital cities, like Sao Paulo, Porto Alegre, Recife, Belém, and Goiânia. In Congress, the same pattern of incremental growth took place. PT did not become a significant political force until 1994, when it reached 10% of the seats in the Chamber of Deputies. In the Senate, the process was even slower. It was only in 2002 that the PT reached more than 10% of the seats. Table 1 presents a broad figure of the increasing importance of the PT in the Brazilian political system.

Table 1. Number of Governors, Senators, Representatives and Mayors Elected by the PT Since 1982

	1982	1986	1990	1994	1998	2002
Governors (n = 27)	0	0	0	2	3	3
Senators (n = 81)	0	0	1	4	3	10
Representatives (n = 513)	8	16	35	49	58	91
Mayors (1) (n = 5000)	2	1	38	54	110	187

(1) Mayors were elected in 1982, 1985, 1988, 1992, 1996, and 2000.
Source: *Dados Eleitorais do Brasil*, IUPERJ.

The data presented on Table 1 must be confronted with the strong support the party has gathered in the four presidential contests since the restoration of democracy. This is a striking dimension of the political influence exerted by the PT in Brazil's political system, even though it did not render the party any significant mechanisms to exercise power. The strong support for the PT in presidential races since 1989 must take into consideration the strong tendency towards personalization in majority-rule elections. This is even more the case in presidential contests. In that sense, although very difficult in practice it is important to try to separate whether voters supported the candidate or the party programme when voting for president.

Table 2. Electoral Support for the PT in Four Presidential Elections, Total and Percentage, Since 1989

	1st round		2nd round	
	# of votes	% of total	# of votes	% of total
1989	11,619,816	17.2	31,070,734	47
1994	17,116,579	27	-	-
1998	21,470,333	31.7	-	-
2002	39,425,283	46.4	52,769,723	61.3

Source: *Dados Eleitorais do Brasil*, IUPERJ.

Table 3. Electoral Support for the PT in Chosen Positions

	1990 (1)		1994		1998		2002	
	#	%	#	%	#	%	#	%
Chamber of Deputies	4,128,052	10.2	5,859,347	12.8	8,786,499	13.2	16,092,411	18.4
Governor(2)	5,297,786	9.7	6,735,429	11.7	9,567,420	14.5	23,228,310	27.6
President(2)	11,619,816	17.2	17,116,579	27	21,470,333	31.7	39,425,283	46.4

(1) the first presidential election was held in 1989.
(2) first round only.
Source: *Dados Eleitorais do Brasil*, IUPERJ.

Table 2 presents the electoral support for the PT in the four presidential elections held after democratization, all of which had Mr. Lula da Silva as the party's candidate. It shows a consistent increase in the total amount and the percentage of votes given to the PT candidate in the first round of the four elections, growing from 17% in 1989 to 46% in 2002 –almost a three fold upsurge. Table 3, on the other hand, compares the amount of votes gathered by the PT in elections for three different positions –representatives in Congress, governors, and president– so that we can make inferences on whether the increase in the support for Mr. Lula da Silva in presidential elections was somewhat matched by PT's performance for other posts in the same year. And the simple conclusion is no –Mr. Lula da Silva's performance was unique if compared to that of his own party.

The significant gap between the performances of the PT in the presidential elections when compared to congressional and governorship elections reinforced the fragmentation of power among numerous political parties –one of the most striking features of Brazilian politics. Fragmentation is the result of two institutional facets of the Brazilian political system: proportional representation (PR) in elections for the lower house of Congress, and very flexible electoral and party regulations (2). At the moment, there are at least 16 parties represented in Congress, none of which have a minimum of 20% of the seats in the lower house. Together, the three major parties (PT, PFL and PMDB) occupy less than 50% of the seats. Party fragmentation in the Senate is less striking since the PMDB holds almost 1/3 of the seats, but even there the government does not count with a reliable majority. If fragmentation makes it difficult for the Executive to pass legislation imagine when it needs to approve constitutional amendments, which require 3/5 of the vote in each one of the two houses.

Fragmentation is also present at the state level, where seven political parties hold governorship positions. In the Brazilian federation, governors are important players as they can interfere in Executive-Legislative affairs as autonomous sources of pressure over congressmen from their own party and/or their own state. Table 4, below, shows that the current opposition parties (PSDB and PFL) made 11 of the 27 state governors –including some of the most powerful states, like Sao Paulo and Minas Gerais, which together account for almost ¼ of the Chamber–, while the PT made only four governors, in politically insignificant states [3].

