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Structural Reforms in Brazil:

Progress and Unfinished Agenda

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Abstract[1]

This paper discusses Brazil's structural reforms since the 1990s and areas where work remains to be done. Reforms of the 1990s included the containment of inflation, the adoption of a comprehensive Fiscal Responsibility Law, a successful debt restructuring program for subnational governments, the reduction of trade barriers, a wave of privatizations, and the expansion of health and education programs. Reforms of the 2000s included strengthening welfare programs, rapidly increasing the minimum wage, and reforming the financial sector to increase access to credit among lower income groups. Political opposition and other factors, however, have prevented reforms in the tax and pension systems and in the labor market. Brazil's recent strong economic performance owes more to generally sound macroeconomic management, and to a favorable external environment, than to a comprehensive and sustained structural reform effort. Doubts remain about the country's ability to sustain high growth rates while keeping inflation low.

JEL classifications: E02, E61, E65

Keywords: Structural reform, Inflation, Social policy, Fiscal management, Brazil

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1. Introduction

After being labeled for decades "the country of the future," Brazil is finally enjoying a good "present." It emerged quickly and strongly from the 2008-09 crises, with the economy growing by some 7.5 percent in 2010; inflation, albeit above target, remains manageable and has started to decelerate. The traditionally tight external constraints seem to have all but disappeared: the current account deficit, at the equivalent of about 2 percent of GDP, is moderate; foreign direct investment (FDI) has soared in the last couple of years, more than covering the current account deficit; and international reserves are at an all-time high. The discovery of large deep-sea oil reserves holds the promise of turning this historically oil-importing country into a large net energy exporter. On the social front, poverty has been substantially reduced from the high levels of the early 1990s, and the distribution of income has improved significantly; a whole new lower-middle class is enjoying unprecedented access to consumer durables and credit. Access to basic education and health services is now nearly universal, and crime rates are falling. Not surprisingly, Brazil is an increasingly assertive and influential voice in international political and economic fora.

Against this background, a number of questions inevitably arise. How sustainable is the recent performance? Is the slowdown in output evident in the last few months just a temporary pause or the beginning of a new slower growth trend? Has Brazil really de-coupled from the advanced economies that have been its traditional partners? What are its main vulnerabilities in the current turbulent global environment? These are difficult questions, because many domestic and external factors are likely to play important roles in shaping Brazil's future performance. But, a comprehensive and critical look at the main factors (domestic macroeconomic, structural, and social policies and reforms; and the external environment) that contributed to the strong improvement in Brazil's performance over the last decade can help identify both the remaining vulnerabilities, and the actions that can be taken by the government to mitigate them, so as to maximize the chances of a continued "good future."

This paper will try to document that some of the roots of Brazil's recent strength go back into the past. Indeed, as concerns the structural reforms that are the main focus of the paper, most of the progress took place in the decade of the 1990s. During that period, following a number of unsuccessful stabilization attempts, the Real Plan of 1994 brought inflation down to low single digits. Later in the decade, the initial inflation anchor (a heavily managed exchange rate) was

replaced by a more sustainable inflation targeting framework for monetary policy, supported by sizable primary fiscal surpluses. The institutional framework for fiscal policy was also strengthened with the adoption of a comprehensive Fiscal Responsibility Law and a successful debt restructuring program for state and local governments.

As detailed in the subsequent sections of this paper, the decade of the 1990s also saw a significant liberalization of the economy, both on the external side through a reduction of initially high tariff and non-tariff trade barriers, and on the domestic side through a wave of privatizations and the introduction of independent regulatory agencies. Progress was also made in widening the coverage of the health and education programs. However, important structural weaknesses, especially in the tax and pension systems and in the labor market, remained largely unaddressed, reflecting strong political opposition by the economic agents (in particular sub-national governments, public employees and the unions) that would have been negatively affected by some of these reforms.

The decade of the 2000s was marked by a continued (for the most part) prudent stance in macroeconomic policies, but little further progress in structural reforms, except in the financial and social sectors. This reflected in part some reform fatigue, but also a different ideological orientation of the Labor Party government of President Lula, and the easing of external pressures for reform. Social policies focused on strengthening welfare programs and rapidly increasing the minimum wage, which, in conjunction with financial sector reforms that opened up access to credit to the lower income groups, facilitated strong growth in consumption.

At the same time, the external environment became increasingly favorable, with strong foreign demand, especially from China, boosting Brazilian exports of agricultural and mineral commodities; and ample liquidity and low interest rates in international markets leading to large capital inflows, reflected in an unprecedented accumulation of foreign exchange reserves. The government's trade and industrial policies supported the growing outward orientation of the economy. Thus, both domestic and external factors contributed to a substantial pick-up in GDP growth (only briefly interrupted by the global financial crisis of 2009), despite a lack of progress in important areas of structural reform.

In summary, Brazil has made significant progress in some areas of structural reform in the last two decades, but the agenda remains very much unfinished. The relatively strong performance of the economy in recent years owes more to generally sound macroeconomic

management, and to a favorable external environment, than to a comprehensive and sustained structural reform effort. Although the cushions (especially in terms of higher international reserves and reduced foreign debt) built up in recent years have certainly reduced Brazil's vulnerability to unfavorable external shocks, doubts remain about its capacity to sustain high growth rates over the longer run while keeping inflation low. In this sense, inadequate progress in structural reforms may well have had a significant opportunity cost for the country.

2. The Macroeconomic Context

2.1 The Stabilization Effort (1994-2002)

During the "lost decade" of the 1980s and through 1994, Brazil experienced an unenviable combination of near-stagnation in real income per capita, very high inflation (peaking in 1993 at an annual rate close to 2,500 percent) fed by pervasive indexation, and recurring balance of payments crises. The poverty rate hovered above 40 percent and the inequality (Gini) coefficient around 60 during most of that period (Table 1). A series of attempts at macroeconomic stabilization faltered because of poor design (heavy reliance on heterodox price controls) and/or weak implementation. Political instability also characterized most of the early years following the end of the military dictatorship in 1985.

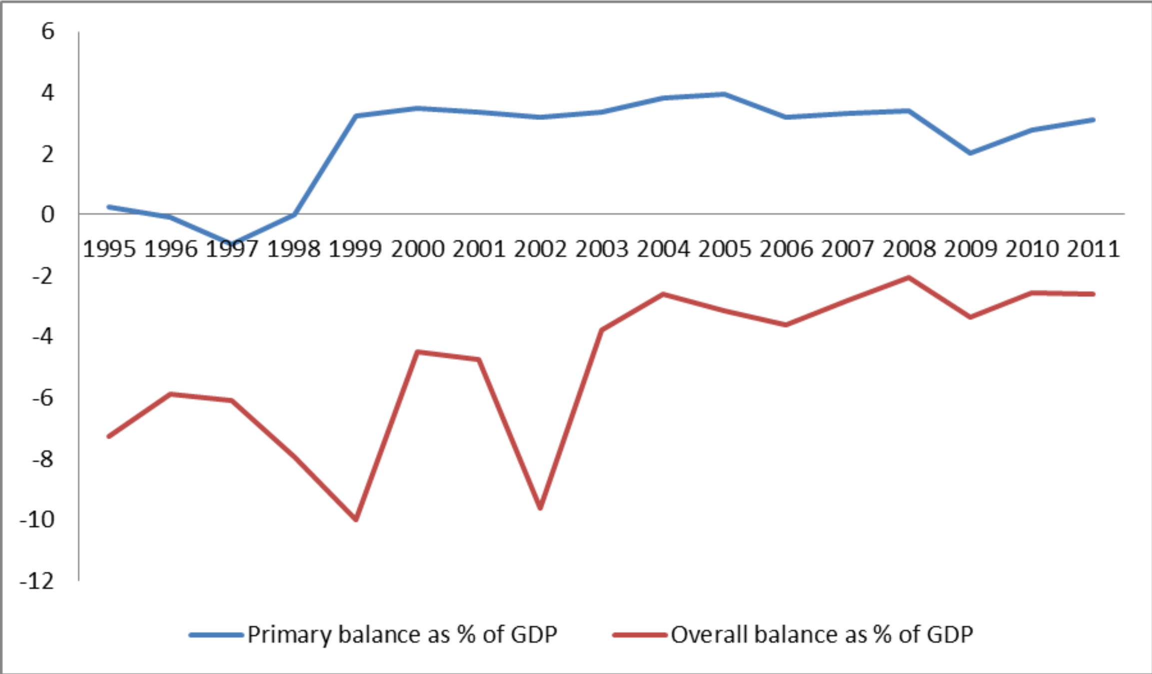
Table 1. Brazil: Main Economic and Social indicators
(in percent, unless otherwise indicated)

