ISSN 1415-4765

*

TEXTO PARA DISCUSSÃO N° 1035

PRAGMATIC POLICY IN BRAZIL: THE POLITICAL ECONOMY OF INCOMPLETE MARKET REFORM

Armando Castelar Pinheiro
Regis Bonelli
Ben Ross Schneider

Rio de Janeiro, agosto de 2004

ISSN 1415-4765

TEXTO PARA DISCUSSÃO N° 1035

PRAGMATIC POLICY IN BRAZIL: THE POLITICAL ECONOMY OF INCOMPLETE MARKET REFORM

Armando Castelar Pinheiro*
Regis Bonelli*
Ben Ross Schneider**

Rio de Janeiro, agosto de 2004

* Da Diretoria de Estudos Macroeconômicos do IPEA.
castelar@ipea.gov.br, bonelli@ipea.gov.br
** Da Northwestern University.
brs@northwestern.edu

ipea Instituto de Pesquisa Econômica Aplicada

Fundação pública vinculada ao Ministério do Planejamento, Orçamento e Gestão, o IPEA fornece suporte técnico e institucional às ações governamentais, possibilitando a formulação de inúmeras políticas públicas e programas de desenvolvimento brasileiro, e disponibiliza, para a sociedade, pesquisas e estudos realizados por seus técnicos.

ISSN 1415-4765

JEL O11
O54

TEXTO PARA DISCUSSÃO

Uma publicação que tem o objetivo de divulgar resultados de estudos desenvolvidos, direta ou indiretamente, pelo IPEA e trabalhos que, por sua relevância, levam informações para profissionais especializados e estabelecem um espaço para sugestões.

SUMMARY

SINOPSE

Os últimos 20 anos foram, como se sabe, um período de grandes transformações econômicas, políticas, institucionais e sociais no Brasil. Desde a primeira metade dos anos 1990 a economia foi progressivamente aberta, tanto ao comércio quanto ao investimento estrangeiro, diversas grandes empresas produtivas foram privatizadas, regulações de preços foram revogadas e um novo marco regulatório foi sendo gradualmente erigido. Exceto pela liberalização comercial, que já estava praticamente finalizada nos moldes originalmente propostos já em meados dos anos 1990, as demais reformas foram aceleradas após o Plano Real.

A consolidação da estabilidade de preços e as reformas orientadas para o mercado, por sua vez, requeriam mudanças institucionais. Entre essas se incluem o fortalecimento da concorrência e a criação de agências reguladoras, bem como a aprovação de nova legislação para promover a disciplina fiscal, melhorar a regulação do mercado financeiro e proteger os consumidores.

Este trabalho focaliza esse processo gradual e fracamente coordenado de redução da presença do Estado na economia. Detém-se, em especial, na análise dos papéis da ideologia, do *policy packaging* e do pragmatismo na implementação das reformas; no grau em que elas avançaram; em quão bem elas foram implementadas; e em se o processo de redução da intervenção estatal veio para ficar.

Argumenta que o pragmatismo — entendido como uma conduta que enfatiza a motivação e as conseqüências práticas como guias para a ação — foi a principal força impulsionadora das reformas. Em contraste com outros países da América Latina, a ideologia e a política jogaram um papel relativamente menor nas reformas no Brasil. Em particular, embora as reformas fossem freqüentemente apresentadas junto com outras, mais urgentes e populares, para facilitar sua aprovação, elas não foram implementadas como uma mudança coerente na estratégia de desenvolvimento. Foram, antes, o resultado de um processo flexível, gradual, episódico e formado por peças desconectadas umas das outras.

O pragmatismo levou a reformas que ficaram incompletas e pouco coordenadas entre si. Embora essas características às vezes facilitassem a política das reformas, abrindo janelas de oportunidade e diminuindo a oposição, elas também reduziram a eficácia das reformas. Em particular, o pragmatismo não foi suficiente para gerar as chamadas reformas de segunda geração.

Até o presente, o impacto das reformas não foi muito significativo no Brasil, se medido pela aceleração da taxa de crescimento do PIB. O pouco que ocorreu foi decorrente do aumento da produtividade, não se observando uma recuperação dos níveis de investimento. Na medida em que o pragmatismo reflete uma abordagem em que o resultado final é a principal justificativa para a reforma, a falta de uma aceleração significativa do crescimento pode colocar a sustentabilidade das reformas em risco.

ABSTRACT

The last 20 years were a period of major political, economic, social, and institutional reform in Brazil. In the first half of the 1990s, reformers opened the economy to foreign trade and both direct and portfolio investment, sold off a number of large and traditional state-owned enterprises, discontinued myriad price and output regulations, and gradually erected a new regulatory framework. Except for trade liberalization, which was largely completed by the mid-1990s, reforms accelerated after the Real Plan. The consolidation of price stability and market-oriented reforms, in turn, required a number of institutional changes including the strengthening and/or creation of competition and regulatory agencies, and the enactment of new legislation to promote fiscal discipline, improve regulation of financial markets, and protect consumers.

This paper focuses on this gradual, piecemeal, loosely coordinated process of partial state retrenchment. The analysis focuses especially on the relative roles of ideology, policy packaging, and pragmatism in advancing reforms; how well reform implementation went; to what extent their results were as expected; and whether state retrenchment is here to stay.

We argue that pragmatism—understood as a conduct that emphasizes practicality and stresses practical consequences as constituting the essential criterion in determining action—has been the main driving force behind reforms. In contrast to other Latin American countries, ideology and politics have played a lesser role in fostering market reforms in Brazil. In particular, although reforms were often bundled together with other urgent or popular policies, to facilitate their approval, they were not enacted as a coherent, overall change in development strategy, and more as a piecemeal, flexible, mostly disconnected reform process.

Pragmatism led to market reforms that, as a rule, were gradual, usually incomplete and only loosely coordinated with one another. Although these characteristics sometimes facilitated reform politics—opening windows of opportunity and reducing political opposition—they also reduced the efficacy of reforms. In particular, pragmatism was insufficient to generate complementary, second-generation reforms.

The overall impact of reforms has not been significant in Brazil, with only a marginal acceleration in GDP growth, due entirely to higher productivity growth. To the extent that pragmatism reflects an approach in which the end results are the main justification for reform, the failure to spur growth after over a decade of reforms puts their sustainability at risk.

1 INTRODUCTION

The last 20 years have been a period of major political, economic, social, and institutional transformation in Brazil. The 1980s witnessed the end of the military regime that began in 1964. In 1985 the military ceded the presidency to a civilian; in 1988 a Constituent Assembly enacted a new constitution; and in 1989 direct popular elections for president were held for the first time since 1960. Democratization entailed, among other things, devolution of policy authority in a number of social and infrastructure areas and the strengthening of Congress and civil society. The civilian governments pursued a number of economic reforms, especially after 1990. Following up on preliminary efforts initiated in the late 1980s, in the first half of the 1990s reformers opened the economy to foreign trade, and to both direct and portfolio investment, sold off a number of large and traditional state-owned enterprises (SOEs), discontinued myriad price and output regulations, and gradually erected a new regulatory framework. Except for trade liberalization, which was largely completed by the mid-1990s, reforms accelerated after the Real Plan, launched in 1994, succeeded in curbing high inflation.

The consolidation of price stability and market-oriented reforms, in turn, required a number of institutional changes including the strengthening and/or creation of competition and regulatory agencies, and the enactment of new legislation to promote fiscal discipline, improve regulation of financial markets, and protect consumers. As much as the structural economic reforms themselves, these institutional reforms highlight the significance of the transformations Brazil underwent in the 1990s. For six decades from the Great Depression through the 1990s economic policy had been characterized by low integration into the world economy, pervasive discretionary state intervention, and the prevalence of planning and command over market competition. The emphasis had been on fostering investment rather than efficiency, and favoring profits at the expense of consumer welfare. This strategy relied on a high degree of centralization and a concentration of power and resources in the federal government. A number of factors reinforced tendencies toward centralized planning and low international integration, including: 36 years of authoritarian rule during these six decades; phases of volatile external environment (such as during the Great Depression, World War II, and the oil shocks of the 1970s); international policy advice; and regional contagion (in terms of ideas on development policies). Thus, the reforms of the 1990s marked a significant reorientation in the overall development strategy.

At the risk of over simplification, the large set of political, economic and institutional reforms enacted can be understood as a transfer of power, policy responsibilities, and resources[1] away from the federal executive to subnational governments, Congress, civil society, and the market.

However, whereas general political reform and devolution continue to progress and enjoy popular support, the same cannot be said of market-oriented economic and institutional reforms. Moreover, the economic reform process remains

1. From the mid-1990s on there was a partial re-concentration of resources in the federal government. But this does not alter the essence of the argument.

incomplete, in the sense that some of the reforms have gone only part of the way. In addition to that, there is a plausible risk that at least some of them will be partially reversed. Indeed, the new president, Luiz Ignacio Lula da Silva, was elected in October 2002 with a program that, although not advocating an outright reversal of reforms, criticized them and defended a re-orientation of economic policy. The president's Workers' Party (PT) spent much of the past decade opposing market-oriented reforms, and may now be representative of a growing center-left backlash in the region, at least in the southern cone (with Presidents Ricardo Lagos in Chile and Nestor Kirschner in Argentina).

By the end of the first year of the new administration, the jury was still out on whether the PT would consolidate or reverse market-oriented reforms. We return at the end of this paper to an assessment of the first year of the PT Government.

This paper argues pragmatism[2] has been the main driving force behind reforms. This is not a new idea, but has actually long been a central feature of economy policy making in Brazil. In contrast to other countries of Latin America, we argue, ideology and politics have played a lesser role in fostering market reforms in Brazil. In particular, although reforms were often bundled together with other urgent or popular policies to facilitate their approval, they were not enacted as a coherent, overall change in development strategy, and more as a piecemeal, flexible, mostly disconnected reform process. Four main factors have helped to motivate and shape these pragmatic market reforms: *a*) the crises of the 1980s, with the collapse of the developmental state and its allied import substitution industrialization (ISI) strategy; *b*) the withdrawal of military from power and the return to democratization; *c*) external pressures, from markets, governments and multilateral institutions, including contagion from other developing and developed countries; and *d*) reform initiatives spontaneously initiated by government officials in lower levels of the state apparatus and often with support from the private sector.