Table 4. Brazil, Distribution of political power among political parties, 1999-2002 and 2003-06

Parties	Governors		Senators		Representatives	
	1999-2002	2003-6	1999-2002	2003-6 (1)	1999-2002	2003-6(2)
PSDB	6	8	14	10 [11]	95	63 (71)
PFL	8	3	17	18 (19)	97	72 (84)
PP	2	-	3	- (1)	53	47 (49)
PMDB	4	5	23	22 (19)	87	68 (74)
PTB	-	-	5	3	33	48 (26)
PL	-	-	1	3	23	33 (26)
PDT	-	1	5	5 [5]	17	15 (21)
PSB	1	4	3	3 [4]	17	29 (22)
PPS	-	2	2	3 (1)	11	19 (15)
PCdoB	-	-	-	-	10	11 [12]
PT	5	4	7	14	58	93 (91)
Others	1	-	1	0 (1)	12	15 (22)
TOTAL	27	27	81	81	513	513

(1) Number of elected senators indicated in parenthesis, when different from current number.
(2) Number of elected representatives indicated in parenthesis, when different from current number.
Sources: Câmara dos Deputados, Senado Federal;

Table 4 (above) and Table 5 (below) compare the distribution of elected officials in Congress and in the state executive level among political parties in the second administration of Fernando H. Cardoso (1999-2002) and the current one. On Table 4, colour lines indicate differences in party ideology –blue (PSDB and PFL) represent parties favouring a 'neo-liberal' agenda (privatization, deregulation, trade liberalization, macroeconomic stability, etc.); yellow (PT, PC do B, PPS, PSB, and PDT) stands for parties favouring left-wing, anti-neoliberal agendas (increase in government intervention in the economy); white (PMDB, PP, PTB, and PL) indicate populist-clientelistic parties, which can associate with either neo-liberal or anti-neoliberal agendas, depending on the payoffs.

Two significant facts of Brazilian politics point to increasing obstacles for the current administration to gather enough support in Congress in order to foster its economic and social agenda. First, and more structurally, Brazilian political parties tend to be internally divided into factions. The bosses of each faction, especially those that do not control the party directive, gain power by resisting the agreements made between the party leaders and the administration. So it makes sense for them to bargain the support of their faction whenever it is considered essential to pass legislation of particular interest to the administration. Normally, they exchange their votes for political resources controlled by the Executive (budget to be spent in regions or particular policy areas that concern them, right to appoint one of their own to occupy key positions in the Executive, etc). In sum, according to Brazilian legislation there is no guarantee that the support of the party's higher ranks to the administration will in fact be followed by total compliance of its ranks in Congress. Second, and more circumstantially, since the beginning of the PT administration, PT congressmen have been confronted with deep changes in the economic discourse and practice of those that hold the most relevant positions in the Executive, including the President. Suddenly they had to decide whether to follow that lead or resist it. It is now acknowledged that those congressmen inside the PT that favour a 'guerrilla' war against the PT administration are only a tiny minority. Nevertheless, they count with the sympathy of 1/3 of the party ranks in Congress. Whether that group will become more prone to resisting the administration's agenda will depend on the evolution of both the economic indicators and the level of social support for the government.

Table 5 is a tentative representation of the strength of the government vis-à-vis the opposition. Comparing the size of the electoral coalition with that of the governing coalition it is evident that the two periods are largely distinct. In the first period, the two coalitions do not differ much while in the second period the governing coalition is almost two times bigger than the electoral coalition in the Chamber and almost three times bigger in the Senate. That leads to a simple conclusion: the level of consistency of the governing coalition tends to be smaller now than in the previous administration while the threat of internal conflict tends to be higher than before.

Table 5. Brazil, congressional support for the Executive (estimated), 1999-2002 and 2003-06

	Electoral Coalition		Governing coalition		Opposition	
	Chamber	Senate	Chamber	Senate	Chamber	Senate
1999-2002 (1)	312	59	370	65	110	16
2002-2006 (2)	137	17	340	48	150	33

(1) The electoral coalition involved: PSDB, PFL, PTB, and PPB (later, PP). The governing coalition also incorporated the PMDB and the PPS (in most of the issues).
(2) The electoral coalition included: PT, PL, and PC do B. The governing coalition also incorporates: PPS, PSB, PTB, PP, and PMDB.
Table 5 shows a large increase in the size of the opposition in 2003 –by 100% in the Senate and by 36% in the lower house. If we consider that constitutional changes are

normally required for any particular government to set its own agenda –given the all-inclusive nature of the Brazilian Constitution– the number of votes needed in Congress for an effective government is much higher than the simple majority of 257 representatives and 41 senators. To pass a constitutional amendment it is necessary to gather 308 votes in the Chamber and 49 in the Senate. As a result, one can easily conclude that one of the main tasks facing the government at this moment is to inflate its coalition in order to assure the necessary votes in each one of the houses.

In short, the challenges facing the new administration are very high in the political arena: political fragmentation (in Congress and in the federation) tends to reduce the effectiveness of the government at the federal level given the need to articulate second-best solutions with many political parties and party fractions; in Congress, the administration lacks the political support it has gathered in the ballot box and the opposition is larger now than during the Cardoso administration; and, finally, the change in political discourse –to be discussed below– can force the government to rely more on the opposition than it could suppose, given the reluctance of approximately 1/3 of his party fellows to accept the new agenda.