	1980-1989 average	1990-94 average	1995-98 average	1999-2002 average	2003-08 average	2009	2010	2011
Real GDP growth rate	1.9	1.3	2.5	2.1	4.2	-0.3	7.5	2.7
Real GDP per capita growth rate	0.9	-0.2	0.7	0.4	3.0	-2.0	6.0	n.a.
Consumer price inflation	431.7	1321.3	9.7	8.8	6.1	4.3	5.9	6.5
Unemployment rate	n.a.	7.0	8.1	10.1	9.4	9.1	6.7	6.0
Current account balance (as percent of GDP)	-2.0	0	-2.7	-3.5	0.6	-1.5	-2.2	-2.1
International reserves (e.o.p. ,US$ billions)	9.7	38.8	44.6	37.8	193.8	238.5	288.6	352.1
External debt (e.o.p. , as percent of GDP)	27.8	26.3	26.5	41.8	12.1	12.6	12.3	11.9
Poverty rate	41.2	42.3	34.8	34.9	29.0	22.6	21.4	n.a.
Gini coefficient	0.60	0.60	0.60	0.59	0.57	0.55	0.55	0.54

Source: Databases of the Central Bank (www.bcb.gov.br) and IPEA (www.ipea.gov.br))

The *Plano Real*, introduced in 1994 by the then Finance Minister, and shortly thereafter President, Fernando Henrique Cardoso ushered in the first successful stabilization. The Plan involved a currency reform, broad stabilization of the exchange rate, and a decisive de-indexation of the economy. In its wake, inflation decelerated rapidly, to single digits by 1996, and the economy resumed moderate growth, as domestic demand, especially of consumers, was boosted by the decline in inflation. The Plan failed, however, to support monetary stabilization with fiscal tightening. In fact, the public finances deteriorated significantly with the primary balance of the consolidated non-financial public sector (NFPS)[2] moving into deficit (Figure 1) and the net public debt climbing steeply (Figure 2).

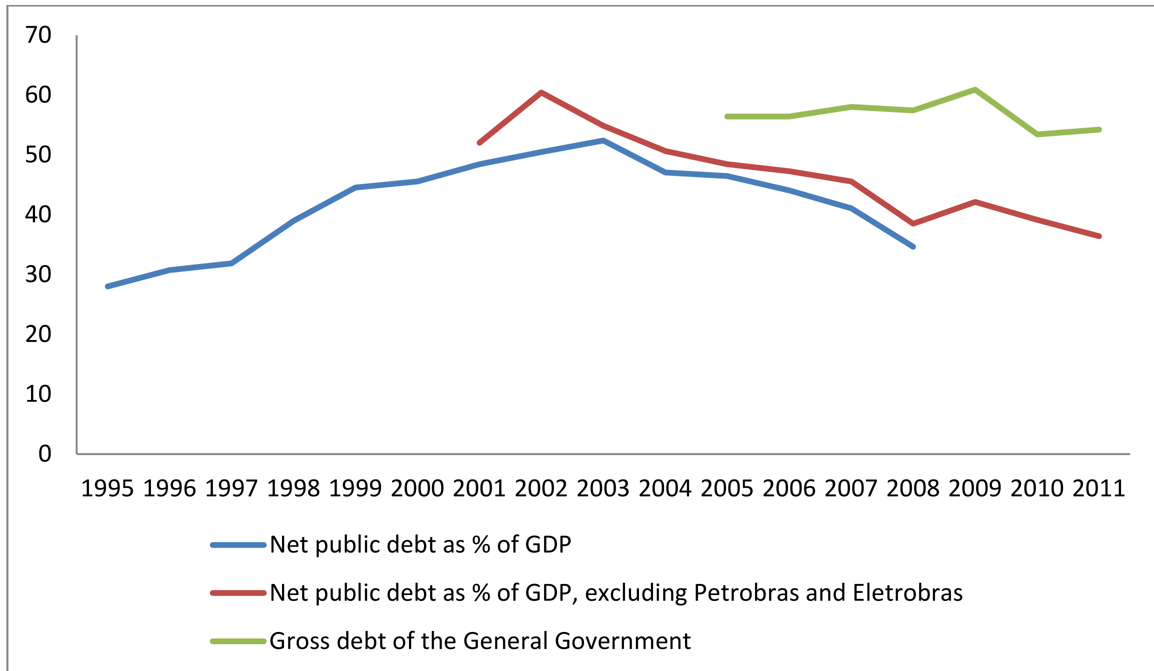
Figure 1. Primary and Overall Balances of the Consolidated Public Sector



Source: Banco Central do Brasil.

[2] The consolidated public sector is defined to include the central, state and local governments, their non-financial enterprises and the Central Bank. In recent years, the coverage of both public sector targets and data has been narrowed, to exclude two major federal enterprises in petroleum (*Petrobras*) and electricity (*Eletrobras*).

Figure 2. Gross and Net Public Debt



Source: Banco Central do Brasil.

The fiscal weakening contributed, along with an accommodating monetary policy and a significant real appreciation of the exchange rate, to the emergence of serious external imbalances that ultimately forced in early 1999 a strong adjustment program, supported by large external IMF and bilateral official financing. The program included: the floating of the *Real;* a substantial tightening of monetary policy and the adoption of inflation targeting; and a range of revenue-raising and public expenditure-containment measures that shifted the primary balance to a surplus of around 3 percent of GDP. Key ingredients of the fiscal adjustment were the adoption in 2000 of a comprehensive Fiscal Responsibility Law, and an effective tightening of controls on the indebtedness of state and local governments, whose finances had contributed importantly to the fiscal deterioration of the mid-1990s.[3]

The program was successful in avoiding both a decline in output and a sustained acceleration of inflation in the wake of the floating of the exchange rate; but inevitably, given the restrictive stance of macroeconomic policies, growth was anemic during the next few years (Table 1).

[3] See Mora and Giambiagi (2005) for a discussion of the comprehensive sub-national debt restructuring and adjustment program of 1996-97. This program was instrumental in ensuring the maintenance of primary surpluses at the state and local level throughout the subsequent years.

2.2 Reaping the Fruits of Adjustment (2003-2011)

Contrary to widespread market fears, macro-economic management remained for the most part prudent during the two successive administrations of President Lula (2003-2010). Monetary policy continued to successfully target relatively low inflation rates (see Section 3 below), and fiscal performance remained relatively strong until the onset of the global crisis. The primary surplus fluctuated narrowly in the 3-4 percent of GDP range, and the overall deficit declined substantially (Figure 1), reflecting a combination of strong revenue increases and a moderation of interest rates. The net public debt also declined steadily, from a peak of nearly 60 percent of GDP in 2002 to 38.5 percent of GDP in 2008 (Figure 2), and its structure improved as well.[4]

The ensuing improvement in Brazil's domestic and international credibility, the pursuit of social policies that boosted private consumption (see Section 4 below), and an increasingly favorable external environment (strong demand for Brazil's exports and large gains in the terms of trade) all contributed to a marked and sustained improvement in economic performance. During 2003-08, GDP growth averaged over 4 percent a year, inflation decelerated to under 5 percent, the current account balance swung into surplus, the external debt was sharply reduced, and international reserves soared. Both poverty and inequality indicators improved significantly (Table 1).

The global financial crisis of 2008-09 initially hit Brazil hard through a sudden stop in foreign capital inflows, a significant fall in commodity prices from their mid-2008 peaks, and a sharp downturn in external demand. GDP declined by over 6 percent between the third quarter of 2008 and the second quarter of 2009. The Brazilian authorities' response was rapid and multifaceted, including a number of measures to: ease credit conditions; reduce interest rates; support the exchange rate, partly with a view to moderating foreign exchange losses for exposed domestic firms; and provide substantial fiscal and quasi-fiscal stimulus. The fiscal impulse to demand was reinforced by increases in current and capital spending already in the pipeline. In addition to budgetary measures, the federal government provided support to demand through various quasi-fiscal operations (not reflected in the primary and overall balances and in the net debt[5]), in particular subsidized loans to public banks (the National Development Bank (BNDES)

[4] The portion of the debt denominated in foreign currency was virtually eliminated, and the average maturity of the debt increased significantly, reducing rollover risks.