Pragmatism led to market reforms that, as a rule, were gradual—and therefore usually incomplete—and only loosely coordinated with one another. Although these characteristics sometimes facilitated reform politics—opening windows of opportunity and reducing political opposition—they also reduced the efficacy of reforms. In particular, pragmatism was insufficient politically to generate complementary second generation reforms. So by the time the new government of President Lula took office in January, 2003, almost two decades after the reform process began, reforms in Brazil were still incomplete.

The overall impact of reforms has not been significant in Brazil, with only a marginal acceleration in GDP growth, due entirely to higher productivity growth.[3] To the extent that pragmatism reflects what Fanelli and Popov (2003) call a substantive approach to reform—that is, one in which the end results are the main justification for reform—the failure to spur growth after over a decade of reforms puts their sustainability at risk.

2. Pragmatism, understood as a conduct that emphasizes practicality, stresses practical consequences as constituting the essential criterion in determining action. In this sense, it refers to both economic policy-making and political action. On a more general level, it encompasses heterodox behavior and conduct.

3. For a comparative overview, see Stallings and Peres (2000).

This paper focuses on this gradual, piecemeal, loosely coordinated process of partial state retrenchment that spans the last twenty years, comprising trade liberalization, privatization, and regulatory and fiscal reform. The analysis focuses especially on the relative roles of ideology, policy packaging, and pragmatism in advancing reforms; how well reform implementation went; to what extent their results were as expected; and whether state retrenchment is here to stay. In comparison with reform processes in other major countries of Latin America—especially Chile, Mexico, and Argentina—, market reforms in Brazil came later and were implemented more gradually and flexibly.[4] In terms of the relative efficacy of market reforms, privatization in Brazil was more successful than in Argentina, Chile (1970s), and Mexico (and in Brazil privatization was more successful in telecommunications and manufacturing than in electricity and transportation). However, trade liberalization promoted more rapid expansion of exports and imports in Mexico and Chile than in Brazil. The paper is not fully comparative, but we use these rough indicators of relative success to situate our analysis. In addition, the reform process in Brazil, as in a number of other countries of the region, is incomplete and lacks complementary institutional reforms, sometimes called second or third generation reforms, in areas such as sectoral and overall regulation, property rights, judicial reform, and administrative reform. Pragmatism in Brazilian policy making helps explain all these outcomes.

The paper is structured in six sections, including this introduction, and an epilogue. Section 2 defines what is meant by pragmatism in reform politics and compares it to other factors such as ideology, partisan politics, and policy bundling or packaging. Section 3 briefly reviews the country's development history and argues that pragmatism has a long tradition in Brazilian policy making, which has helped to make it a key driving force behind market reform in its first stages. Section 4 describes the major reforms and their implementation. Section 5 analyzes the limited aggregate impact of these reforms with particular attention to growth, productivity, poverty, and inequality. Section 6 considers why the process of state retrenchment and market reform has been only partially completed. A final epilogue provides a preliminary assessment of the process of "reforming the reforms" under the new government.

2 VARIETIES OF REFORM POLITICS

On the surface, most countries of Latin America adopted apparently similar sets of reforms in the 1980s and 1990s. However, the implementation of these reforms differed remarkably from country to country. Differences emerged less in *what* policies were adopted than in *how* they were implemented. A crucial range of variation is how centrally reform implementation focused on inducing the desired change in micro behavior by economic agents in the targeted area of the economy, and how far it was tied to other policy and political goals. Trade liberalization, for example, often became a key component of stabilization programs as macro policy makers used an exchange rate anchor and reductions in tariffs to force price

4. For comparative overviews, see Murillo (2001 and 2002), Schamis (2002), Stallings and Peres (2000), Teichman (2001), and Weyland (2002).

moderation on domestic producers. When so packaged, policy makers were less concerned with maximizing competitiveness among firms and more interested in overall price stability. In other cases the implementation of privatization permitted monopolies and questionable business practices (as in Chile in the 1970s). In such cases policy makers often preferred to maximize the sale price—in order to pursue other goals—rather than focus exclusively on optimizing post-privatization performance in the firms sold. Overall, as in many areas of policy making, policies were implemented in ways designed to further multiple government goals.

These goals can be classified as ideological, partisan, policy packaging or bundling, and pragmatic.[5] Pragmatic, or narrowly micro-oriented policies, focused primarily on inducing the desired change in the behavior of the agents directly targetted by the specific reform policy. For pragmatists, privatization should maximize growth, efficiency, investment, and management quality of the resulting firms. Or, trade liberalization is implemented to maximize the longer term efficiency of firms and promote export oriented (labor intensive) activities. What is distinctive about the other three kinds of motives is that they generate policies that often sacrifice short term performance in the targetted sectors in order to maximize other political or economic goals. In pragmatic reforms, policy makers know which variables to monitor to gauge success, and generally adjust policy instruments flexibly in the face of changing performance and conditions in the target sector.

Ideological goals are generally longer term strategies to create new development models and societies to fit them. In terms of market oriented reform, policy makers are sometimes moved by radical forms of neoliberal ideology. Ideologically motivated policy implementation will generally sacrifice short-term micro performance for longer term goals. In Chile in the 1970s, for example, radical neoliberal reformers, the so-called "Chicago boys," were willing to let much of industry go under rather than use trade policy more flexibly to help potentially competitive firms adjust. Nationalism is another ideology which inspires some policy makers to restrict foreign participation (in privatization for example) even if the restriction has a substantial economic opportunity cost in terms of lower efficiency or investment.

Reform implementation inspired primarily by partisan goals is designed to hurt political groups opposed to the government and favor those who support (or who could be induced to support) the government.[6] In Chile in the 1970s, Pinochet declared that he wanted to turn a nation of proletarians into a nation of entrepreneurs, and most policies favored business over industrial workers. More narrowly, selling a particular government firm might weaken an opposition union and curry favor with the new buyers. The many logistical details of selling any particular SOE—sale price, debt, output pricing, or post-privatization restrictions on entry—can be structured to provide major benefits to buyers.

---

5. In an earlier analysis, Schneider (1990) classified reform goals as systemic, partisan, or pragmatic. Systemic corresponds roughly to our category of ideological. We add in packaging motives which stand out in reform processes in the 1990s in many countries. Feigenbaum, Henig and Hamnett (1999) make similar distinctions.

6. See especially Murillo (2002) and Schamis (2002) on Latin America, and Boix (1997) on Europe.

Packaging, bundling, or policy linking, is visible in market reforms that are designed in a way to maximize other goals such as fiscal balance, macro stability, reducing foreign debt, or attracting foreign investment [Heredia and Schneider (2003)]. Many of these goals are evident in privatization programs. In Mexico in the early 1990s privatizers used various mechanisms to maximize sale price. In Argentina the design of privatization promoted the reduction of foreign debt and increase in new foreign investment [see Manzetti (1999)].

Some policies will provide happy coincidence among multiple goals, but most policies involve trade offs among goals. Most governments and even individual policies have multiple goals, but it is usually possible to weigh the mix of goals and compare them across policies, across countries, and across governments within individual countries. So, market reforms in Brazil in the 1990s were, overall, more pragmatic than in Chile in the 1970s—where ideological and partisan motives predominated—, or in Argentina and Mexico in the 1990s—where packaging and partisan goals prevailed. Or, to take policy change overtime in one country, most observers draw a sharp distinction in Chile between ideologically motivated reforms in the 1970s and pragmatic reform in the 1980s [Silva (1996)].

The relative success of several policies of market reform in Brazil resulted from primary pragmatic attention to inducing changes in private behavior. Productivity, efficiency, investment, quality, all increased dramatically in many sectors privatized by governments in the 1990s. Although pragmatism has advantages in promoting the desired economic performance, it suffers politically compared to other goals, especially in the short run. Market reforms, like any economic policy, hurt some groups and favor others, and on balance usually have significant political costs. Coalition building is easier using ideology, packaging, or partisan logics, than the more humdrum, often incremental and gradual, benefits from pragmatic reform. So, for instance, linking trade opening to popular policies that ended hyper inflation as in Argentina makes it difficult for protectionists to lobby against the trade opening. However, pragmatism may have some political advantages over the longer run. The co-existence of multiple goals in some countries helps explain the absence of complementary reforms designed to support new behaviors by private agents. For example, if privatization is conceived primarily as a means to buy political support, then there is little incentive to promote subsequent regulatory or other measures to promote competitiveness.

3 A BRIEF HISTORY OF PRAGMATIC DEVELOPMENT POLICY IN BRAZIL: SETTING THE STAGE FOR MARKET REFORM

Historically, pragmatism—a policy approach legitimated by the success in generating high growth and in which policy content was an issue of lesser importance—was a main trait in Brazil's economic policy throughout most of the 20th century, and was generally accepted as a decision criterion by economic and political elites.[7] Hence, by the 1990s, when market-oriented reform topped the international development agenda, it was possible for the same elite that engineered the expansion in state

7. See Thorp (1991) who argues that Colombian economic policy was also long characterized by pragmatism and flexibility.

intervention to lead the process of state retrenchment, based on the argument that circumstances, and thus what was pragmatic policy, had changed. Pragmatism also facilitated the formation of coalitions amongst political groups with different priorities: businessmen, bureaucratic elite and, in the 1930-1980 period, the military.