Brazilian fragmented presidential system requires that politics be also played in the intersection of the Congressional and the bureaucratic arenas. It is not uncommon that coalition governments find it useful to split the key executive positions among allied parties and party factions. In that regard, the administration of the PT can be described as a coalition of (i) administrative powerbrokers; (ii) at least three kinds of left-wing political groups; and (iii) centre and right-wing populists. Administrative power-brokers are top political advisers to the president, recruited among PT higher ranks. They are mainly concerned with creating good conditions for the administration remain in power. Substantially, it means that they favour the expansion of the current governing coalition in Congress and the adoption of sustainable economic policies.

The three left-wing factions are: social-democrats, pragmatic-socialists, and radical-socialists. Social-democrats are entrenched in three key ministries –Finance (and the Central Bank); Development, Industry & Foreign Trade; and Agriculture –from where they set the economic agenda and impose its logic to the rest of the government. Social-democrats suffer the direct opposition of radical-socialists, for whom government actions should be consisted with ideas cultivated when the PT was in the opposition. That is to say, they favour direct government interventions on the economy to promote compulsory wealth redistribution from 'capitalist' to 'workers'. They represent approximately ¼ of the electoral coalition in Congress and, in the Executive, they control two somewhat important cabinet positions –Agrarian Reform and Science & Technology– and the inexpressive Ministry of Sports. Finally, pragmatic-socialists are the largest group both in Congress, where they account for over half of the government electoral coalition, and in the Executive. They favour government intervention to foster a specific model of economic development –mainly, import-substitution industrialization. But they understand some of the limits the state faces when trying to accomplish those objectives –especially budget restraints and the need to secure private sector cooperation with government plans. In the current administration they are responsible for microeconomic regulation (ministries of Communications, Mines & Energy, and Labour), social policy (ministries of Health, Education, and Social Security) and less significant macroeconomic affairs (Minister of Planning & Budget).

Centre and right-wing populists (parties and factions) make up the third and final group in the governing coalition. In Congress, this groups is made of old-fashioned caudillo-type political bosses who dominate important sections of their political parties [(4)]; emerging political leaders representing powerful religious factions [(5)]; and conservative party bosses [(6)]. The PL, a conservative-populist party with a strong stake among evangelical groups, joined Mr. Lula da Silva in the beginning of the electoral campaign and was granted the right to appoint Mr. Lula da Silva's running-mate, now vice-president Jose Alencar. It was also provided with the Minister of Transports. The other parties were among the last to enter the coalition – eg, PMDB and PP only assured their support for the administration later on June – and for that reason are the least represented in the highest echelon of the administration [(7)]. Nevertheless, they hold important positions in the structure of the federal government which grant them the access to key power resources. They have also been granted the freedom to be managed such resources in their traditionally clientelistic way.

In short, the fragmented nature of the political system forces all administrations to carry out extensive negotiations in Congress so that it can secure the votes needed to approve its most important projects. The all-embracing character of the Brazilian Constitution, on the other hand, creates the need for the governing coalition to be also encompassing as almost any governing agenda will depend on the passing of Constitutional Amendments which require 3/5 of each one of the two houses of Congress. In order to enlarge its support base, it is natural that the administration finds it necessary to share decision-making power with parties favouring different ideological perspectives. So the nature of the governing agenda will almost necessarily reflect an ideological compromise and may change through time in accordance with the changing circumstances of the political circumstances.

2. Macroeconomic Stability and Fiscal Reform

Macroeconomic stability depends on the administration's commitment to a set of macroeconomic policies that is perceived by economic agents as sustainable in the long run given key macro indicators such as the evolution of inflation, the exchange rate, the external balance, and the growth rate of the economy, among others. The long term sustainability of macroeconomic policies in Brazil will, to a great deal, be determined by this administration's ability to:

develop a credible long-term strategy to balance the government budget out;

reform the tax system in order to make it more efficient, transparent and fair;

cut current public spending levels and programmes so that a sustainable tax reduction plan can be accomplished in the near future;

increase the efficiency of the state so that a greater part of its existing resources is used to promote collective goals;

change government spending priorities in order to deal more efficiently with scarce funds and pressing needs.

The launch of a credible long term strategy to balance the government budget out is fundamental for a number of reasons, but especially because Brazil is one of the emerging economies with the largest public debt and annual deficits. Hence, the risk premium paid by the country's Treasure and private firms is much higher than those of countries in comparable levels of development. At times, confidence in the government is so weak that even international export credit lines are cut, as happened in 2002.

In order for Brazil to gain credibility in the international financial markets it needs to diminish the risk of the government defaulting on its internal and external debts. Part of the problem is to assure investors that the country will stick to a consistent macroeconomic path in terms of (i) future public revenue and spending levels, and (ii) its current account figures (inward less outward flows of foreign currencies). This latter point is also important to assure investors that private companies will also be able to honour their contracts in foreign currency since the government must provide private firms with foreign reserves.