[5] Treasury loans to public banks are recorded below the line in the fiscal accounts and do not impact the net debt because they involve simultaneous increases in the federal government's assets and liabilities. However, the

and the Housing Bank (*Caixa Economica Federal*)) equivalent to about 3.5 percent of GDP in 2009. This countercyclical fiscal response contrasted markedly with previous crisis episodes, when market pressures, financing constraints, and sustainability concerns had forced pro-cyclical fiscal policies.

The recession was short-lived. Reflecting both favorable external developments and the effects of the expansionary domestic policies mentioned above, GDP began to grow again in the second quarter of 2009, and accelerated strongly in 2010 to an unprecedented 7.5 percent. The recovery was driven by domestic demand and as a result, despite a significant gain in the terms of trade, the current account of the balance of payments shifted back into a deficit of over 2 percent of GDP. Inflation accelerated as well, peaking at 7.3 percent in September 2011. Despite increasing evidence of rising demand pressures, both monetary and fiscal policies remained accommodating in 2010 (a presidential election year). Policy interest rates were reduced, public expenditures rose sharply,[6] and quasi-fiscal operations continued on a substantial scale.

Monetary and fiscal policies began to be moderately tightened in early 2011, after the new administration of President Dilma Rousseff took office, contributing—along with a weakening of external demand, and a significant real appreciation of the exchange rate—to a pronounced deceleration of activity, especially in manufacturing, during the second half of the year. For 2011 as a whole, GDP growth slowed to just 2.7 percent. In response, monetary policy was eased again, through repeated cuts in policy interest rates and a reversal of some earlier credit restraint measures. In addition, the government announced an expansion of subsidized credit facilities, an increase and acceleration of public investment programs in both infrastructure and social housing, and selective tax cuts to support a range of sectors in manufacturing and tradable services. A further fiscal stimulus to demand is expected to be provided in 2012 by a large (14 percent) increase in the minimum wage, minimum pensions and other social assistance benefits indexed to it.

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substantial difference between the rate paid by the Treasury on its market borrowing and that received on those loans is reflected over time in an increase in net interest payments and therefore in the overall deficit of the federal government.

[6] Federal spending rose by over 22 percent (compared with an estimated growth of less than 15 percent in nominal GDP) in 2010, from an already high level in 2009.

3. Structural Fiscal and Financial Reforms

2.1 Strengthening the Institutional Framework for Macroeconomic Management

In the wake of the external crisis of 1998-99, the Brazilian authorities recognized that, given the country's long history of time-inconsistent macroeconomic policies, regaining market credibility and entrenching the gains from the adjustment effort would require a substantial strengthening of the institutional framework for macroeconomic policy making. The two most significant reforms undertaken towards this objective were the adoption in 1999 of an inflation targeting framework for monetary policy and the enactment in 2000 of a Fiscal Responsibility Law (FRL).

The inflation targeting framework aimed to provide an alternative to the exchange rate as an anchor for inflationary expectations, following the floating of the *Real*. It envisaged the setting of inflation targets (measured by the most comprehensive consumer price index, IPCA) for 12 and 24 months forward, with a tolerance band of 2 percent on either side of the targets. Responsibility for the choice of the targets was attributed to a Monetary Council presided over by the Minister of Finance and including the Minister of Planning (who in Brazil is responsible for the federal budget) and the President of the Central Bank (BCB). The BCB was provided full operational freedom and responsibility for the pursuit of the targets. In the process, it developed increasingly sophisticated analytical tools for modeling the channels and lags of transmission of monetary policy instruments to output and inflation; and it adopted transparent decision-making mechanisms, aimed to ensure adequate accountability for its actions (such as the publication of the minutes of the monthly meetings to set the benchmark overnight (SELIC) rate, and of quarterly inflation reports outlining the economic prospects ahead and the factors underlying its monetary policy decisions).

There is broad consensus among those who have analyzed the framework[7] that it has been quite successful in anchoring inflationary expectations, which not only decelerated fairly quickly in the aftermath of the sharp initial devaluation of the *Real*, but also withstood repeated supply shocks in subsequent years (such as the above-mentioned renewed strong pressures on the exchange rate in the run-up to the 2002 presidential elections, and the escalation of commodity

[7] See, e.g., Schwartsman (2004) and Mathias (2009) for fuller discussions of the features and performance of the inflation targeting framework.

prices in the first half of 2008). This represented a substantial achievement in a country that had a long history of periodic bouts of near hyper-inflation.

On the fiscal policy side, the enactment of the Fiscal Responsibility Law (FRL) in May 2000 also involved a true "regime change" by institutionalizing the government's commitment to fiscal sustainability. Although the law does not include a numerical fiscal balance rule, it requires the federal government to announce in the annual budget framework law rolling three-year targets for the primary balance of the consolidated NFPS, and to explain any revisions to previously specified targets for the year. The law also contains expenditure rules (ceilings on payroll expenditures as a ratio to revenues for each level of government) and debt rules for the state and local governments (SNGs). Importantly, the law also contains a prohibition of inter-governmental bailouts, and extensive transparency requirements. It requires governments at all levels to maintain and report standardized accounts of their operations; it also requires budget documents to include estimates of tax expenditures and of major fiscal risks and contingent liabilities. The law includes specific escape clauses and significant sanctions for non-compliance.

The Brazilian FRL compares favorably with most other countries' fiscal responsibility laws as regards comprehensiveness of coverage, accounting and transparency requirements, and enforcement mechanisms. It also has withstood repeated bouts of pressure, especially by SNGs, to ease its requirements. However, some weakening has taken place in recent years through the exclusion of important non-financial public enterprises from the balance targets. Also, some of the law's provisions (e.g., the specification of a ceiling for the federal debt, and the creation of an inter-governmental Council) have not been implemented yet (Ter-Minassian, 2010).

3.2 Tax Reform

For decades, tax policy in Brazil has been mainly shaped by revenue-increasing objectives, frequently at the expense of efficiency and equity considerations. It has also been importantly influenced by the design of intergovernmental transfers, in particular the fact that the main revenue-sharing arrangements with the states and municipalities apply only to certain categories of taxes. As a result of this provision, the federal government, under the pressure of the fiscal adjustment requirements, has frequently resorted to the creation or increase of distortive levies (cascading taxes on turnover and taxes on financial transactions), earmarked to financing social programs, because they were not subject to sharing with the SNGs.

For their part, the states that in Brazil control the most important form of indirect taxation—a mainly origin-based VAT—have substantially increased the rates of this tax on key production inputs (e.g. electricity and telecommunications); frequently have refused or delayed credits for interstate transactions; and have used the tax as an instrument of predatory competition to attract both domestic and foreign investment.[8]

Thus, while the tax ratio to GDP has risen steadily to a level (over 35 percent) significantly higher than those prevailing in comparable emerging markets, it has done so at a significant cost in terms of efficiency and competitiveness, with adverse effects on investment and export performance (FIESP, 2010). The strong reliance on indirect taxes has also exacted costs in terms of equity, as they tend to be regressive (Siqueira, Nogueira and Souza, 2010).

Attempts at fundamental tax reform, initiated either by the Executive or by the Congress, have abounded in recent years, but they have been largely unsuccessful. In particular, attempts at replacing the multiple distortive indirect taxes with a unified VAT, shared among the three government levels, or with a dual (federal and destination-based state) VAT (with a common base and limited rate-setting autonomy for the states, and complemented by a municipal retail sales tax) have floundered in the face of strong opposition by the sub-national governments.

More successful have been partial reforms that included: the modernization of the income tax; the introduction of zero-rating for exports under the state VAT in 1996; the reduction of cascading in the federal turnover taxes in 2002-03; and the abolition of the financial transactions tax in 2008. There have also been successful efforts to modernize tax administration at all levels of government, albeit more focused on strengthening enforcement than on reducing the high compliance costs for taxpayers.[9]

3.3 Pension Reform

The rapid growth of revenues permitted the maintenance of high real rates of growth of current spending, even during periods of fiscal adjustment. In contrast, public investment stagnated or was cut back during those periods, contributing to an increase in infrastructure gaps (see Section 4 below).

[8] A compact overview of the Brazilian tax system can be found in Afonso and Barroso (2008). See also OECD (2009), Dornelles and Afonso (2009), and Rezende (2010), for more comprehensive discussions of tax reform needs.
[9] According to the World Bank's "Doing Business" Index, Brazil ranks among the countries with the highest taxpayer compliance costs worldwide. Particularly damaging in this respect is the diversity of fiscal regimes and tax administration practices under the state VATs, which affects enterprises doing business in multiple states.