This section develops this argument by showing how pragmatism influenced the growing presence of the State in the economy; then, how state intervention was used to deal with the foreign debt crisis of the 1980s, when the state assumed many private debts and incorporated them into public debt; and, finally, how the government started to pursue market-oriented reforms when it became clear that a large and burdensome state was no longer instrumental in fostering development. The pragmatic features of economic policy are also illustrated by the combination of seemingly inconsistent initiatives, such as privatizing while at the same time increasing trade barriers.

State intervention was relatively minor in Brazil until the 1930s. The state played an important role in sustaining coffee prices but otherwise maintained relatively neutral policies with respect to resource allocation [Pinheiro et al. (2001), and Topik (1987)]. With the collapse of coffee prices and the drying up of external finance in the wake of the Great Depression, the government raised import barriers and established a regime of multiple exchange rates. The degree of trade openness in that period followed closely the international price of coffee. Imports and the acquisition of foreign exchange were allowed according to a list of priorities set by the government, which helped to keep the exchange rater overvalued from the late 1930s until the mid-1960s.[8]

The import-licensing schemes and foreign exchange controls implemented in the 1930s and 1940s aimed largely at curbing foreign exchange expenditures in order to deal with balance of payments disequilibria. These controls were highly successful in fostering high GDP growth rates and a deepening of industrialization through a spontaneous process of import substitution in light manufactures [Fishlow (1972)]. Starting in the late 1940s, the potential of these instruments to foster industrialization was perceived and eagerly exploited. To that end, trade, credit and investment policies were geared towards increasing investment in heavy manufacturing and infrastructure, which provided essential services to industry. Economic policy also became much more sector oriented, focusing on "occupying empty spaces" in Brazil's industrial matrix.

Targeted sectors were favored by import restrictions and access to imported capital and intermediate goods at a subsidized exchange rate. Public credit to industry was greatly expanded and the cost of essential services, such as electricity, was also lowered in real terms. In sectors in which domestic investors lacked the technology, such as the automotive sector, incentives were created to attract foreign investors [Shapiro (1994)]. In sectors in which foreign investors were not interested, in some cases owing to poor regulation, or in which national security concerns "recommended" that they be kept at bay, SOEs were created. State coordination of market activities became pervasive through the creation of public monopolies for

8. A devaluation was deemed ill advised due to its unwelcome effects on the international price of coffee, inflation, the cost of investment goods and the fiscal accounts.

goods such as sugar, coffee, mate-tea, etc., and a strong influence on private investment through selective public credit and fiscal subsidies, public sector and SOE procurement, and regulations.

This new development strategy was based on a strong commitment to planning and coordination at the federal level, as presented in the government's *Plano de Metas* (Plan of Targets) laid down in the early 1950s. Influencing this commitment was the success of the American New Deal in bringing the US out of the Great Depression and the Soviet Union's success with economic planning that, according to a then highly influential book, was the only alternative "capable of saving the world from an economic collapse".[9] Also important was the strong political influence of developmentalist military officers who since the 1930s promoted ideas of "economic nationalism" and for whom, by training, national security concerns were paramount. In this regard, the shortage of essential goods experienced during World War II helped to strengthen the idea of self-sufficiency as a means to achieve national security, also highlighting the importance of external crises in shaping economic policy.

Thus, this strategy was backed by a strong coalition formed by the national-security concerned military; newly empowered bureaucrats who gained increasing command over public resources, industrial business elites, and the urban population who had gained influence after the previous decades of industrialization and were among the main beneficiaries of this new policy stance. And, despite following policies most economists would currently frown on, Brazil achieved rapid output growth in the 1950s, with a remarkably good performance of manufacturing, in this way validating pragmatism as a policy approach.

In the early 1960s, however, GDP growth decelerated, the public deficit expanded and inflation increased. Investment declined, as a result of distortions introduced by tax policy and regulation and an increase in political turmoil. The military and business and urban elites would soon line up with the political opposition, and in March 1964 a military coup overthrew the civilian government. A process of market-oriented structural reforms began to be implemented. A stabilization program was then launched to lower inflation, reduce the public deficit and correct relative prices. The exchange rate was devalued and, in 1968, a crawling peg regime, with devaluations at randomly determined moments, adopted to protect exporters from inflation. Other reforms included:

a) A reduction in the number of non-tariff barriers and a lowering of import tariffs—for manufactures, the average tariff had fallen by half in 1967. The impact on imports was small, though, for tariff cuts essentially reduced redundancy in protection. Essential imports had always counted on special import regimes. So, in practice they faced low protection.

b) The tax system was completely revamped, with the introduction of value added taxes and a variety of fiscal incentives to private investment. Fiscal revenues and spending were concentrated at the federal level, with the consequent loss of fiscal

9. From Landauer (1944), quoted in Simonsen (1945) whose public interventions helped to foster the idea of planning in Brazil's economic policy making.

autonomy by subnational units. In only three years tax revenues increased from 16.3% to 22.4% of GDP, enhancing the state's investment capacity.

c) A substantial administrative decentralization and re-organization aimed at improving public governance. One of the explicit goals of this reform (DL 200) was to raise the efficiency of public production by giving SOEs and other government agencies greater autonomy. Together with a large real increase in the prices charged by those companies for their products and services, a favorable tax treatment and privileged access to credit, this led to a boom in the number and reach of SOEs.

Yet, the change from left- to right-wing government in the mid-1960s did not bring with it a significant change in development strategies. Planning and coordination continued to be seen as the guiding principles for economic policy. Pragmatism was reinforced by the new administration inaugurated in 1967, which folded back some of the trade liberalization initiatives and increased price controls. In 1968-1973 Brazil experienced the heydays of pragmatism. Then, a substantial acceleration of GDP growth seemed to legitimize a severe authoritarian regime. Not only high growth, but also the shared command of the allocation of public expenditures and credit helped to solidify the political coalition among the military, bureaucrats and business elites [Pessanha (1981), and Schneider (1991)].[10]

Most contemporaneous authors concurred that the expansion in state intervention was not the result of ideology, but instead the outcome of superimposed—although disconnected—movements. In an early statement, Cardoso (1973, p. 143), for example, argues that "That policy orientation (state intervention), as has now been well documented, was more a short-term response to practical problems than a coherent set of projections based on a nationalist ideology."[11]

Things began to change with the first oil shock, which coincided with a change of government. Brazil was highly dependent on imported oil, and with an already large current account deficit, the natural reaction to this deterioration in terms of trade and the slowdown in global economic growth would have been a currency devaluation and contractionist fiscal and monetary policies. Brazil opted, though, for staying on a high growth path, relying on foreign debt to finance its external deficit during what was expected to be a short-lived shock. A more long-lasting external adjustment, consistent with sustained growth, was sought through a new round of import substitution and fiscal and credit incentives to manufacture exports.

More than a shortsighted decision, this strategy reflected the sensitive political moment Brazil was going through and the shortcomings of pragmatism as a policy

10. As noted by contemporary observers, "A good deal of the government's political legitimacy during this period (1967-73) rested upon these apparently impressive achievements (...) in too many interpretations an authoritarian and centralized regime and its associated 'rational and pragmatic' economic policies have been presented as the main elements behind these achievements" [Malan and Bonelli (1977, p. 21)].

11. Martins (1977, p. 26-27), however, frontally disputes this argument, stressing the importance of broader national political objectives, which, as noted above, formed the second pillar of Brazil's economic pragmatism: "(…) there was always an ideology of state intervention (whether in the form of *statism, nationalism*, or *developmentism*), in which the point of reference was the concept of the nation. (…) This was why, on the ideological plane, these three 'isms' often appeared in an intermingled form, as interchangeable concepts (…). It is historically inexact, however, to state, as is now frequently stated, that the business activities of the state emerged in Brazil almost accidentally and without any link to any defined political project".

approach. To a large extent, the authoritarian regime owed much of its legitimacy to the good economic performance of 1968-1973 and the argument that security and development were closely associated. Yet, political support from urban elites had declined considerably with political repression after 1968, and the opposition scored unexpectedly well in the 1974 Congressional elections. This threatened the gradual and controlled political opening process that was one of the new administration's key goals, for the hard-line military feared losing control of this process. Thus high growth was important to sustain optimism and popular support, while giving the new administration room to implement its project of controlled political liberalization [Lamounier and Moura (1984)].

The decision to sustain growth despite the significance of the external shock also owed much to President Geisel's (1974-1979) personality, in a sense the quintessential pragmatic—a general, who had for years been president of Brazil's largest (SOE) company, was closely associated with bureaucratic elites and did not want to mark its presidency by stagnation. He had clear developmental objectives, a "development marked in a certain sense by a neo-Bismarckian sense of historical urgency and the aspiration to transform Brazil in a respectable power, in the shortest possible time" [Lamounier and Moura (1984, p. 31)]. Investment rates reached record levels in this period, but, as discussed by Malan and Bonelli (1977), Brazil was living beyond its means, and the 1970s were marked by relatively volatile growth, with rising inflation and accumulating distortions. SOEs experienced a large expansion, as they led a number of large industrial and infrastructure projects, but helped to pressure the external accounts. To control the trade deficit, tariffs were raised and a number of non-tariff barriers created, among them a "negative import list". Export subsidies were also stepped up. However, the current account deficit stayed high and the external debt accumulated.

The emphasis placed by Geisel's administration on SOE investment would produce the first split in the association between technocrats and business elites, who feared for their access to public funds and subsidies. In 1975, the business establishment launched a campaign against the "statization" of the economy. Far from ideological, this movement opposed the insulation of the political leadership from the influence of private firms, who wanted to be "heard throughout the whole process of decision on the national economy, helping to establish criteria for the activity of the state and the private sector, orienting the use of the SOEs and controlling their expansion, deciding directions for the investment of their savings etc." [Pessanha (1981, p. 154)]. That is, a return to old-fashioned pragmatism. Indeed, businessmen were fast in discarding liberal reforms, such as privatization, which would have in principle created greater room for private initiative, for they thought them inconsistent with development: In a document produced by business leaders, this issue is expressed as follows:

"Either the private-sector company acquires state-controlled companies from the government, *with funds from the public sector itself*, an option which will make it extremely difficult to choose the new owners without falling into paternalism, or the already scarce funds of the private sector will be absorbed in buying existing undertakings, leading the government to fill up the newly-formed 'empty spaces' with these funds" [Pessanha (1981, p. 105), emphasis in the original].