In order to assure investors, foreign and domestic, that there is no risk of the government having to default on its debts, it is crucial to show that future spending levels will be consistent with the need to service the existing (and future) debt. In practice, that's why it is so important for the government to commit itself to fiscal discipline. In December 2002, the total debt/GDP ratio was 56%, while the annual deficit of the public sector hit 9% of GDP (8). In order to restore previous debt/GDP ratios, the coming PT administration decided to increase the level of the primary surplus (total revenues minus spending before the payment of interests on existing debt) from 3.91 to 4.25% of GDP. The ideal situation would be for Brazil to manage to generate nominal (in contrast to primary) budget surpluses so that the credibility of its government could be entirely restored. The question is, then, would that ideal path be politically feasible?

The easiest political strategy to reduce the government deficit has traditionally been to cut spending directed towards the disorganized sectors of Brazilian society. Nevertheless, a nominal budget surplus could not be achieved by simply cutting programmes that primarily benefit the weakest groups, given that they respond for just a small percentage of public expenditure. On the other hand, as the more organized sectors have already been able to build their entitlements into the legislation, especially in the Constitution, cutting their economic rights require building a very large support base in Congress, where those groups are strongly represented, and in the Judiciary.

Public servants –Congressmen and judges included– are by far the main beneficiaries of the current spending priorities of the Brazilian state. The federal government spends almost 50% of its revenues with the payroll –active and retired public servants–, a result of the 'last salary rule' (9). In 2002, the public sector workers pension regime caused an estimated deficit of approximately 3.5% of GDP. This scheme benefits less than one million people and is in sharp contrast with the private sector workers pension regime. Although this latter system, which is also a public scheme, serves around 18 million people, the annual deficit it generates is inferior to 1.5% of GDP. This is particularly because the system is based on a very strict ceiling for pension benefits (today, R$ 1,500 or US$ 500 a month).

Reforming the pension's regime is a central concern in the agenda of president Lula da Silva's administration. The Executive has already sent to Congress a Constitutional Amendment intended to fix the problem and was able to gather the support of the twenty-seven state governors –also interested in gaining political leverage to reform their own public sector workers pension's schemes. In Congress, though, the administration's support base in internally fractured in the issue of pension's reform –in the recent past, the PT voted against a similar proposal sent by the Cardoso administration and now at least 1/3 of its congressmen have already stated their disagreement with the initiative. The same has already taken place inside other political parties that share the government with the PT –PDT, PC do B, and PMDB are good examples. The more such discontentment grows inside the government's support base in Congress, the more the administration will have to rely on conservative parties that have advocated similar measures under Cardoso's and are now constrained to vote with the PT. This is particularly the cases of the PSDB and the PFL.

But the problems to balance the budget do not stop at reforming the pensions system. As the current tax level in Brazil is considerably above that of other emerging economies – more than 34% of GDP in Brazil and less than 20% in average for middle income countries. Consequently, if the administration wishes to improve the level of international competitiveness of the Brazilian economy it will have to consider at least two things. First, a substantial reduction in the level of taxation. Second, an increase in the quality of the tax system, more specifically, it needs to get rid of the 'cascade' structure (where a tax applies over the same product repeatedly while it moves forward in the production chain).

The focus of political resistance to the adoption of an innovative tax reform is inside the government. Short-term fiscal concerns have led the Finance Ministry to oppose any serious discussion on the subject. This is not expected to change much under the new administration, as already confirmed in the debates that led the Executive to send to Congress a very modest proposal for reforming the tax structure.

Another dimension of the importance of macroeconomic stability has to do with the intertemporal equilibrium of the current account. Investors tend to feel threatened by the inability of the government to follow macroeconomic policies that grant an adequate balance between the levels of inflow and outflow of foreign currencies –particularly, the exchange rate regime. Intertemporal balance of the current account is imperative to assure investors who bring in hard currencies to invest in Reais that, in the future, they will be free to withdraw hard currencies from the Central Bank at a reasonable exchange rate.

As far as the sustainability of the exchange rate regime depends on the level of supply and demand for imports and exports, it is totally dependent on the consistency of monetary and fiscal policies, on the one hand, and on the international competitiveness of the economy, on the other. One of the main advantages of the current macroeconomic strategy in Brazil is the combination of a floating exchange rate with an inflation-targeting regime. Together with fiscal responsibility and the maintenance of the current level of trade openness, it is possible that in the following years Brazil will be reasonably protected in the event of an external shock. That is no guarantee for major confidence crises, like the one that hit the country during last year's electoral campaign. But given the fact that the major apprehension of investors in 2002 was related to how a PT administration would manage the economy, and given that they already know that there are not major changes in that respect, it is possible to assume that economic fundamental will tend to be the lead indicator from now on. As far as they keep showing that the administration has seriously committed to the sustainability of macroeconomic policies, external shocks will tend to be minimized.