The relentless growth of current spending over the last couple of decades mainly reflected inadequate progress in needed structural expenditure reforms. Attempts at a reform of rigid employment regulations for civil servants, aimed at increasing flexibility and mobility in public administration, largely floundered in the face of the opposition by politically powerful civil service unions. Moreover, already-pervasive earmarking requirements for public spending were further increased.[10] And, while some progress was made in pension reform, it fell short of what would have been necessary to adequately strengthen the finances of the social security system.

The public pension system in Brazil includes two separate regimes for private and public employees. Expenditures of the former (with over 23 million beneficiaries) amount to over 7 percent of GDP; those of the latter (with about 3 million beneficiaries) to around 2 percent of GDP. Both are defined-benefit, pay-as-you-go systems, currently running primary deficits around 1 percent of GDP each, despite relatively high levels of social security contributions. There is also a growing network of private (open or closed) pension funds, operating mostly on a defined contribution basis, in which participation is voluntary. At around 9 percent of GDP, public spending on pensions is significantly higher than could be expected in a country at Brazil's level of development, and with a still relatively young (albeit rapidly aging[11]) population.

The system for private employees suffers from a number of significant weaknesses that are largely responsible for the relatively high (from an international perspective) level of its expenditure:

- The indexation of its minimum benefits (that currently account for nearly half of total benefits) to the minimum wage (which rose by 66 percent in real terms over the last 10 years);
- The absence of a minimum retirement age requirement after 35 years of contributory service;

[10] These provisions include the earmarking of federal contributions on payroll, turnover, and company profits to fund social security expenditures; a constitutional requirement to devote 25 percent of total primary spending to education; and a mandate (also constitutional) to increase health spending at least in line with nominal GDP.
[11] The share of the population aged 60 and above is projected to virtually double (to over 21 percent) over the next 20 years, and to exceed 36 percent by 2050 (Giambiagi and Tafner, 2011).

- A relatively low minimum retirement age for women (60 years, or less after 30 years of service); and
- Excessively generous survivor benefits.

The system for public employees is widely recognized to suffer from excessive generosity in both retirement age and determination of benefits.

Reform efforts in 1998 and 2003 included the introduction of a formula to link the level of benefits under the system for private employees to the recipients' contributive history and life expectancy, and measures to increase the pensionable age and reduce the generosity of benefits for new public employees.[12] These reforms moderated the growth of benefits under the regime for public employees, but had a limited impact on the expenditures of the one for private employees, which have been boosted strongly by the above-mentioned rapid growth of the minimum wage (Carvalho Pinheiro, 2004; Tafner and Giambiagi, editors, 2007; and Amaro, 2011).

Significant reforms were also enacted for the private pension funds, to increase the portability of benefits and lower costs of participation for small and medium enterprises. These steps are seen as having had positive effects on labor mobility, reduction of labor market informality, and the development of the Brazilian capital market.[13]

3.4 Financial Sector Reforms

Over the last 15 years or so, the financial sector in Brazil has undergone substantial changes that have significantly increased its soundness and resilience to shocks. Policies and structural reforms have played a key role in this evolution.

The high and volatile inflation of the 1980s and early 1990s constituted a major obstacle to the development of deep financial markets in Brazil. Domestic banks, sheltered from competition by restrictions on foreign banks' entry, concentrated their activities on short-term lending and purchases of Treasury bills at high real interest rates. The large public sector banks

[12] The 2003 reform also envisaged the introduction of a ceiling for the pension benefits of public employees. This was to occur simultaneously with the creation of a complementary mandatory defined-contribution regime for new civil servants. The latter reform has just been approved by Congress, and the former is still awaiting implementation.

[13] Dos Santos (2011) notes that in 2010 the resources of Brazilian pension funds were equivalent to 14.5 percent of GDP, and among the 10 highest worldwide in absolute terms.

(federal and some state-owned ones) were the sole providers of limited longer-term financing for investments.

The successful disinflation brought about by the *Plano Real*, while creating the necessary preconditions for an eventual development of more modern and sound financial markets, also deprived the banks of a source of easy profits and exposed underlying weaknesses in many of them. As a result, the mid-1990s saw a number of actual or threatened bank failures, which required decisive government intervention. This centered on two programs (McQuerry, 2011):

- A program for private banks (*PROER*), involving: i) liquidity provision for banks in difficulty but assessed to be ultimately solvent; ii) financial support for the acquisition of failing but salvageable banks by stronger ones, and for an orderly unwinding of clearly insolvent ones; iii) the creation of a deposit guarantee fund; and iv) a strengthening of the Central Bank's powers of supervision and bank resolution; and
- A program for state-owned banks (*PROES)*, many of which were in serious financial difficulties, having been used by the states to finance their own ballooning deficits and politically sensitive private sector projects. The *PROES* mainly focused on closing or privatizing these banks, with a view to hardening the budget constraint on the states, following the comprehensive restructuring of their debt mentioned above.

These programs entailed a substantial fiscal cost, estimated at several percentages points of GDP (Fishlow, 2011), but they set the foundations for a sounder development of the financial system in their wake. Other reforms also contributed importantly over the last decade or so:

- Liberalizing restrictions to entry by foreign banks;
- Further strengthening bank regulation and supervision by the Central Bank, ensuring compliance with high prudential requirements;
- Strengthening the regulation of non-bank financial intermediaries and of the stock exchanges;
- Modernizing the financing of housing; and
- Improving the legislation regulating the realization of collateral for non-performing loans and bankruptcy procedures.

These reforms undoubtedly contributed to a significant deepening of financial intermediation (without bubbles) during most of the past decade. The financial system proved very resilient to the shock of the global crisis of 2008-09. Nevertheless, the system remains dominated by relatively few large private and public banks; directed credits continue to play a large role, especially in the longer-term segment of the market; and borrowing costs for both the public and the private sector, especially small and medium enterprises remain quite high in real terms, pointing to the need for further reforms in this area.

4. Social Sector Reforms

4.1 Labor Market and Minimum Wage Policies

Historically, the Brazilian labor market has been characterized by relatively high rates of informality and self-employment (over 50 percent), labor force turnover, and unemployment (Table 1), especially for young people. A number of factors contribute to explaining these characteristics (Camargo, 2009):

- Very rigid labor legislation that leaves little scope for negotiations between the (relatively unrepresentative) unions[14] and employers, and limits differentiation of contract conditions across regions, sectors, and categories of workers. Compliance with the legislation is controlled by a special branch of the judiciary, which typically tends to side with workers in individual or collective disputes;
- A relatively high (close to 50 percent) burden of social contributions and other non-wage labor costs;
- The fact that informal workers have access to significant social benefits (a pension equivalent to the minimum wage at age 67; free health care; and social assistance transfers), which, while desirable on equity grounds, may reduce incentives to formalization, especially for low-skilled workers; and

[14] The unions are financed with a universal levy on formal workers, rather than member fees. This reduces their accountability to the membership.

- An unemployment insurance system which promotes high turnover,[15] thereby discouraging firms from investing in the training and professional development of their workforce.

Despite broad consensus among experts in the area on the need for reforms to address some of the abovementioned weaknesses, virtually no progress has been made to date because of opposition by the relevant interest groups, including the unions, the judiciary, and the political base of the ruling Labor Party.

Labor market conditions have improved significantly in recent years, despite the lack of progress in reforms, reflecting the acceleration in output growth. The unemployment rate fell steadily between 2005 and 2008 (despite a significant increase in the labor force over the same period), rose briefly in 2009, in the wake of the short-lived recession, but resumed a steady decline thereafter, to under 5 percent by the end of 2011. Moreover, estimated informality rates also fell significantly during the same period,[16] and average wages rose by over 3 percent a year in real terms. The minimum wage was adjusted significantly faster, contributing to the decline in poverty and income inequality.[17]

4.2 Reforms of Social Assistance Programs

Federal spending on social assistance programs has risen strongly in Brazil over last decade, more than doubling in relation to GDP, but at less than 1 percent of GDP it remains a small fraction of total social spending. It is widely recognized, however, to have played a significant role in reducing poverty and income inequality,[18] and to have contributed to the emergence of a lower-middle class largely responsible for the consumption boom of the last few years.

There is a variety of (still not always well coordinated) social assistance programs at all three levels of government, but successful efforts have been made to improve their targeting and

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[15] When leaving a job (regardless of cause), workers have the right to 140 percent of the funds accumulated in their individual severance pay account, built through own and employer contributions, as well as to unemployment insurance benefits.