The government reacted by extending tax and credit subsidies to national private companies, but otherwise going ahead with the expansion of SOEs, so as to "occupy empty spaces" in the industrial matrix. As a reaction to complaints against *statization*, Finance Minister Mário Henrique Simonsen, and a well-known liberal, remarked that in Brazil SOEs originated from the objective of "filling empty spaces", and not from ideological motives [Pessanha (1981, p. 122)], and that "any discussion on privatization will always be innocuous, if one is to leave empty spaces".

At the end of the 1970s, the macroeconomic situation worsened again, culminating in the foreign debt crisis of 1982. The severity of debt and second oil shocks was such that throughout most of the 1980s economic policy was totally subordinated to overcoming balance of payments disequilibria and controlling inflation, to the detriment of furthering industrialization. Pragmatism led to a re-orientation of economic policy and in particular of traditional instruments of state intervention. To curb the rapid expansion of SOEs, which was inconsistent with stabilization, the government created in 1979 the Special Secretariat for Control of SOEs (SEST).[12] SOEs would also be used to help finance the external deficit and foster export competitiveness through the subsidized sale of basic inputs and infrastructure services. Trade policy was entirely subordinated to the goal of generating a trade surplus to service the external debt—in a sense, a return to the situation experienced fifty years before.[13]

Although successful in temporarily overcoming the foreign exchange crisis, this strategy harmed growth and led to fiscal disequilibria and rampant inflation. Brazil would also become a very closed economy, with non-oil imports of just 2.8% of GDP in 1983-1987. By the mid to late-1980s, infrastructure sectors were also performing poorly. Infrastructure SOEs were harmed by low tariffs, artificially depressed to subsidize exports and reduce inflationary pressures, causing a decline in real revenues and in their ability to self-finance investment. Earmarked sources of public funds were redirected to the stabilization effort, while management practices worsened. Together with the fiscal constraints on spending—to which insiders preferred to adjust by cutting investment, rather than current expenditures—this led to a fall in investment and the slow expansion in output capacity, limiting the ability of SOEs to cope with the increasing demand for their services.

Although macro stabilization dominated the economic scene in the 1980s, this period also recorded a number of market-oriented reforms, essentially geared at eliminating some of the excesses introduced in the post-1974 period. In 1979, a National De-Bureaucratization Program was launched to reduce the red tape in general, including a lightening of business regulation. In 1981 a presidential decree

12. As then noted by Rezende (1980, p. 37), and somewhat paradoxically, "to the extent that the decisions to invest in certain sectors by private enterprises are subordinated to public credit and/or fiscal incentive schemes, control of the decisions of the privately-controlled companies is greater than the control of the decisions of the public companies, whose capacity to mobilize funds gives them a certain independence in relation to the central power".

13. Export subsidies were expanded and import barriers raised. The negative import list was substantially expanded to cover 40% of all tradable goods, firm import programs and finance of imports became mandatory, while administrative procedures (e.g., delaying authorization to import) became the main instrument to control imports. On the export side, credit and financial subsidies were raised, to reinforce the effect of an already weak exchange rate, and in 1981-1982 firms received incentives worth 74 cents for every dollar of manufacture exports.

created the Special Privatization Committee (*Comissão Especial de Desestatização*) and set "rules for the transfer, transformation and divestiture of companies controlled by the federal government". Overall, 38 companies were privatized in the 1980s, with several others being closed down. As the foreign exchange constraint lessened in the late 1980s, Brazil also moved towards a more open and neutral trade policy, with reforms (1988 and 1989) that had the stated objective of reducing redundancies in tariff protection, bringing the average tariff on imports down from 51% to 35%. A number of export subsidies were also discontinued.

Overall, however, these reforms lacked coordination and were very timid, regarding their objectives and what was actually accomplished. According to the World Bank, for instance, "Brazil's first flirtation with privatization was a 'classic example of failure'". Reforms also counted with very little political support. Indeed, the 1988 Constitution was clearly a nationalizing one, establishing public monopolies in telecommunications, oil and distribution of gas, and setting up barriers to foreign ownership in mining and electricity.

Yet, less than two years after the promulgation of the new constitution, Brazil launched major market-oriented reforms, significantly enlarging the trade liberalization, privatization and deregulation programs. What caused this major shift in the political view of the role of the state in the Brazilian economy? The answers to this question include changes in the domestic and international political scenarios, low growth, and imperatives of macroeconomic policy.

While the military maintained their influence in government, the protective mantle of "national security" blocked a deeper integration into the world economy and the privatization of large SOEs. The reason was a concern that SOEs would end up with foreign investors, seen as the only ones with funds to buy those companies. An increased presence of foreign investors in the economy was perceived as against the national interest. Thus, to a large extent, democratization facilitated the introduction of market-oriented reforms.

Changes in the international environment, with the end of the Cold War, also helped to mitigate the need for a strong state presence in the economy for reasons of national security, as in other countries [Nestor and Mahboodi (1999)]. Indeed, a remarkable aspect of the discussion on state-retrenchment reforms in the 1990s is how the issues of national security and denationalization of the economy have lost importance in the public debate.

Also important was the link between market-oriented reforms and the continued effort of macro stabilization that shifted in the 1990s from external adjustment to inflation control and fiscal adjustment. As discussed in Section 4, market and fiscal reforms were instrumental in furthering the stabilization effort. At the same time, the bundling of market reforms with popular inflation control initiatives enhanced their political support.

The frustration with the low growth rates of the 1980s was the third main source of motivation for reform. A return to the regime of public sector planning and coordination of economic activity was not feasible. Partly because the quality of the bureaucracy had deteriorated, but mostly because the huge worsening in the fiscal accounts had greatly reduced the scope for state intervention. It was also perceived that the scope for furthering the import substitution process was not large, not the least because Brazil lacked the necessary technological skills to expand in the most dynamic industrial areas.

The option was then made to shift from a strategy focused on accumulation—presented as a concern to "occupy empty spaces"—to one more concerned with efficiency and productivity growth, and in which the investment process was to be led by the private sector. As part of this process, Brazil decided to enlarge its market-oriented reforms and pursue integration into the world economy to an extent unseen since the 1920s.[14] In this regard, international contagion was also important: in particular, the example set by Chile and the United Kingdom, the economic transition in former communist countries and the fact that other Latin American countries were pursuing the same strategy.

Moreover, at the beginning of the 1990s it became apparent that the state had exhausted its capacity to lead the process of accumulation, since it was not capable of either generating a fiscal surplus or borrowing abroad. Finance to SOEs disappeared for another less obvious reason: because virtually all long term credit in Brazil was (and still is) extended by public banks. Because these could not execute the collateral given by SOEs, for political and legal motives, SOEs did not bother to pay back. So in the mid--1980s public banks were forbidden to lend to SOEs, drying up their last source of finance. Privatization became then the only means through which public banks could finance the sectors in which SOE presence was massive—being private, these companies could credibly offer their assets as collateral. This was a common ground that allowed a tactical coalition between those who believed that the state should permanently exit commercial activities and those that saw privatization as a necessary evil.

It was probably the case, though, that chance also had some influence, if not in the direction of reform, at least on its pace. Reforms were greatly enhanced in 1990, when the Collor Government took office. Collor had little political support, as was later evident in his impeachment in 1992. This facilitated his decision to break from the gradualist approach that had characterized the controlled political and economic transitions in the 1980s. He was also very successful in bundling market-oriented reforms—in particular, privatization, trade and regulatory reform—with his stabilization plan, all launched and approved together by Congress (and the Judiciary) in his first months in office. The hyperinflation episode of 1989, which was key to allow Collor's election, helped to legitimize the stabilization attempt and, indirectly, market reforms.

4 MAJOR MARKET REFORMS OF THE 1990S

4.1 TRADE LIBERALIZATION

A conspicuous feature of industrial and trade policies adopted in Brazil to support ISI was their neglect towards competitiveness. Brazilian manufacturing long benefited

14. Many of these ideas came from inside the state bureaucracy, including the advocacy of furthering the privatization process, which managers of some SOEs saw as the only way out for their companies [Schneider (1990)].

from a host of import barriers, the most important of which were high tariff and non-tariff protection, foreign exchange controls, and, at times, undervalued exchange rates. Imports of so-called non-essential goods were severely penalized. Non-tariff barriers were widely used. Redundant tariffs were the norm. Forty-two special import regimes allowed for the exemption or partial reduction of import duties. Starting in the late 1960s, though, Brazil also cared to foster export growth, with exchange rate overvaluation being oftentimes compensated by special export supporting schemes.[15]

Protection, stimuli and regulation of manufacturing activity changed over time, as discussed in Section 3, but as a rule the high tariff and non-tariff barriers associated with ISI were a drag on productivity growth. Excessive protection contributed to profit differentials in favor of domestically oriented, import substituting sectors, diverting resources towards the corresponding activities. In addition, lack of competitive pressures from imports hampered productivity, particularly in manufacturing, and the pressure for greater efficiency and lower prices of non-tradables. Complacency with the low quality of infrastructure and no availability of modern services (in telecommunications, for instance) were a natural result of these developments. The high cost of essential imports or of their domestic substitutes, in turn, penalized exports. Low domestic and external competitiveness and an anti-export bias were the obvious results.