3. Microeconomic Regulation and Competitiveness

In the last decade, Brazil has evolved from a model of economic self-sufficiency to one that fosters interdependence with the global economy. In that process, government regulations have focused the correction of macroeconomic imbalances that threaten foreign investors, the opening up of the economy to foreign direct investment (mainly through deregulation and privatization of state enterprises), the liberalization of international trade, and the promotion of economic specialization and of integration of firms established in Brazil into global networks of production and finance. That is considered to be a risky strategy since interdependence implies that the national economy will be more susceptible to events happening abroad. On the other hand, given that the countries that have benefited the most from globalization are the ones that deliberately opted for integrating their national economies to the world, Brazil's option seemed right.

Since the electoral campaign, though, Mr. Lula da Silva advocated a nationalistic approach to economic policy making. That vision was not at all important when he appointed Mrs. Antonio Palocci and Henrique Meirelles to the most important economic positions in the government, the Finance Ministry and the Central Bank, respectively.

Together with the ministers of Agriculture and Development, Industry & Trade, they are pushing for the continuity of liberal economic policies in the new administration.

In contrast, the president has filled some key economic positions in his cabinet with politicians and technocrats that reject the idea that a more interdependent economic environment might be the best strategy to foster growth and development. In that respect, opponents of liberal policies are especially concentrated on agencies in charge of microeconomic policies and regulations –like the ministries of Mines & Energy, Communications, Agrarian Reform, and Science & Technology, as well as the National Bank for Economic and Social Development (BNDES) [(10)].

Microeconomic regulations and policies affect private investment decisions in a number of ways. Above all, they are important as they tend to distort relative prices of public goods and services supplied by private firms –like gas & electricity, telephone, road tolls, sewage and water, among others. As they change relative prices, their content and sustainability are central to the definition of private firms' investment plans.

Since its inauguration, the new administration has been sending mixed signals on its strategy for microeconomic policies and regulations. First, in the administration there are important advocates of an import-substitution strategy based on policies affecting trade protection, industrial structure and science & technology programmes. To the extent that those policies increase trade protection and the use of tax subsidies for domestic firms, they risk hurting the productivity of firms in other industries already established in Brazil which use imported inputs and/or technology.

The ideological decision to resume import-substitution industrialization is a third example of how microeconomic regulation might hurt future sustainable growth perspectives. Import-substituting industries tend to be located in uncompetitive sectors of the economy. This is so because in an open economy business will tend to be diverted into those activities that present the highest returns. Those are the ones that use more intensely factors of production that are abundant in the country/region (as their relative prices will tend to be particularly attractive) causing production costs to be lower –and returns higher– than elsewhere. When specialization takes place in a particular country, it will import most of the goods and services it demands with the revenues from exports. And specialization and interdependence are the best ways any country has to accumulate wealth.

An import-substitution strategy, on the other hand, implies that the state will make choices for the whole economy in terms of what must be produced domestically (instead of imported), and it does so out of some particular notion of the future evolution of the global economy. Economists are almost unanimously against import-substitution policies –especially when it is aimed at promoting the production of goods to the internal market– because it presents a high opportunity cost, ie, there are alternative ways of spending the money that result in higher benefits for the whole society. In the Brazilian case, the PT administration seems to be committed to promoting high-tech industries at any cost. If that option really gains momentum, it will imply the use of scarce resources (capital through subsidies) and of special regulatory frameworks (trade protection) in order to foster internal production at a higher price than available imports. The risk of such a strategy is already known to Brazil: the spreading to the whole economy of the inefficiencies of the substituted industry. In the longer term, import-substitution entails an anti-export bias, since the competitive sectors of the economy progressively loose efficiency as they are forced into buying inputs and technology produced in the country but for a higher price and lower quality than their imported counterparts.

A second, and more vital, area of concern on microeconomic regulations is the question of the so called 'regulatory agencies' –independent organizations created by the Cardoso administration to regulate infrastructure sectors, electric energy, oil & gas, public waters, and telecommunications, which had been recently privatized. For the last six years, such agencies have taken charge of policy formulation, rulemaking, adjudication and supervision of activities performed by state and private firms engaging in economic activities in their respective areas.

One of the most important issues raised by the PT administration regarding those agencies has been their high level of autonomy *vis-à-vis* the federal government. Up until now, the independence and even the technical competence of these regulatory bodies have been deeply criticized by the new incumbent elite whenever their decisions diverge from those that prevailed in the administration. Conflict over authority to set priorities and regulations as well as over adjudication has arisen in almost all four areas. Such disturbances have brought major instabilities to the institutional environment that applies to the interaction between private firms and the state in the infrastructure sector. They have also created an atmosphere of mutual suspicion which might reduce the confidence of private investors over the long-term sustainability of the regulatory framework under which they operate and invest.