[16] Formal employment (*empregos com carteira*) rose as a share of total employment by 8 percentage points (to 53.6 percent) between 2002 and 2011. Over the same period the share of the employed contributing to the social security system rose from 63 percent to 72 percent.

[17] In 2010 a law was adopted mandating annual adjustments of the minimum wage in line with the increase of the consumer price index (IPCA) during the previous year and of the real GDP of two years before. As indicated in Section 3 above, minimum pensions are also adjusted at the same rate as the minimum wage, a fact that has contributed significantly to the deficit of the social security system.

[18] Barros (2007) estimated about 20 percent of the decline in inequality to be due to the social assistance programs. Other authors have estimated even larger effects.

effectiveness. The two main programs are transfers (equivalent to the minimum wage) to indigent elderly and disabled adults, and conditional transfers to poor households with children under the age of 17 (*Bolsa Família*). The *Bolsa Família* program was created in 2004 to replace and enhance a number of previous social assistance programs. The federal government is responsible for its design and funding; municipalities administer it. Benefits under the program vary with the household's level of per capita income and number of children, and are conditional upon the latter's school attendance school and participation in basic preventive health care programs. It reaches over 13 million households, at a budgetary cost equivalent to around 0.4 percent of GDP.

Bolsa Família is recognized as an effective social policy instrument because it is means-tested (on the basis of local information consolidated in a national registry) and targets the age group (under 17 years of age) which shows the highest incidence of poverty. Proposals for its further reform advocate expanding the size of benefits to increase its effectiveness in reducing poverty, while at the same time tightening its conditionality (especially as regards school attendance) to increase its impact on human capital accumulation (Neri, 2009).

4.3 Health and Education Reforms

Over the last two decades, Brazil has undertaken wide-ranging and complex reforms in both health and education.

4.3.1 The Creation of the National Health System

In the health area, by affirming the universal right of citizens to public health services, the 1988 Constitution severed the prior link of the provision of these services with the Social Security system (since affiliation with the system would no longer be a requirement for such provision) and ushered in the creation of a National Health System (*Serviço Universal de Saúde,* or *SUS*). At the same time, the Constitution also specified a responsibility of sub-national (state and especially local) governments in the provision of health services. This created the challenge of promoting convergence towards reasonably uniform standard of health care provision across a national territory characterized by wide disparities in the fiscal and administrative capacities of the sub-national governments. The Constitution also recognized a role for private provision of health services, creating the further challenge of ensuring an articulation of the two systems that

would adequately safeguard public resources for attending to those unable to access private services.

These daunting challenges had to be addressed in an environment of tight budget constraints, and a changing epidemiological profile of the population that combined a still-high incidence of infectious diseases characteristic of low-income countries with a growing incidence of diseases more prevalent in industrial ones.

Reforms focused in particular on: i) defining the respective roles of the different levels of government in the provision of health services; ii) strengthening local capacities to attend to their respective responsibilities, especially the provision of preventive and basic curative family care; iii) ensuring a growing flow of federal and sub-national resources to the sector; and iv) strengthening the regulatory powers of the federal government in areas like drugs and medicines, and sanitary standards (Biasoto, 2004; Fishlow, 2011). The system that emerged can be briefly described as follows.

The federal government sets national guidelines and finances part of the health services, either directly or through transfers; the states and the largest municipalities are responsible for the more complex services; and the rest of the municipalities focus on prevention and basic care. The states are required to devote a minimum of 12 percent of their revenues to health spending, and the municipalities a minimum of 15 percent. A constitutional amendment approved in 2000 requires federal health spending to rise every year at least in line with GDP.

Federal transfers to the states and municipalities to finance health services have grown rapidly in recent years, to over 60 percent of total federal health spending, substantially outpacing direct payments to hospitals and private health providers, signaling a growing decentralization of health spending responsibilities. These transfers are partly mandatory and partly discretionary. The mandatory component includes different programs, with amounts determined on the basis of different criteria (size of population, nature of services financed, etc.). One of these programs is directed at compensating the sub-national entities that provide the most complex health services for the costs involved in treating patients residing outside those entities' jurisdictions. Discretionary transfers are negotiated on a case-by-case basis to support the provision of specific services in specific communities. Not surprisingly, these types of transfers are more subject to political influence.

Federal transfers account for over one third of total health financing on average, but with significant variance across regions, ranging from about 33 percent in the Southeast to over 45 percent in the poorer Northeast region. The system has had some success in reducing (but far from eliminating) differences in per capita health spending across regions over the last decade or so. It suffers, however, from a lack of clear linkage of resource transfers with indicators of both need and performance.

Brazil has made substantial strides forward in the provision of health care in the last two decades, as witnessed by strong improvements in life expectancy, child and maternal mortality rates and other indicators. Nonetheless, the public health system continues to be beset by the inherent tensions between the mandate of universal coverage, at no cost to beneficiaries, and the limitation of budgetary resources. This tension leads to rationing through queuing, especially significant for more complex medical treatments, and to shifting balance between private and public provision of health services. Ongoing difficulties can be expected to rise steadily over the medium term as the population ages and as demand for more advanced medical technologies increases.[19]

4.3.2 Education Reforms

Brazil's education system has traditionally been characterized by a number of important weaknesses that in turn have adversely affected both equity and productive efficiency. These weaknesses included, in particular:

- Wide divergences in education quality and achievements, both across regions (with the poorer states in the North and the Northeast lagging far behind the rest of the country) and across income groups;
- Comparatively high rates of class repetition and low rates of completion, especially among students from poorer families;[20]

[19] For detailed analyses of the challenges facing the Brazilian health system see Medici (2011) and Viegas Andrade and Noronha.

[20] For instance, the proportions of 19-year-olds completing secondary education in the mid-1990s was below 40 percent among those from the richest 25 percent of families and less than 5 percent among those from the poorest 25 percent.

- A disproportionate share of public resources being spent on university education, to which mostly students from higher income families had effective access;[21] and
- Lack of secondary technical/vocational training.

Reform efforts since the mid-1990s have focused on: broadening the coverage of primary education, which is now virtually complete; reducing regional disparities in resources spent on basic (primary and secondary) education; and improving the quality of teaching by broadening the coverage of standardized achievement tests.

The key step in the reform effort was the creation of a fund (FUNDEF) to which all states and municipalities were required to contribute 15 percent of own and shared revenues, and the federal government contributed resources needed to ensure minimum levels of expenditures per student across the national territory. This fund was replaced in 2007 by an expanded one (FUNDEB), created by a Constitutional Amendment that increased to 20 percent the share of state and municipal revenues earmarked for basic education, as well as the resources contributed by the federal government to the fund.

Resources devoted to basic education have risen significantly since the creation of the FUNDEB. The fact that both the federal and the state and municipal contributions to the fund are linked to revenues, however, makes, however, the fund's resources quite sensitive to cyclical fluctuations. The fund has been instrumental in reducing (but not eliminating) regional differences in public spending on basic education, and in indicators of educational achievements (net enrollment and completion rates). With a view to increasing its effectiveness in promoting quality improvements, a portion of its resources is now reserved to reward schools that record improvements in performance of their students, as measured by a standardized index.

Despite these important achievements, significant challenges remain: improving the quality of basic education; further reducing the still relatively high rates of class repetition, drop-out, and functional illiteracy; increasing the role of technical and vocational education, with a view to improving workforce skills; and raising enrollment in higher education, while containing its cost.

[21] Public spending per pupil in universities was nearly 20 times that in primary schools. At the same time, enrollment in university education (at around 12 percent) was among the lowest among emerging market countries (e.g., less than half than in neighboring Argentina).

5. Microeconomic Reforms

5.1 Privatization and Regulatory Reforms

Brazil emerged from the military dictatorship period with a large public sector, involved not only in such traditional sectors as energy, transportation and communications, but also mining and manufacturing activities such as steel, petrochemicals, fertilizers, and aircraft production. Initial attempts at privatization, mainly motivated by revenue-raising objectives, remained small and hesitant until the early 1990s, when President Collor made privatization an important component of his liberalization agenda. A wide-ranging program of sales of government stakes in 64 enterprises was approved by the Congress in 1990; and between 1990 and 1994, a number of large wholly or partly owned public enterprises, especially in the steel, petrochemical and aircraft sectors, were sold. Proceeds from the sales were relatively small (under US$12 billion), and a significant part was paid through the use of public debt instruments at well below face value. More than 95 percent of the proceeds came from national investors, including employees of the privatized enterprises, who had been given the right to acquire up to 10 percent of the shares at reduced prices in a bid by the government to soften unions' opposition to the sales. The National Development Bank (BNDES) played a key role in the process, through both equity participation and financing of other investors.