Starting in 1988, Brazil implemented liberal import policies to foster allocative efficiency via external competition. Three rounds of tariff reductions took place: in 1988-1989, 1991-1993 and 1994 [Kume, Piani and Bráz de Souza (2003)]. By far, the trade liberalization begun in 1990 has had the deepest and most lasting effects on the economy. Also in 1990, industrial policies became more horizontal and less pro-active. Indeed, for a while industrial targeting seemed to belong to the past.[16] Thus, non-tariff barriers without legal support were eliminated in 1990; requirements of floor values for import financing were gradually abolished; minimum domestic content indices for financing equipment purchases were reduced; and administrative procedures were abolished or simplified. Economic policy directives after the mid-1990s included sector priorities in only a handful of cases: *a*) high technology industries (informatics, fine chemicals, precision mechanics, biotechnology and the so-called "new materials"), considered infant industries; *b*) car industry; and *c*) industries in need of restructuring.

With the benefit of hindsight, it can be said that part of the industrial and trade policy measures then adopted reflected both domestic pressures and indecision with respect to which course of action to follow. Exemption of import tariffs on capital goods, for instance, would be re-enacted in 1995, in the context of the automotive agreement then celebrated. Indeed, liberalization suffered a number of setbacks in 1995-1998, when, after the Mexican crisis of late 1994, Brazil found it difficult to finance its soaring current account deficits. As we argue below, this swinging pendulum of tariffs cuts and hikes followed a mostly pragmatic course, reflecting

15. See, on these issues, Kume, Piani and Bráz de Souza (2003).

16. See, for instance, Bonelli, Motta Veiga and Fernandes de Brito (1997).

essentially pressures from domestic producers and changing macroeconomic conditions.

As a general rule, the objectives of industrial and trade policies were subordinated to macroeconomic objectives after the Real Plan was implemented. Thus, trade policy became formally oriented towards: *a*) increasing trade flows; and *b*) perfecting the control of these trade flows with the objective of ensuring adequate domestic supply, avoiding unfair trade practices and contributing to the equilibrium of the balance of payments. Still, *de facto*, the deepening of trade liberalization in late-1994, via the anticipation of the liberalization timetable, represented the final step of the process initiated in 1990. The impact on the manufacturing structure and performance was substantial as productivity increased up to 1997 (see below). Competitiveness suffered from exchange rate appreciation, but increased in some periods. Still, despite policy makers stated preference for "horizontal" instruments[17]—which was clearly in agreement with the priority ascribed to macro stabilization—one of the main legacies of Cardoso's industrial policy (1995-2002) was markedly sector oriented: the automotive agreement. Again, this reflected pragmatism in policy making.

The original schedule of trade liberalization proceeded according to the timetable shown in Table 1. The logic behind this schedule was: *a*) 0% import tariffs should be applied to goods characterized by clear comparative advantages (exportable), goods of high international transport costs, goods with no domestically produced similar and commodities characterized by low value added content; *b*) 5%t import tariffs would apply to products already at that import bracket; *c*) 10%—agricultural products and derivatives; *d*) 10%, 15% and 20% to products that use up in their productive chain inputs with 0 import duties; and *e*) all the remaining ones [see Horta, Piani and Kume (1991)].

TABLE 1
ORIGINAL SCHEDULE FOR REDUCING IMPORT TARIFFS—1990-1995
[%]

Dates	Average	Mode	Median	Range	Standard deviation
1990	32.2	40	30	0 – 105	19.6
February, 1991	25.3	20	25	0 – 85	17.4
January, 1992	21.2	20	20	0 – 65	14.2
October, 1992	16.5	20	20	0 – 55	10.7
July, 1993	14.9	20	20	0 – 40	8.2
January, 1995	12.1	14	10	0 – 20	6.1

Source: Pinheiro (1996*b*).

The schedule was modified several times in order to anticipate tariff cuts. This happened, for instance, just after the Real Plan was implemented, in late 1994. Widening of trade liberalization at the end of 1994 was essentially pragmatic: import tariffs were reduced to check domestic price increases, as producers threatened to raise prices under demand pressures and low idle capacity. Trade liberalization was

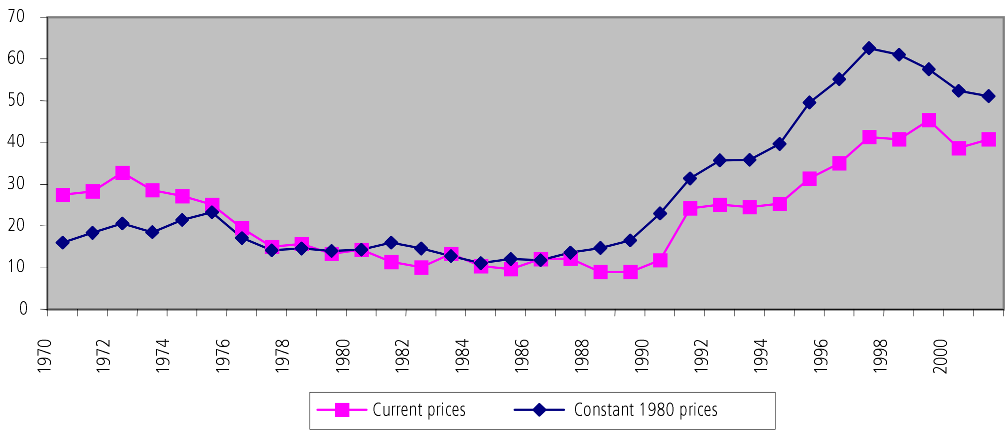
17. These measures include policies to reduce the "Brazil cost," institutional change in foreign trade practices and regimes, competition policies etc.

further deepened by the substantial real appreciation of the exchange rate in the aftermath or price stabilization.[18]

The impact of trade liberalization on import flows was not immediate, on account of the 1990-1992 recession. The still high average tariffs prevailing up to 1993 and the lack of distribution channels to commercialize imported goods limited the impact of trade liberalization before 1993. This coincided with the recovery from the recession plus the upswing associated with implementation of the stabilization plan after mid-1994. The protracted reaction of import volumes helped to mitigate the resistance of domestic manufacturers to trade liberalization.[19]

The public at large, in turn, greeted the new import regime with enthusiasm, for the access to goods that had been unavailable to domestic consumers for decades. A wide range of producers also benefited from newly imported raw materials, parts, components and machinery and equipment of superior quality (Figure 1). This helps to explain the improved productivity performance of Brazilian firms as well.

FIGURE 1
SHARE OF IMPORTS IN TOTAL CAPITAL GOODS INVESTMENT — 1970-2001



The early 1990s also witnessed the introduction of new and modern management and organizational techniques, especially in manufacturing. The timing of the two phenomena coincided, leading firms in nearly all sectors to restructure defensively, further contributing to raise productivity, although at the cost of a substantial reduction in manufacturing employment [Bonelli (1999)]. By focusing on defending market shares, rather than seeking an expansion of activities, this kind of restructuring led to a concentration of investment in modernization.

However, unexpected changes increased uncertainty and helped to create a business climate against trade liberalization in many areas. Among these we might mention the anticipation of the timetable of tariff reduction, reductions of tariffs

18. The exchange rate was an anchor for the prices of tradables. High domestic interest rates attracted foreign capital and allowed for increasing trade deficits from 1995 to 1998 as exports grew only modestly.

19. Periodical surveys conducted by the Brazilian National Confederation of Industries in the first years after trade liberalization reveal that most firms did not perceive competitive imports as a threat.

anticipating the Mercosur Common External Tariff (CET) and other unexpected tariff reductions adopted with anti-inflation purposes.[20]

Revealed preference towards imports, compounded by a progressively overvalued exchange rate, fast domestic demand growth and slow progress of structural reforms contributed to increasing trade deficits. In a reaction to this—and as a response to pressures from sectors exposed to import competition—the government increased import duties on a number of consumer goods, some of which had been the object of tariff reductions only a few months before. At the same time, in order to check (so-called abusive) price increases of domestic goods, tariffs on a selected set of food products, chemicals, textiles and metallurgical products were reduced.

The pragmatic, flexible character of trade liberalization is clearly seen from these initiatives [see Baumann, Rivero and Zavattiero (1997)]. With an eye on curbing inflation and the other on responding to pressures from the most vocal groups and organized lobbies, the government pragmatically proceeded to manage a period of high growth, expressive productivity increases and stabilization of the economy from 1994 to 1997. One of the characteristics of import policies, especially with regard to Mercosur, were the frequent alterations of import duties of goods in CET's "exception list" so as to keep duties on certain products well above those accorded in Mercosur's CET.

Underlying the option for periodical tariff reductions was the concern to raise public support to the liberalization program. Thus, the way the tariff reduction schedule was organized was supposed to gradually increase access to imported consumer goods, without pushing the trade balance into a deficit or swamping domestic markets with imports, which would quickly stimulate resistance to trade liberalization. Foreign competition was expected to increase in the final stages of the process. By then, it would be important to have a clear perception of advantages stemming from liberalization, to guarantee support to the program's continuity [Kume, Piani and Bráz de Souza (2003 *passim*)].

Average tariffs were substantially reduced between 1987 and 1990, from 57.5% to 30.5% (Table 2). In 1987, import tariffs ranged from 15.6% to 102.7%. By 1990, a substantial narrowing had occurred, with tariffs ranging from 3.3% to (a still very high) 78.7%. Reductions continued up to 1994, when the average was 11.2%, and the interval ranged from 0% to 23.5%. But, as noted, when the September 1994 round of tariffs reduction took place it was clear that imports were growing too fast relative to exports. An opposite trend is observed after 1994, when tariffs are increased in some sectors, notably cars, trucks and buses. These tariff increases reflected the pressure from interest groups, but rising trade deficits were also behind this change in direction. Thus, in November 1997, authorities raised tariffs in 3 percentage points in a reaction to increasing current account deficits and the shortage of external finance after the Asian crisis, so that by 1998 the average tariff had

20. Anti-inflation objectives dominated import duties management in the second half of 1994. Among them, the reduction to 0% or 2% of import duties on inputs and consumer goods with significant importance in the domestic consumer price indices.

returned to 15.5%, the same level reached six years before, when liberalization was still under way.