A third grey area in microeconomic regulation is the agrarian reform agenda of the new government. The key issue is how lenient the administration will be regarding property rights violations conducted by the Landless Workers Movement-MST, a socialist organization that advocates popular (ie, anti-capitalist) 'cultural revolution'. The Ministry of Agrarian Development and, under it, the National Institute for Agrarian Reform (Incra), the two Executive bodies in charge of agrarian reform, have been assigned to PT politicians and grassroots leaders associated with MST. After the inauguration of the new administrations, public officials in such organizations have contested existing legislation that prohibits agrarian reform to take place on lands occupied by force. Higher echelons of the administration have since spoken in favour of the maintenance of legal restrictions in order to disincentive the MST to undertake more radical strategies under a PT government than it did under Cardoso's. In the midst of an unstable institutional environment, MST has started to invade and occupy productive lands –'large landed estates' (*latifundios*, as they are called in Portuguese)– which are responsible for the most competitive sector of the Brazilian economy.

Beyond the issue of fragile property rights and its impact on private investments in agriculture, a second concern in this area is the potential setbacks in the priorities for agricultural policy. It is widely known that the high international competitiveness of the Brazilian agribusiness has been fundamental for Brazil's external equilibrium. The policy strategy of the Ministry of Agriculture undoubtedly favours the deepening of the economic model inherited from the Cardoso administration. However, the intensification of Brazil's competitive advantage in agribusiness might be threatened by a combination of (1) an agrarian reform strategy aiming to increase the number of family-sized subsistence properties; (2) a development model whose priority seems to be on import-substitution rather than on export promotion (despite rhetorical pledges on the contrary), and **(3)** an ideological refusal to accept the extensive use of transgenic crops and to deepen biotechnology researches already under way at Embrapa, a public research agency devoted to agricultural and livestock.

In Brazil, microeconomic regulations are only indirectly affected by congressional politics. Most parties seem to understand that the administration is free to pursue whatever development path it chooses. In that regard, ideological considerations and intra-coalition struggle tend to restrict the available options and define which among them is preferred. However, two of the cited issues will tend to deserve Congress' attention: agrarian reform and regulatory agencies. The first is the area of strongest concern for around one third of the members of the lower house –politicians elected in rural areas or who are landowners. Regulatory agencies, on the other hand, attracts the attention of former president Cardoso's political party –the PSDB– who will tend to resist any proposal from the administration to change the institutional frameworks in order to restore to the ministries some of the authority transferred to the agencies in the past. Consequently, those two issues will tend to be dealt with much more zeal than the decision to pursue an import-substitution strategy.

4. Social Policy

Contrary to commonsense assumptions, the size of the social budget is not small (and has not been small for some time now), in Brazil. In 1998, social expenditures accounted for approximately 21% of GDP (or 64% of the total expenditures of the Brazilian government) [(11)]. The total amount spent yearly on health, education, and pensions is considered by eminent social policy experts to be more than enough to eliminate indigence and substantially reduce poverty within a few years.

The major problem associated with social policy in Brazil is not the amounts spent but rather the lack of focus, ie, whether the money is spend with those who really need it. As pointed out by many experts, to increase the effectiveness of social policies will necessarily involve:

(1) restructuring the social budget in order to increase social spending to the real poor;

(2) conditioning the concession of social policy benefits to some sort of human capital gain for the recipients; and,

(3) eliminating any mechanism that makes possible for political groups (parties, unions, associations) to profit from the distribution of social benefits.

Those ends tend to be seen as obvious priorities and, indeed, have been pursued with relative success by the social and economic policy strategies of the two Cardoso administrations. However, if we examine the issue through the lens of political economy we might see why and how Brazil has been delaying for so long the need to tackle its structural social problems.

First of all, we must consider that any major change in government programmes tends to have distributional consequences –ie, to create winners and losers. It can be reasonably assumed that, in trying to avoid major loses in their income and status, potential losers will resist policy and institutional changes even if they expect those changes to benefit people who really need the extra money. And they will have an incentive do so before the changes occur. On the other hand, potential winners are harder to organize and tend to have less influence over the political process. That results from them being weak in economic and political terms. Consequently, the political economy of social policy reform is not very favourable to structural reforms in general, and to those that target poverty alleviation, in particular.

In Brazil, industrialists, professionals and public sector workers are among the key beneficiaries of the traditional mode of state intervention in the economy. They are also among those that benefit most from the pattern of social spending by the government. One example can clarify why that is the case and how difficult it might be to change the system. Government expenditure in education is biased towards state universities and not to lower school levels. In such universities, students study for free, regardless of their social and economic origins. The only requirement is that they pass difficult entrance exams –what benefits those coming from private (paid for) high schools. Poor people only rarely finish school; when they do they seldom pass a state university's entrance exams; and when they pass them, it is likely to be for 'second-rate' careers. At the same time, a large part of the population is illiterate or under-schooled. So, the policy of favouring university over lower school levels is unquestionably a type of pro-rich social spending. But it is not only supported by those that use the system as a consumer –the students and their families– but also by all those that supply the good –professors and university workers– who avidly lobby for the continuity of free of charge state universities. Those groups are entrenched in the PT and have been able to avoid it from debating the major economic and social consequences of the current pattern of social spending.