The privatization program accelerated markedly under the first Cardoso administration, and it was broadened to include enterprises and banks owned by the states, as part of a debt restructuring program for the latter (Mora and Giambiagi, 2005). Between 1995 and 1998, sales of federal and state enterprises yielded more than the equivalent of US$73 billion, of which over 80 percent was in cash and the rest in the form of debt transfers. In all, 52 federal and 28 state enterprises, including very large ones in the mining, electrical, and telecommunication sectors were privatized. In contrast to the first wave, foreign investors played a significant role in some of these sales, in particular that of the telecommunication giant *Telebras*. The proceeds of the sales were used to reduce the public debt.

Analyses of the impact of the privatization program (e.g., Pinheiro, 2000, and Fishlow, 2011) generally agree that it was beneficial not only to public finances, but also to productivity and longer-term economic performance. Some of the privatized enterprises have thrived under private management, becoming important international players in their respective fields (see Section 6 below). The success of the privatization program is also suggested by the fact that the

subsequent government of President Lula, whose party had strenuously opposed the program while in opposition, did not reverse it upon taking office.

The privatization of all or parts of sectors like telecommunications, electricity and oil and gas required the establishment of sound and transparent regulatory frameworks for the sectors, as well as a strengthening of anti-trust legislation and enforcement. This led to the creation in the latter part of the 1990s of a number of federal regulatory agencies, most notably in telecommunications, electricity, oil, gas and biofuels, and transport sectors as well as of municipal regulators for the sanitation sector in 2007.

These agencies were provided statutory independence and stable sources of financing. Their modus operandi differs, especially as regards price determination, reflecting the nature of the sector and the remaining degree of government presence in it (still substantial in electricity generation and transmission and in all aspects of the oil and gas sector). The electricity and telecommunication agencies set the prices to consumers in their respective sectors, while the retail prices of oil products are determined in the market, in which the national oil company Petrobras is a dominant player. The agencies' oversight roles have been somewhat reduced, however, in recent years, reflecting the government's increasing intervention in these sectors (see below).

Anti-trust legislation was strengthened in the mid-1990s, and the relevant authorities have had some successes in high-profile cases of mergers and acquisitions and price abuses (e.g., in the steel sector), but they continue to be affected by fragmentation of responsibilities, partial overlap with the regulatory agencies, resource constraints, and limited support by the judiciary (Salgado, 2004).

5.2 Infrastructure and Industrial Policies

Although the Lula government, contrary to market expectations (and fears), did not roll back the liberalization-oriented reforms of its predecessor, it halted the privatization process and progressively reinforced the role of the public sector in the economy in a number of areas, particularly infrastructure, energy and external trade. This trend appears to be continuing, and possibly intensifying, under the current government of President Rousseff. The remaining large financial and non-financial federal enterprises are playing a key role in this process.

There is little doubt that Brazil suffers from substantial shortages of infrastructures in areas such as railways, highways, port, and airport facilities that represent a constraint on the exploitation of its production and export potential, especially in agriculture and mining. A number of studies (including by Multilateral Development Banks) have documented the impact of such bottlenecks on the competitiveness of Brazilian firms. Substantial infrastructure deficits are also evident in social areas, especially water and sanitation, prisons and low-cost housing.

The Lula government, faced with strong fiscal constraints in its early years, initially placed great hopes in the development of public-private partnerships (PPPs),[22] for which it adopted a well-crafted legal framework, including appropriate features to limit risks to the budget.[23] However, and possibly in part as a result of such cautions, PPPs, especially at the federal level, have been slow to take off. In the meantime, as the strong growth of revenues eased budget constraints, the government's focus shifted to ramping up direct public investment in infrastructure. As a first step, it excluded federal investments meeting certain process requirements (cost benefit analysis, close monitoring and evaluation, etc.) from the budget deficit targets. Also excluded from the targets were investments by Petrobras.

In 2007, in the context of a comprehensive plan to boost growth, a substantial (equivalent to over US$ 230 billion) public works program in both productive and social infrastructure areas was announced. Implementation of that program remained slow, however, with only about 60 percent of its resources having been spent by the end of 2009. It was replaced in 2010 by a larger, more ambitious, program (the so-called *PAC II*) covering four years and involving a trebling of the overall resource envelope. The sectors expected to receive the bulk of these resources are energy, especially oil and gas exploration, transport (development of the railroad network, and upgrading of the road network, the vast majority of which is still unpaved), and social housing (the program *Minha Casa, Minha Vida*). A comprehensive discussion of the *PAC II,* and of actions that should be taken to increase the effectiveness of its implementation can be found in OECD (2011).

[22] Brazil has a long tradition of use of concessions for roads and other infrastructure. Concessions are granted when the project is expected to receive no financial support from the government (i.e., when the latter bears no financial risk). In contrast, PPPs are characterized by a sharing of risks between the private partner and the government.

[23] The 2004 law on PPPs mandates the Treasury to assess the financial risks involved in PPP contracts and to ensure the observance of specified limits on the ratio of future budgetary payments for PPPs to revenues. BNDES is tasked with advising the government on structuring PPP projects during the development stage of the projects (OECD, 2011).

There is broad consensus in the relevant literature that public investment selection, monitoring of implementation, and evaluation procedures need to be further strengthened in Brazil, both at the federal and the sub-national levels. Political patronage still plays a significant role in the selection of projects; cost-benefit analyses are frequently inadequate; approval processes are often mired in bureaucratic red tape and in environmental and judicial disputes; cost overruns and delays in implementation are endemic; and value-for-money-based ex post evaluations are virtually nonexistent. Effective actions to mitigate these weaknesses will be crucial to the success of the government's efforts to ease major infrastructure bottlenecks, especially ahead of the upcoming World Cup and Olympic games.

As regards industrial policy, both the Lula and Rousseff administrations have placed renewed emphasis on it, but the focus has shifted during the period. An initial program, launched in 2004, emphasized public support, particularly through trade policy and directed credit, to specific industrial sectors considered of key importance for the economy, namely capital goods, electronic components, software and pharmaceuticals.

This changed in subsequent years, as the escalating foreign demand for commodities, propelled industries based on natural resources (agriculture, mining and energy) to the forefront. A new "Productive Development Policy," announced in 2008, emphasized support to these industries, not only through the provision of low-cost access to investment and export financing, but also through the promotion of investment in R&D and innovation, with a view to boosting their productivity and positioning them at the frontier of the relevant technologies.

The Rousseff government's latest industrial policy program (*Plano Brasil Maior*), announced in July 2011 and expanded in early 2012, appears to be an attempt to balance the two approaches, and it is heavily influenced by the objective of mitigating the strong deterioration in the competitiveness of Brazilian manufacturing in the preceding two years or so. The program includes: a number of fiscal benefits for selected sectors (both capital goods and traditional consumer goods); increased use of defensive trade measures (anti-dumping and safeguard clauses, and national origin requirements in government procurement); and a strengthening of credit lines by BNDES.

The role of the latter, traditionally important in Brazil's infrastructure and industrial policies, has gained much additional momentum in recent years. BNDES, which obtains a substantial portion of its funding from a captive source (the unemployment insurance fund, FAT)

at well below market rates, has traditionally been the main source of low-cost, long-term financing for private investment and selected other activities (e.g., exports, the rural sector, and small and medium enterprises). As mentioned in Section 2 above, it was used by the government in 2009-10 as a major instrument of quasi-fiscal stimulus. It is now increasingly involved in the financing of the massive Petrobras investment program (see the next subsection below). Although the bank is widely recognized to be well-staffed and managed, questions are frequently raised about political influences on its decisions; the fiscal and efficiency costs of the large interest rate subsidies it provides to selected sectors and activities; potential contingent liabilities for the budget stemming from its activities; and its longer-term funding prospects, as the share of resources received from the FAT is on a declining trend (Giambiagi et al., 2009; Teixeira Torres, Pimentel Puga and Barbosa Meirelles, editors, 2010; and IPEA, 2011).

5.3 Energy Policies and Reforms

In the energy (fuel and electricity) sector, the decade of the 1990s was marked by liberalization trends. The long-standing and constitutionally sanctioned monopoly of Petrobras was dismantled by a constitutional amendment in 1995 that, while maintaining the requirement of federal control of the company, allowed the privatization of the excess government share, the undertaking of joint ventures between Petrobras and private companies, and the entrance of other domestic and foreign firms into petroleum exploration, production, importation, refining and distribution.