TABLE 2
NOMINAL TARIFFS (WEIGHTED BY FREE TRADE VALUE ADDED), BY SECTOR—SELECTED YEARS
[%]

Sector	1987	1990	1991	1992	1993	1994	1995	1998
Simple average	57.5	30.5	23.6	15.7	13.5	11.2	12.8	15.5
Weighted average (weights: value added)	54.9	27.2	20.9	14.1	12.5	10.2	10.8	13.4
Standard deviation	21.3	14.9	12.7	8.2	6.7	5.9	7.4	6.6
Maximum tariff	102.7	78.7	58.7	39.0	34.0	23.5	41.0	38.1
Minimum tariff	15.6	3.3	1.7	0.6	0.0	0.0	0.0	0.0

Source: Kume, Piani and Bráz de Souza (2003).

The sector structure of effective protection also varied considerably with liberalization, with significant increase in external competition (Table 3). In 1987, the five most protected sectors were cars, trucks and buses (308.1%), textiles (123.1%), rubber products (122.4%), processing of vegetable products (121.6 %) and footwear (117.2%). Rates above 100% were not uncommon. The least protected industries were oil and coal extraction (8.3%), chemicals, miscellaneous (12.3%), mining (16.9%), steel (30.9%) and plastics (31.4%). Successive rounds of tariff reduction in 1990-1993 brought the average effective tariff down from 37% (1990) to 15.2% (1993). The standard deviation went down from 60.6% in 1990 to 13.5% in 1993. [21]

TABLE 3
EFFECTIVE PROTECTION RATES (WEIGHTED BY FREE TRADE VALUE ADDED)—SELECTED YEARS
[%]

Sector	1987	1990	1991	1992	1993	1994	1995	1998
Simple average	77.1	47.7	34.8	20.3	16.7	13.6	17.1	20.2
Weighted average (weights: value added)	67.8	37.0	28.6	17.7	15.2	12.3	10.4	16.2
Standard deviation	53.8	60.6	36.5	17.2	13.5	8.4	19.5	21.3
Maximum tariff	308.1	351.1	198.3	93.5	76.5	27.7	113.8	129.2
Minimum tariff	8.3	–3.4	–4.0	–4.0	–5.0	–4.9	–2.4	–2.2

Source: Kume, Piani and Bráz de Souza (2003).

4.2 PRIVATIZATION

It is not straightforward to say in which of the categories discussed in Section 2—ideological, partisan, bundled, pragmatic—Brazilian privatization fits best. Sprawling over the last 20 years, with total revenues of close to US$ 83 billion and almost 170

21. Effective protection on cars, trucks and buses declined from 351% in 1990 to 76.5% in 1993 and to only 27.7% in 1994, after which protection increased substantially, to 129.2% in 1998, stressing the favorable protection awarded to the auto sector throughout. Even in the most unfavorable (to the industry) year (1994), effective protection on cars, trucks and buses was still twice the average of all sectors. In 1998 the ratio was on the order of 6.5. Protectionist interests in the sector are supported by many interest groups, ranging from the industry itself to powerful labor unions, auto dealers, politicians and government officials who frequently call attention to the income and employment generating effects associated with the industry's performance.

SOEs transferred to the private sector, privatization led to substantial changes in the country's economic and political landscapes. Yet, privatization in Brazil was above all a pragmatic response to short-term macroeconomic problems, arising mainly from the disarray of the country's fiscal accounts [Pinheiro and Giambiagi (2000)].

Privatization entered the economic policy agenda in 1981, when the Special Privatization Committee was created.[22] Overall, 38 companies were privatized in 1981-1989, grossing US$ 723 million in revenues. A number of other small SOEs were closed down or transferred to local governments. In this same period, however, six companies in a bankrupt situation were incorporated by the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), through what were then called "hospital operations". Most of the sales in the 1980s were carried out by the BNDES, whose motivation for privatizing owed more to the need to free itself of problematic, loss-making companies than to a favorable perception about privatization on the part of the government: the president of the BNDES in the late 1980s, and a central figure in this early phase of Brazilian privatization, put the issue in the following way:

> "Privatization, in reality, was not such a central policy. It was the need which the BNDES had, primarily, to generate funds from within its own equity holdings, secondly, to obtain liquidity for its normal activities, and, thirdly, because its own internal management was greatly weakened by the build-up of necessary management activities in its day-to-day routine. It was, after all, owner or controlling stockholder of more than 25 highly complex companies" [Fortes (1994)].

In 1990 the Collor Administration launched the Brazilian Privatization Program (PND), significantly widening the scope of privatization. Privatization was bundled together with the stabilization program launched at the time, to an extent that their own intrinsic logics were closely tied together.[23] The stabilization plan was based on freezing public securities at the Central Bank for 18 months. The main idea was to encourage a swap between frozen public debt securities and SOE shares, at once reducing public indebtedness and creating a captive demand for the privatization program.

The synergy between stabilization and privatization failed due to problems in both programs. Privatization began with very optimistic targets regarding revenue and timetable, which turned out impossible to fulfill due to the bad financial situation of the SOEs and the complexity of stockholders' agreements. It was only at the end of 1991 that the first company was sold under the PND. Since at that time

22. The main objectives of the Committee were to strengthen the private sector, limit the creation of new SOEs, and close or transfer to the private sector the SOEs whose control by the public sector was no longer necessary or justifiable either on economic terms or by national security concerns.

23. In 1989 Brazil experienced a near hyperinflation episode, ascribed by the new administration to the high liquidity of the public debt, which caused public securities to function as quasi-money. That is, inflation would be caused by a high supply of money in the economy, and any attempt to reduce the flow of new debt entering the economy by lowering interest rates could precipitate a run into real assets and goods.

the public debt was starting to return to private investors, regaining their liquidity, their use as a privatization currency turned out to negligible.[24]

As the failure of the government's stabilization plan became increasingly evident, the administration started to rely on the PND as proof of its commitment to structural change. To a large extent, this reflected international pressures from multilateral organizations—then a major source of external finance—and foreign investors in general. In a sense, it was a typical case of a government trying to slip into Friedman's (1999) Golden Straitjacket in order to integrate into the world economy. As characterized by Rodrik (2000, p. 182), a government trying to compete with others puts on this straitjacket "by pursuing policies that they believe will earn them market confidence and attract trade and capital inflows: tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around".[25] Indeed, this Golden Straitjacket effect was so strong that the PND continued after Collor's impeachment and his replacement by a president who had previously publicly voiced his opposition to privatization.

Although representing a substantial expansion with respect to the 1980s, the scope of privatization in the early nineties would be severely limited by rising inflation and low growth, which reduced the already compressed levels of domestic and foreign investment. In all, 33 companies were privatized during the Collor and Franco governments (1990-1994). Total revenues reached US$ 8.6 billion (Table 4).

Almost all companies were in manufacturing, with revenues concentrated in the steel, petrochemicals and fertilizer sectors. The companies selected for sale had in common the fact that they belonged to relatively competitive sectors or to ones for which trade liberalization would create a competitive environment. The privatization of the state monopolies was not even considered at the time.

Brazilian privatization reached its peak during President Cardoso's first term (1995-1998), when 80 companies were sold, grossing US$ 73.3 billion in total proceeds. In only five years (1996-2000), the state greatly reduced its participation in telecom, electricity, railways, ports, roads, and water and sanitation. The telecom and railroad sectors and most port terminals were completely privatized. In the electricity industry, private participation rose from almost nil to 63% in distribution and 22% in generation. Private participation remains less significant in roads and water and sanitation, but there too it expanded quite remarkably, considering the intrinsic characteristics of these sectors.

---

24. Tying together privatization and a reduction in the public debt would continue to be pursued. However, other, less liquid debt securities had to be included in the basket of "privatization currencies", thus weakening the initial logic of the two programs.

25. In Friedman's (1999, p. 87) vivid original formulation, "as your country puts on the Golden Straitjacket, two things happen: your economy grows and your politics shrinks (...).(The) Golden Straitjacket narrows the political and economic policy choices of those in power to relatively tight parameters. This is why it is increasingly difficult these days to find any real differences between ruling and opposition parties in those countries that have put on the Golden Straitjacket. Once your country puts on the Golden Straitjacket, its political choices get reduced to Pepsi or Coke—to slight nuances of tastes, slight nuances of policy, slight alterations in design to account for local traditions, some loosening here and there, but never any major deviation from the core golden rules".

TABLE 4
PRIVATIZATION PROCEEDS AND NUMBER OF SOES SOLD—1991-2002

Year	Proceeds (US$ million)[a]					Number of SOEs		
	Federal level	State level	Total	GDP (%)	Privatization related FDI	Federal level	State level	Total
1991	1,614		1,614	0.4	[b]	4	–	4
1992	2,401		2,401	0.6	[b]	14	–	14
1993	2,627		2,627	0.6	[b]	6	–	6
1994	1,966		1,966	0.4	[b]	9	–	9
1995	1,004		1,004	0.1	[b]	8	–	8
1996	4,080	1,406	5,486	0.7	2,645	16	2	18
1997	8,999	13,617	22,616	2.8	5,249	21	15	36
1998	23,478	7,497	30,975	3.9	6,121	7	11	18
1999	554	2,648	3,202	0.6	8,766	6	5	11
2000	7,670	2,752	10,422	1,7	7,051	1	5	6
2001	2,905	27	2,935	0,6	1,079	1	1	2
2002	2,233	–	2,233	0,5	280	1	–	1
Total	59,531	27,949	87,480	–	31,191	94	39	133

Sources: BNDES and Central Bank.

Note: Data on proceeds is distributed according to year of sale, whereas for privatization related FDI according to year in which resources actually entered the country. [a] Includes sales of minority shareholdings. [b] Information not available prior to 1996. Foreign participation in the privatization program prior to 1996 was, though, close to nil.