Second, it must be taken into account that Latin America still has eager supporters of state intervention to foster rapid growth via the increase of fixed capital rather than human capital. Supporters of import-substitution policies advocate that the state should create incentives to increase the economy's productive potential in physical terms. They tend to ignore that such policies aggravate the concentration of wealth as the increase in production is achieved by subsidizing and protecting businesses at the cost of impoverishing consumers. When it comes to social policy options, supporters of an import-substitution strategy tend to favour universal (welfare-state type) social policies rather than policies targeted at the real poor. In contemporary Brazil, universal social policies –labour legislation, welfare benefits, social security, and the like– require the worker to hold a formal labour contact, something which is not met by more than half of the active labour force given the relatively high cost of formal hiring [(12)]. In that regard, they are not.

Resources to be used for social policy purposes tend to be particularly scarce, not only due to the underdeveloped nature of those countries but also as a result of the use of substantial amounts of money to finance business. Furthermore, the greater part of such resources tends to be appropriated by the politically strongest groups in each society. The real poor are targeted by the state mainly via compensatory policies which are likely to take the form of schemes for direct food distribution. That is an inadequate policy choice if compared with direct transfers of money to targeted groups for two reasons. First, because it reduces the freedom of beneficiaries to spend the money in the way that best serves their needs. Second, because benefits are not traded for some kind of human capital gain so that recipients can become less dependent on such programmes. Unfortunately, schemes for direct distribution of food have a strong political logic behind that makes them preferable to the superior alternatives: they can be politically manipulated, ie, exchanged for political support. In a way they tend to be functional to broaden the political base of regimes whose main programmes concentrate wealth and political power in the hands of the few.

The social policy options of the new PT administration are not yet clear. The only action taken in its first six months was the launching of the 'Zero Hunger' initiative –a programme of direct distribution of food donated by society and bought by the state to rural population. Up until now, the major directives of the programme have not been entirely defined. Although only a trial-version is being implemented in two small villages (one in the state of Piaui and one in Minas Gerais), problems associated with the political use of resources have already been detected. Unfortunately, given the public and political commitment of the President to the idea of food distribution the administration is expected to stick to this idea even in the face of sound accusations relative to its nature and administration.

Finally, it must be considered that egalitarian social policies tend to be effective only under stable macroeconomic environments. High inflation and large fluctuations of the exchange rate disincentive productive investment (which increase unemployment), favour the concentration of wealth and the erosion of the purchasing power of those who do not have access to financial intermediation mechanisms. As already discussed above, fiscal equilibrium is essential for macroeconomic stability and, hence, of the possibility for an effective social policy strategy. In this regard, the existence of large interest-groups inside the PT and in the new administration who favour an expansionist fiscal approach threat the feasibility of egalitarian social policies. Not surprisingly, public sector workers and left-wing economists who advocate import-substitution policies are some of the most vigorous supporters of such an option.

In short, despite its obvious importance, the adoption of egalitarian social policies in Brazil is constrained by its political economy. Politically powerful groups –who have benefited from the pattern of state intervention in the economy– resist policy changes that could benefit the real poor. Old-fashioned economic ideologies still powerful among left-wing political parties –now in power– still favour an economic strategy that promotes the concentration of wealth and hinders the achieving potential of poor individuals and families. Finally, macroeconomic instability discourages private investment, increasing the need for social policy, and paradoxically reduces the effectiveness of egalitarian social policies.

The road map for an efficient resolution of the political economy of social policy reform involves: turning down internal focuses of resistance to change, in order to be able to formulate an effective social reform agenda; establishing a support coalition to push for the reform, both in Congress and in the society at large –which depends on creating beneficiaries in the short-term and on phasing-out the costs of reform; and, more generally, on adopting a more updated model of state intervention in the economy.
The prospect for major changes in that perverse socio-political equation depends on the ability of the current administration to resist the pressure of vested-interests inside the PT and inside the government as well as to build a reform coalition in Congress. The administration may count with the votes of the opposition parties that have been advocating such policies in the recent past –facing the opposition of the PT. But the more the administration delays the launching of an egalitarian social policy agenda, compatible with macroeconomic stability (fiscal responsibility), and the more it sends disturbing signs to the private sector, the less effective it will tend to be when (if) proposed.

5. Conclusions

The purpose of this chapter was to discuss the key challenges faced by the Worker's Party administration in Brazil, in social and economic terms given the existing political constraints. The Brazilian political system is deeply fragmented and the administration is internally divided into groups advocating different development agendas. The trend of government intervention in the economy and society will be determined by the way political conflicts are handled inside the governing coalition.