As mentioned above, this was accompanied by the setting up of a regulatory agency and a progressive liberalization of ex-refinery and pump prices for oil products. By 2002, pump prices were fully liberalized and a new excise tax on them put in place. Between 1999 and 2002, four successive waves of auctions for exploration of new oil fields were conducted, with Petrobras participation (sole or in partnership with other firms) averaging about 40 percent. Petrobras maintained, however, a de facto near monopoly of oil refining and transportation activities, and a dominant presence in the retail distribution market.

There is broad consensus in the relevant literature that the liberalization measures contributed (along with the favorable external developments discussed below) to a substantial strengthening of *Petrobras*' governance, productivity and financial performance in recent years. The company has recorded large and growing profits, expanded its activities to the gas and

biofuel businesses, and substantially ratcheted up its international operations and investment (Ubiraci and Narciso, 2009).

In the electricity sector, privatization affected parts of the generation sector and the distribution sector. The *Eletrobras* group (another large federal enterprise) maintained the dominant role in generation and a monopoly of transmission. The definition of an inherently very complex regulatory framework proved quite lengthy and difficult, and the regulatory uncertainty affected negatively private entry and investment in the sector. With public investment also severely constrained by budget imperatives, and adverse climatic conditions seriously impacting hydrological sources (which in Brazil account for a large share of electricity production), an energy crisis materialized in 2001. The government reacted decisively, initially with a rationing scheme, but also with price adjustments, and by speeding up public investment in the sector. The resulting supply and demand adjustments rapidly reestablished balance in the sector. A new regulatory regime was put in place at the end of 2003 (Ferreira, 2009).

As in the industrial sector, government involvement in the energy (especially oil) sector increased again during the decade of the 2000s. This reflected in part the ideological orientation of the Lula administration, but also the discovery of major new oil fields (*pre-sal*) that, because of their location miles under the seabed, would require an unprecedented technological and financial investment effort in their exploitation (Gabrielli, 2009; and Gall, 2010).[24]

The discovery of the *pre-sal* has prompted a revamping of the regime for oil exploration, with a shift from concession to production sharing arrangements (PSA) for the new fields. In addition, Petrobras has been granted sole or joint (with a minimum 30 percent participation) bidding rights for the *pre-sal* fields.

The PSA regime is expected to increase significantly the federal government's take of petroleum resources, compared with the current concessions regime. Specifically, under the current regime, concessionary oil companies pay various types of rents: i) a signature bonus, which goes entirely to the federal government; ii) area fees, which are related to the size of the oil field being explored, and go the National Petroleum Agency (ANP), a federal institution; iii) royalties levied on a monthly basis as a share of production at a basic rate of 5 percent, or at a higher rate (of up to 10 percent), depending on characteristics of the field; and finally iv) a

[24] In his paper, Gabrielli (the current president of Petrobras) estimates the investment requirements for *pre-sal* exploration at over US$ 110 billion over the period up to 2020. The total investment program of Petrobras for 2011-15, including investments in other oil, gas, and biofuel related activities, is on the order of US$ 175 billion.

special rent levied on the more productive and profitable fields. Both the royalties and the special rent are shared among the three levels of government.

Under the PSA, the federal government will receive, in addition to signature bonuses and its share of royalties, the entire value of the oil obtained from a field, after deduction of exploration and production costs and of the profit margin stipulated in the leasing arrangement to go to the enterprise granted the exploration of the field. In the new system, royalties will continue to exist, but the special rent will disappear. The resulting prospective decline in the share of revenues going to some of the states and municipalities, especially Rio de Janeiro, is eliciting strong resistance from the affected governments.

6. Trade Liberalization and Integration into the Global Economy

Reflecting its continental size and long-entrenched historical traditions, Brazil's model of development was oriented for many decades towards the development of the domestic productive capacity and market, privileging import substitution over export orientation through resorting to high degrees of tariff and non-tariff protection. As a result, the shares of imports and exports in GDP remained very low (generally under 10 percent each).

The late 1980s and especially the early 1990s saw a significant opening up of the economy to foreign trade through unilateral reductions in tariffs[25] and in conjunction with the successful conclusion of trade negotiations, both multilateral (the Uruguay Round) and regional (the creation of the customs union among Argentina, Brazil, Paraguay and Uruguay, known as *Mercosul*, in 1995). To be sure, the extent of reduction in effective protection varied significantly across sectors, with some consumer goods (e.g., apparel) and most capital goods industries remaining relatively more protected.

The reduction in trade barriers contributed to a steady increase in the ratio of total trade (measured at constant international prices) to GDP from the beginning of the decade through 1998 (Mesquita Moreira, 2004). Some studies (e.g., Muendler, 2001 and López-Córdova and Moreira, 2003) have found evidence of positive effects of the trade integration (via increased competition in both the domestic and external markets) on the growth of total factor productivity (TFP), which accelerated significantly during the second half of the 1990s. Moreover, other

[25] The nominal average tariff was reduced in steps from a peak of 55 percent in 1987 to 27 percent by 1990, and to around 10 percent by 1994; the average effective tariff declined from 68 percent to around 12 percent over the same period; and a wide range of non-tariff barriers were eliminated in the early 1990s.

studies have documented a reduction in the price of capital goods that benefited investments, especially in manufacturing, during that period.

The momentum in import liberalization slowed substantially, however, during the second half of the 1990s and the early 2000s, reflecting a number of factors: a flagging multilateral trade liberalization agenda (Motta Veiga, 2004 and 2009); various bouts of foreign exchange crises in emerging markets, including in Brazil's *Mercosul* partners (Fishlow, 2011); and the deterioration of Brazil's own competitiveness that eventually necessitated the floating of the *Real* in early 1999. Although the tariff reductions were (for the most part) not reversed, Brazil intensified its use of anti-dumping procedures, often to protect monopolistic domestic producers. The focus of trade policy shifted to export promotion through a number of institutional initiatives, such as the creation of an inter-ministerial committee to coordinate export policies, and of an agency in charge of export-promotion; the provision of tax reliefs; and a strengthening of export financing facilities.

The Lula government, while eschewing a (feared by markets) intensification of tariff protection, effectively ruled out further import liberalization, unless as a part of an (increasingly elusive) agreement under the Doha round. It also adopted an essentially defensive strategy in regional trade negotiations under the US-sponsored Free Trade Area of the Americas (FTAA) initiative and with the EU. Despite high-level political declarations to the contrary, negotiations for further integration within *Mercosul* were also stalled by the intransigence of all parties.

As a result, according to UNCTAD data, Brazil remains among the countries with the highest median nominal tariff. Moreover, the variance of nominal, and even more effective, tariffs remains high, with protection concentrated in particular on automotive vehicles, alcohol, apparel and footwear. Furthermore, pressures to increase tariff and nontariff barriers have intensified in the recent past, as the strong rise in labor costs, appreciation of the *Real,* and rising penetration of imports from China and other East Asian countries are putting increasing pressures on Brazil's manufacturing industry.

A further trend increasingly evident over the last decade has been the geographical re-direction of Brazilian trade from its traditional US and EU partners towards other emerging markets, especially China. The latter surpassed the United States as the main export destination for Brazil in 2009. In 2011, it accounted for about 18 percent of Brazil's exports, compared with 2 percent only 10 years earlier. This was partly a reflection of an active policy of political and

trade engagement with these countries by the Lula government (South-South dialogue), but mostly resulted from the growing demand by these countries for, and rising prices of, the agricultural and mineral commodities in which Brazil abounds.

An increasingly outward orientation of Brazilian enterprises in both trade and investment also contributed to this shift, and more generally to strong export performance. This was particularly evident in the agro-business area (where Brazil ranks among the top exporters worldwide[26]), but also in minerals, some manufacturing, construction and engineering services, and, as mentioned in the preceding section, energy sectors.

Export penetration abroad was facilitated in many sectors by rising outward investment (both greenfield and acquisition of existing companies). Large national firms like Petrobras, Embraer (aircrafts), Vale and EBX (mining), Gerdau (steel), Votorantim (cement, pulp and paper, and other commodities), JBS (meat), Odebrecht (construction) and Pão de Açúcar (retail) have vastly expanded their foreign operations and investments in recent years (Schneider, 2009).