Two related developments led to this substantial expansion in the size and scope of privatization. One was the engagement of state (regional) governments in the privatization process, leading to the sale of several electricity distribution companies, in addition to a number of smaller companies in banking, transportation, and other sectors. Another was the decision to amend the constitution to discontinue public monopolies and end discrimination against subsidiaries of foreign companies. This opened the opportunity to extend privatization to telecommunications, electricity, gas distribution and mining, where Brazilian largest SOEs were present. During this period, other sectors controlled by the state for decades, such as the railways and ports, were also partly or totally transferred to the private sector.[26]

Several factors contributed to these two movements. First, the repeated failures of successive governments to control inflation had limited their ability to follow a more aggressive privatization program. The success of the Real Plan in stabilizing the economy gave the government the political leverage required to get the necessary constitutional amendments through Congress, so as to extend privatization to the telecom and gas sectors and to facilitate its progress in mining and electricity.

Second, to sustain price stability the government needed to achieve fiscal discipline, and this limited its ability to carry out the high levels of investment necessary to increase supply at the pace required by the recovery in economic growth.

26. See the papers in Pinheiro and Fukasaku (2000) for further discussion on privatization during President Cardoso's first term.

Also, for fiscal reasons, economic policy limited the access of SOEs to domestic and external financing.

Third, the regional states saw in privatization an important source of funding, which would allow them to reduce their debt and, in some cases, expand spending. Moreover, in the debt restructuring contracts between the states and the federal government the latter included clauses that required the states to downpay part of the principal. This could be done only through the sale of their assets, i.e., through privatization [Pinheiro and Giambiagi (2000)]. An additional stimulus was provided by the contracts of the states with the BNDES, which allowed the states to borrow against future privatization revenues.

Fourth, stability itself, and the change in the perception of risk and growth potential of the Brazilian market—reflected, for example, in the growth in FDI flows—helped to increase company values, thereby increasing the appeal of privatization.[27]

Fifth, the success of privatization carried out in 1991-1994, evidenced by the companies' increased efficiency and investment, helped to widen political support for the program. Pinheiro (1996*a*) shows that privatization substantially improved the performance of the former SOEs, with significant increases in real sales, sales per employee, net profit, stockholders' equity, investment, fixed assets and the ratio of investment to sales. Efficiency practically doubled when measured in terms of sales per employee, increasing 83% when gauged by labor productivity. Profitability went from negative to positive, stockholders' equity increased by a factor of almost five, while debt diminished and liquidity increased. The median investment also increased almost by a factor of five, rising more than four times as a proportion of sales and more than doubling in relation to fixed assets. Sales per employee rose in 92% of the companies privatized, net profit in 78%, investment in 93% and labor productivity in all of them.

Of all the factors contributing to expand privatization in Cardoso's first term, the most important was the role played by privatization in sustaining his stabilization program, the Real Plan. With the large sales of 1997-1998, Brazil attracted sizable volumes of FDI, which helped to finance the country's current account deficit.[28] Privatization was also instrumental in averting an explosion in public debt, in spite of the growing fiscal deficit posted since 1995. Carvalho (2001) shows that thanks to the predominant use of privatization to abate public debt, in December 1999 it was 8.4% of GDP lower than what it would have been without privatization.

For various reasons, the privatization process decelerated to almost a complete stop under Cardoso's second term (1999-2002). Foremost among those was the decline in popular support for privatization.[29] But also relevant were the reduced pressures stemming from the needs of macroeconomic policy—as a result of changes

27. Economic instability was also the main (though not the only) reason for the lack of interest of foreign investors in Brazilian privatization until 1994.

28. In 1997-2000, the ratio between FDI inflows associated with privatization and the current account deficit averaged almost 25%.

29. See for instance the results of the Latinobarómetro survey reported in *The Economist* (2001, p. 37-38).

in the fiscal regime and a large inflow of non-privatization related FDI—and the rising technical and political complexity of privatizing the remaining SOEs. As a result, the state remains the owner of sizable assets in the electricity (generation and transmission), oil, financial and water and sanitation sectors.

This account reveals that privatization was not much different in motivation from the process of nationalization in the post-World War II period, when SOEs were created to overcome specific barriers in certain sectors. Ideology and the pursuit of structural adjustment were motivations espoused by only a fraction of those in charge of taking the process forward [Velasco (1997*a* and *b*)]. In fact, many opinion polls showed that throughout the 1980s and 1990s a relevant share of the electorate opposed privatization, especially after 1999. In many instances, the reason to move forward was the bundling of privatization with macro stabilization, and the perception that privatization was instrumental in achieving stability. Also important were international pressures and the view that the poor situation of the fiscal accounts blocked a rise in much needed investment, which was expected to occur under private ownership.

4.3 REGULATORY REFORM

Until the mid-1980s, direct ownership and the powers of a dictatorship made economic regulation, in the sense that it is commonly understood, of lesser importance. In key sectors of the economy, such as infrastructure and finance, SOEs were dominant, and regulation was done directly, through the appointment of the president and executive directors of these companies. Whenever present, regulatory agencies were weak and captured by the firms they were supposed to control. In most other modern sectors, the state controlled much of the private sector's investment through fiscal and credit incentives, tight entry controls, and direct supervision by sector ministries and agencies.

State retrenchment and the return to democracy have required, therefore, that a new regulatory apparatus be put in place. To some extent, the same may be said of price stability and the need to achieve fiscal discipline. These at the same time required institutional changes of itself and imposed limits to former regulatory practices that depended on access to fiscal subsidies. Thus, most sectors in the economy have been subjected to some kind of regulatory reform.

During the 1990s Brazil adopted a number of initiatives to increase competition in domestic markets, by freeing firms and markets from many administrative controls introduced during the ISI period, and by strengthening competition agencies. A first set of measures was implemented by the Federal Deregulation Program,[30] under the

30. This program, established in March 1990, was quite active until Collor's impeachment in late 1992. Brazil (1991-1992) give an account of the main initiatives implemented in that period.

aegis of which 113,752 presidential decrees were revoked, from a total of 123,370 decrees issued in the previous hundred years.[31]

Yet, despite all these simplifications, the bureaucratic burden faced by firms is still perceived as rather heavy when compared to other developing countries. This is exemplified by Djankov et al. (2000), who show that Brazil fares worse than average among 75 countries regarding the procedures to start up a company. The number of procedures necessary to start up the firm, the official number of working days necessary for completing those procedures, and the financial cost of doing so, as a proportion to per capita income, are all above average.

Another set of measures were aimed at strengthening anti-trust and consumer protection policies. In 1991, the anti-trust law enacted in 1962 was reinforced by new and more stringent legislation; in the same year, a Consumer Protection Law was enacted; in 1994, a new anti-trust law was passed, consolidating the legislation on competition, while establishing harsher penalties and more expeditious enforcement.

Other measures focused on the elimination of a host of legal restrictions limiting entry into a number of non-tradable sectors. Foremost among these were the constitutional amendments that discontinued public monopolies in oil and infrastructure and the differential treatment afforded to national and foreign companies. The oil sector, since 1953 a monopoly operated by a state-owned enterprise, was opened up to new entrants. A new regulatory agency was created. The gas sector was also opened up, after a constitutional amendment discontinued the public monopoly introduced by the 1988 Constitution.

Other, infra-constitutional, distinctions, such as the restrictions imposed by Law 4131 on the access of foreign firms to public credit, were also discontinued. The end of legal restrictions limiting entry and establishing price controls in a number of sectors such as civil air transport, ports, interstate and international road transportation, the distribution of fuels and the distribution and transportation of steel also encouraged competition. Nationwide price equalization was discontinued for fuel and other prices and services.

The end of the high inflation era in mid-1994 exposed the deficiencies of bank supervision in Brazil, and triggered a process of reform that has produced better and more stringent regulation, particularly regarding minimum capital requirements. Corporate governance law was also changed and Comissão de Valores Mobiliários (CVM), the agency responsible for regulation and supervision of capital markets, was restructured and strengthened, becoming more autonomous from the government.

It was in infrastructure that regulatory reform was most significant. Infrastructure regulation started to change in the early 1990s, but the first critical steps were given in 1995, when a Concessions Law was approved and the

31. Other initiatives included *a*) the end of public monopolies in exporting coffee and sugar and importing wheat, and the need for prior government approval for exporting and importing other products, such as steel; *b*) greater flexibility in shopping hours and foreign investment regulation; *c*) the reduction in the minimum national content level for a project to qualify for public credit; *d*) a reduction in the red tape in citizens' lives, with a substantial simplification of documentary, tax, and utility billing procedures; and *e*) a simplification of foreign trade paperwork.

constitution amended to end public monopolies in telecom and pipeline gas distribution and discontinue the restrictions to foreign entry in some key sectors, in particular electricity generation. Together with privatization, these six sectors also experienced the dismantling of their regulatory framework, which in some cases had been in place for half a century.

Although the reform process evolved independently in the various sectors, with differences in timing and emphasis, the diagnosis that motivated it and the principles underscoring the new regulatory model put in place were essentially the same. Thus, in all sectors reform was motivated by the perception that the state-led model in place since the mid-twentieth century had exhausted its usefulness. As shown in Table 5, the investment slump of the 1980s had greatly reduced the pace of expansion in infrastructure output capacity. These sectors badly needed an inflow of investment that was beyond the reach of the public sector, on account of the fiscal crisis, which not only reduced capital transfers to SOEs, but also imposed policy constraints on their ability to invest, even when they would have been able to raise funds in the market.

TABLE 5
AVERAGE ANNUAL RATES OF EXPANSION IN SELECTED INFRASTRUCTURE SECTORS
[%]

	Railways	Electricity generation	Paved roads	Telecom
1931-1950	0,6	4,5	5,1	
1951-1963	–0,3	9,8	23,9	6,8
1964-1980	–1,6	9,8	16,0	11,2
1981-1993	1,0	4,1	4,9	6,9
1994-2002[a]	–0,5	3,8	1,5	22,9

Source: Pinheiro (2003).