In the six months since its inauguration, there are mixed signs pointing to a genuine understanding of the major macroeconomic constraints imposed by decades of economic mismanagement only partly corrected by the Cardoso administration. The decision to follow a strategy based on fiscal responsibility and liberal structural reforms are consistent to such understanding and has been supported by the President and his closest political support base. Unfortunately, given the level of internal conflict among left- and right-wing supporters of the government, as well as among influential interest groups –particularly public sector workers and industrialists– it is still unclear whether that path is politically sustainable in the long run.

Microeconomic regulations are also a point of concern for the future. The logic of import-substitution, somewhat present in the current administration, calls for a stronger role for the state in directing private investment to chosen industries through protection and subsidies. That might threaten private investors who had been induced to invest in infrastructure sectors via market-friendly regulations now being criticized. There still is a strong possibility that the logic of macroeconomic management also applies to the management of microeconomic issues, but that will also depend on the way intra-bureaucratic conflicts are settled.

Finally, social policy options favoured by the new administration are not concerned with the future incorporation of recipients to the market. The elimination of previous requirements for some sort of human capital gain in order to collect compensatory benefits provides poor incentives for human and economic development and risks being captured by political machines. Finally, political resistance to a better targeting in the use of the social budget may harm Brazil's development opportunities as the world economy requires countries to be more productivity, stable and integrated. In that respect, poverty and inequalities hamper economic development by limiting the availability of potentially productive workers and social stability.

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Notes:

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(3) The military dictatorship, which had begun in 1964, extended until March 1985. In that year, Tancredo Neves –a conservative politician and, at the time, governor of Minas Gerais, one of the largest Brazilian states– was chosen by an enlarged Congress to run the country for the next six years. PT, then a small party, decided not to vote for Mr. Neves as it did not want to legitimize the electoral mechanism that had served the authoritarian regime. Mr. Neves never took the Presidency as he fell sick the night before his inauguration and died the next month. Vice-president elected José Sarney –a former president of ARENA, the party that gave political support for the military presidents for almost two decades– took the job. During Sarney's presidency, an elected Congress wrote and promulgated a new Constitution, in a process that finished in 1988 after taking over two years. Under this new Constitution, Sarney's tenure in office was reduced from six to five years and that of all subsequent presidents was fixed in four years. Despite the pro-active role it had played throughout the constitutional debates, PT did not sign the new Constitution for it was considered to be very far from the interests represented by the party.

(4) First, as PR prevents major distortions between the numbers of votes a party receives and the number of seats it is allowed to hold in Congress it contributes to political fragmentation. Second, electoral and party legislations in Brazil provide additional grounds for fragmentation as they protect small parties. No matter how minute, every political party represented in Congress is granted a minimum of material resources to compete –eg, free radio and TV time twice a year to be used for propaganda. The legislation attributes the mandates to the individual (not the party), and imposes no restrictions or punishments on those that change parties between elections. That makes it advantageous for them to change parties depending on what they can get in return. Small parties are also allowed to run together (as a coalition) in order to pass minimum representation clauses. Those regulations help explain the high level of political fragmentation in Brazil.

(5) The four states where the PT rules are Amapá, Roraima, Acre, and Mato Grosso do Sul.

(6) Among those, the most important are: former president Jose Sarney (sen., PMDB), former president Collor's congressional leader Roberto Jefferson (rep., PTB), and Antonio Carlos Magalhaes (sen., PFL).

(7) Bishop Rodrigues (rep., PL) is an excellent example.

(8) Especially, Jose Carlos Martinez (rep., PTB), Renan Calheiros (sen., PMDB), Michel Temer (rep., PMDB), Valdemar C. Neto (rep., PL), Pedro Correa (rep., PP) and their parties.

(9) Such parties have been promised the right to indicate ministers of their own in the future, most probably after October.

(10) In the previous years, the annual deficit of the public sector was closer to 6% of GDP. The much higher figures shown in 2002 reflect the impact of the confidence crisis on the servicing of the internal debt. As confidence on the Brazilian government decreased, given the prospect of a PT victory in the October presidential elections, the proportion of the debt attached to the variation of the US dollar grew bigger. Consequently, the major devaluation of the Brazilian real that begun in May caused the government deficit to increased.

(11) The figures for states and municipalities is even more dramatic.

(12) BNDES is the major source of long term finance for development. Despite being hierarchically under the directives of the Ministry of Development, Industry & Foreign Trade, its new president was appointed by Mr. Lula da Silva himself, after hearing some PT economists that oppose economic interdependence. BNDES' budget are the largest available in Latin America for development matters – even bigger than that of the Inter-American Development Bank (IDB), a Washington-based regional institution created to finance development.

(13) José Márcio Camargo & Francisco H.G. Ferreira. (2000), 'The Poverty Reduction Strategy of the Government of Brazil: a rapid reappraisal'. Rio de Janeiro, Departamento de Economia, Pontifícia Universidade Católica (PUC), Texto para Discussão, # 417, pp. 17-18.

(14) Some experts suggest that the cost of formal hiring exceeds 100% of the wage paid to the worker.