Most of these enterprises are in sectors involved in the exploitation of natural (mineral or agricultural) resources or in selected services. With the notable exception of Embraer, the internationalization of manufacturing enterprises has been modest. This reflects a number of factors: the size of the internal market; the strong growth of domestic demand since 2003; the loss of competitiveness in recent years; still relatively high degrees of protection of traditional industries; and the fact that in general Brazilian manufacturing lags behind East Asian competitors in terms of technology and innovation.

Brazilian outward FDI rose strongly from 2004 on, averaging over US$ 10 billion a year, more than ten times the average of the previous decade. Inward FDI averaged about US$34 billion a year during the same period, with a strongly rising trend, only briefly interrupted by the 2008-09 global crisis, approaching US$67 billion by 2011.

[26] Brazil is the world's largest exporter of sugar/ethanol, orange juice, chicken, beef, coffee and tobacco, and second-largest exporter of soybeans.

7. Conclusions and a Look Ahead

The necessarily summary review in the sections above of Brazil's record with structural macro, micro and social reforms points to very significant progress over the last two decades. In brief:

- The institutional framework for macroeconomic management was much strengthened by: the enactment of a comprehensive Fiscal Responsibility Law; a restructuring of state and local debt and the imposition of a hard budget constraint on the sub-national governments; the adoption and successful implementation of an inflation-targeting framework for monetary policy, and of a floating exchange rate regime; and financial sector reforms that eliminated the weaker links in the system, modernized the regulatory framework, and improved supervision.
- Significant progress was made during the 1990s in liberalizing an economy historically characterized by a large presence of the public sector in key industrial and services sectors, and by a high degree of tariff and non-tariff protection. Especially important in this area were sizable privatizations, the setting up of autonomous regulatory agencies, trade liberalization, and efforts to promote export orientation.
- On the social front, the decade of the 1990s saw important reforms in the health and education sectors, and first steps in the reform of a pension system that is in many respects inequitable, excessively generous and financially unsustainable over the longer term. In the subsequent decade, greater emphasis was placed by President Lula's government on reducing very high income inequality through rapid increases of the minimum wage and minimum pensions, and a substantial expansion of social assistance programs.

On the other hand, progress has been non-linear (with pauses, stops and even some reversals), and in some areas the reform agenda remains very much unfinished. In particular:

- Little progress has been made in tax reform. Although so far very productive in terms of revenues (with the tax to GDP ratio, at around 36 percent, well above emerging markets' and Latin American averages), Brazil's tax system

continues to be beset by high taxpayer compliance costs and distortions that adversely affect efficiency, competitiveness, and horizontal and vertical equity.

- The pension reform remains incomplete, and major weaknesses are still present in the system, threatening its longer-term sustainability. Also, the burden of social security contributions on labor remains relatively high, undermining competitiveness and contributing to labor informality, although the selective cuts recently announced by the government will alleviate this burden for some sectors.
- The rapid growth of public expenditures has further accelerated in recent years, as a welcome increase in needed infrastructure investments has not been accompanied by reforms (especially in the civil service, and in pervasive earmarking provisions) to curb the growth of current spending.
- The financial system remains highly concentrated; lending spreads, especially for small and medium enterprises and individuals, remain quite high; and most domestic long term-financing to investment and exports continues to be provided (at subsidized rates) by BNDES, at significant fiscal and perhaps efficiency costs.
- The labor market continues to be characterized by significant informality and turnover, although the unemployment rate has fallen substantially in the wake of strong economic growth. There are clear signs of emerging bottlenecks in jobs requiring specialized skills, while overall youth unemployment remains high, signaling the persistence of significant rigidities in the market. Needed labor market reforms do not appear to figure in the agenda of the current government.
- As noted in the relevant sections above, further progress is needed in health and education reforms, reflecting the changing demographic profile of the population, and the evolution of labor market needs.
- The last several years have seen a resurgence of government interventionism in industrial, energy, and external trade policies, partly under the pressures of

a significant loss of competitiveness in manufacturing, as a result of the rise in labor costs and the appreciation of the *Real* during that period.

It is, of course, difficult to assess rigorously the net impact of the pluses and minuses in the reform process on the performance of the Brazilian economy in recent years. Most structural reforms tend to be reflected in economic outcomes with variable, and often long, lags. There is, however, broad consensus in the literature that the improved macro-economic management framework facilitated the pursuit of responsible policies during most of the last decade, contributing importantly to reducing volatility in output and inflation, and easing the long-standing external constraints. The liberalization policies of the 1990s undoubtedly also contributed to productive efficiency and a re-orientation of Brazilian enterprises towards the global economy. And the social policies of the Lula government were instrumental in reducing income inequality, and in the emergence of a lower-middle class whose pent-up consumption demand has contributed importantly to the strong economic growth of the last years.

But, it cannot be denied that Brazil has also enjoyed a quite favorable external environment over the last decade, marked by high commodity prices; a strong growth of demand in large emerging markets that, because of the size of its productive capacity, it was uniquely placed to satisfy; ample liquidity and, for most of the period, relatively low international interest rates; and finally the discovery of potentially very large (albeit difficult to exploit) offshore oil reserves. It is to the credit of Brazil's entrepreneurs that they have responded flexibly and very effectively to these opportunities, and of the government that it has supported in various ways the strategic redirection of trade and outward orientation of industry.

Looking ahead, prospects may not be as bright. Increased global integration also means that Brazil's economy is more dependent on the evolution of its trading partners, now especially China. A significant slowdown in the latter would both dampen Brazil's commodity exports growth in volume and likely worsen its terms of trade. And the downturn in Europe, which remains Brazil largest export outlet, will certainly not help the performance of manufacturing exports, already undermined by the loss of competitiveness.

Moreover, there are also disquieting signs on the domestic economic front, with output decelerating sharply since mid-2011. While the wide-ranging monetary, financial, and fiscal stimulus measures announced in recent months can be expected to boost domestic demand growth in the second half of 2012 and into 2013, there are risks of a pick-up in inflationary

expectations and pressures, especially if the government's current efforts to curb import growth are successful. In brief, the growth-inflation tradeoff may have become steeper, as suggested by the rather modest deceleration in inflation since mid-2011 in the face of the pronounced slowdown in output.

Against this background, a reinvigoration of the structural reform agenda would seem to acquire added urgency. A more comprehensive tax reform is clearly a priority to improve productivity and competitiveness. Early progress in pension reform would facilitate lowering the burden of social contributions on labor while improving the long term financial prospects for the system. Effective steps to reduce rigidities in current spending would create sustainable "fiscal space" for increases in aging-related health spending and needed infrastructure investment (Mendes, 2010). Further financial sector reforms should aim at reducing the cost and lengthening the duration of both private and public sector financing, and reducing the role of directed credit. And government intervention in the economy should focus on improving the business environment, promoting innovation, increasing the transparency of markets, and correcting their failures, rather than attempting to "pick winners" and increasing the already significant barriers to trade. Needed reforms of the labor market and education system would help ease bottlenecks, reduce pockets of structural unemployment, and promote a further decline of informality.

The payoffs of further progress in structural reforms are potentially large, but political economy realities constitute significant obstacles to such reforms:

- Some of the reforms mentioned above may not be in line with the ideology of the government, and not be supported by its political base (in particular the unions).
- Some would affect adversely powerful interest groups (including enterprises in protected and favored sectors) that benefit from current distortions.
- The political "window of opportunity" before the next presidential elections in October 2014 is relatively narrow. Moreover, although the government enjoys a sizable majority in Congress, being a coalition, it is affected by internal conflicts.
- States and large municipalities wield substantial political power, and can therefore block reforms that would affect some of them adversely (such as

interrelated reforms of indirect taxation and the inter-governmental transfer system).

- Finally, the (historically often effective) external pressures for reform are virtually absent for the time being, as demand for commodity exports remains so far relatively strong; foreign investors are trying to position themselves to benefit from the discovery of the offshore oil reserves; international liquidity remains ample and in search of relatively high yields, such as those currently prevailing in Brazil; and international markets focus more on the high reserves and relatively low external debt of the country than on potential longer-term vulnerabilities.

Therefore, further progress in structural reform may well remain small in the next few years, unless the global economic environment deteriorates substantially, thereby imparting much greater urgency to the reform process. In a limited-reform scenario, Brazil would likely still not experience a foreign exchange crisis as in the 1980s and 1990s, given its much stronger reserves and external debt position. Probably it would also not go back to high inflation, since the authorities can be expected to calibrate the macroeconomic stance to ensure inflation moderation, given the strong popular support for the latter. But it is unlikely to make the sustained shift to a significantly higher growth path (closer to those of the more dynamic emerging markets) that a stronger structural reform effort would facilitate.

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