[a] For railways and paved roads, average rates in 1994-2000.

Bringing in private investors was the solution to raise investment without sacrificing fiscal discipline. However, because infrastructure sectors lacked a good regulatory framework, this needed to be revamped if private capital was to be attracted. Traditionally, regulation and supervision had been entrusted to departments in the sector ministries that controlled the corresponding SOEs. These departments lacked independence from the government, were captured by SOEs, and did not control tariffs—which were set by the Ministry of Finance, in accordance with macroeconomic objectives. Price structures carried a number of cross-subsidies, across consumer groups and companies, leading to allocative and technical inefficiency. Lack of proper regulation also meant that SOEs were left unaccountable regarding the quality of services offered to consumers, not the least because they faced no competition. Moreover, sector ministries had lost their ability to plan and set policy, activities which were often left out to SOEs.

Regulatory reform had similar objectives and followed the same blueprint in all sectors. The main objective was to attract private investors and give them the ability and incentives to operate efficiently and expand output capacity. Private ownership and competition were expected to raise efficiency and, together with adequate tariffs and the higher creditworthiness of the new private owners, facilitate the access to finance, fostering higher investment levels. Moreover, in private hands former SOEs would be able to base investment decisions on their own business criteria, rather than on government's goals.

The new policy separated the policy, regulatory and business activities in each sector, with policy ascribed to the sector ministry, regulation entrusted to an independent agency, and business activities left with sector SOEs (which were supposed to be eventually privatized). Regulatory agencies were to control prices—subject to the rules set out in the concession contracts and the general principle of financial and economic equilibrium of the concession established in the Concessions Law—and enjoy administrative and financial independence, playing the dual role of fostering investment and efficiency while guaranteeing private investors from the risk of administrative expropriation. Competition, to the extent possible, would encourage technical and allocative efficiency, which together with adequate tariffs and the protection of an independent regulator would help the new operators to secure the capital necessary to finance the required investments.

As a rule, the concern to introduce competition was reflected in the setting up of non-monopolistic industry structures, at least on a nationwide scale, with several SOEs being separated horizontally and vertically before privatization. Examples of horizontal separation include the railroad, electricity and telecom sectors, and examples of vertical break-ups telecom and electricity. In addition, limits were imposed on the participation of individual investors in different markets, regional and national, and even on the ownership structure of some companies (such as the railroads).[32]

The importance of optimal sequencing, with regulatory reform preceding privatization, was also in general recognized in all sectors, although not always followed in practice. Thus, except for telecom, reform stopped midway in all sectors and faced serious sequencing problems, with privatization often preceding the setting up of regulatory agencies. These were sometimes established before an overarching regulatory framework had been defined for the sector. Sequencing problems reflected the importance of fiscal adjustment objectives in pushing privatization forward (both at the regional and at the federal level), the fact that different agencies were in charge of privatization and regulatory reform, and the resistance to change by sector insiders. Indeed, when fiscal adjustment and the weaker exchange rate put the Real Plan on sounder footing, in early 1999, the priority ascribed to privatization declined considerably, causing the reform process also to lose steam, notably in the electricity sector.

The most successful case of privatization cum regulatory reform is, undoubtedly, telecommunications. The process began with the approval of the so-called "Minimum Law", which enabled the B-Band cellular telephony concessions to be auctioned.[33] When privatization took place, the entire regulatory structure was already established and the regulatory agency responsible for the sector was

32. For a general discussion and analysis of Mexico, see Mariscal (2002).

33. The B-Band companies are private sector firms operating in a range of the spectrum different from the one used by former SOE operators, this being called A-Band.

functioning at full steam. Lately, though, regulation has been weakened by the constant recourse of concessionaries to the judiciary to solve disputes supposed to be arbitrated by Agência Nacional de Telecomunicações (Anatel).

Implementation of regulatory reform in the electricity sector was much less successful.[34] The order of events tended to limit the capacity of the regulatory agency to operate and, as a result, limited its prestige in the eyes of the public at large. Moreover, electricity regulation lacked a clear separation between the functions of the various agencies involved, reducing the accountability of the various institutions. In 2001, a severe power shortage brought to light (no pun intended) several flaws in the regulatory framework of the electricity sector, and led to a virtual paralysis in the reform process.

In transportation, regulatory reform was more successful in some segments than in others. Privatization of highways was closely based on franchise bidding as an alternative to economic regulation. In federal privatization auctions, a minimum set of investments was defined, including rehabilitation and expansion of the existing network, and the concession was granted to the bidder who offered to charge the lowest toll rate. Once this was decided, regulation was limited to inspection of investment and operation activities and the annual tariff adjustments. The states, which as a group privatized nine times as much as the federal government, followed a similar model, but some of them charged a fixed positive price for the right to explore the concession. Most of the road network remains, though, in state hands and its concession to private operators has been delayed by implementation and political problems.

In the privatization of ports, the emphasis was on container terminals, since private terminals already handled most bulk and liquid cargo. Container terminals in all Brazil's major ports were privatized [see Doctor (2000)]. The evidence so far is that these privatizations made possible a considerable increase in investment and productivity, yet only a minor part of this rise in productivity translated into lower prices for consumers. The explanation for the lack of price reductions appears to be the absence of significant competition, which in turn resulted from two factors: high concentration of traffic in the port of Santos (above 40%), and the low efficiency of the railroads. Moreover, the regulation of ports remains insufficiently structured.

The privatization of railroads included the Rede Ferroviária Federal S.A. (RFFSA), the former federal railroad network, Ferrovia Paulista S.A.(Fepasa), Estrada de Ferro Paraná Oeste S.A. (Ferroeste) and the railroads owned by Companhia Vale do Rio Doce (CVRD), sold with the rest of the company.

Water and sanitation are the sectors in which least progress was accomplished by way of regulatory reform and privatization. Although there have been privatizations in several municipalities, some initiatives were aborted and none of the large state companies has yet been sold. There is an enormous regulatory *imbroglio* in this sector, with both states and municipalities claiming the right to award (i.e., sell) concessions. Curiously enough, privatization of sanitation seems to be high on the

34. Agência Nacional de Energia Elétrica (Aneel), the sector regulator, was created only in 1997, two years after privatization in the sector had begun.

recentlyelected government's agenda, although it is unclear how it plans to overcome the problems that have hindered it so far.

Regulatory reform and ownership change succeeded in increasing productivity and investment in all infrastructure sectors, but from low levels. In particular, whereas the new private owners invested in rehabilitation and modernization, not much was invested in new projects, so the expansion in output capacity was rather limited. Indeed, Table 5 shows that in the second half of the 1990s, infrastructure output capacity expanded even more slowly than in the previous decade. The telecom sector was the major exception and its output capacity increased annually at double digit rates after reform began.[35]

In other infrastructure sectors, though, reform failed to produce the rise in investment necessary to achieve a substantial expansion in output capacity. The reasons for that include lack of a regulatory model; overlapping responsibilities and poor inter-agency coordination; weak or no agencies; problems with vertical integration or cross ownership of companies; and reform process stopped midway. There are, though, nuances across sectors, with the necessary amendments illustrating well the implementation shortcomings of regulatory reform in Brazilian infrastructure.

There are also four issues that cut across the various infrastructure sectors. First, while great emphasis has been placed on establishing and strengthening regulation, and using privatization to improve the performance of sector SOEs, little attention was given to providing the sector ministries with capacity and instruments to carry out policy and planning activities. This has often resulted in the lack of well designed sector models that could help to structure the institutional framework in which regulation and business activities were to take place. Second, government commitment to the new overall framework adopted for infrastructure has often been lacking, raising uncertainty and lowering investment. Third, it is necessary to develop finance and risk management instruments that facilitate infrastructure investment, particularly in greenfield projects. This increment in investment is also dependent on long-term funds and characterized by risks that are high and different from those faced by standard commercial business. It is important, in this regard, not to underestimate the role of earmarked funds in financing the expansion of infrastructure from the fifties to the eighties. So, financial sector reform, and in particular lowering of the cost and expanding the supply of capital, seems to be a critical element in a strategy to increase private participation in infrastructure. This seems to have been a key point somewhat overlooked in the reform process. Fourth, the Judiciary is unprepared to deal with disputes concerning the regulation of infrastructure sectors. In recent years, the courts were asked, typically by private

35. Four features of regulatory reform in the telecom, acting together, seem to have been crucial in producing this outcome: *a*) a tariff hike that ended cross-subsidies and brought telecom rates to international levels; *b*) good sequencing of reform; *c*) heavy and increasing promotion of competition, following a well publicized timetable; and *d*) access to finance at competitive rates. Moreover, the telecom sector had other unique features, unrelated to regulatory reform, that were also critical in fostering change and a substantial rise in investment: rapid technical progress, increased product diversity, large market growth potential, and no need for complex inter-government coordination in the privatization and regulatory reform processes.

concessionaires, to interfere in regulatory decisions in the telecom, transportation and electricity sectors.[36]

4.4 FISCAL REFORM AND DECENTRALIZATION

Fiscal reform is an instrument aimed at achieving both the objectives of tax efficiency and political devolution. Thus, one of the main issues in the Brazilian economic-political agenda in the late 1980s concerned the quest for fiscal decentralization, after a long period, under military rule, of progressively concentrated economic and political power at the federal level. Democratization brought strong demands for less centralism and more devolution. This desideratum was further reinforced in the 1990s by the fact that fiscal decentralization was very much in vogue during the decade, in the industrialized and in the developing world, as many governments turned to devolution to improve the performance of their public sectors. Brazil was no exception. But, as we suggest in what follows, increased expenditures and assumed debts of various kinds fueled fiscal crises that constrained the possible courses of action insofar as fiscal reform is concerned.

Indeed, international multilateral agencies' recommendations constituted additional factors in favor of enforcing fiscal decentralization. Both the International Monetary Fund (IMF) and the World Bank have been very much in favor of decentralization (the so-called golden straitjacket being the form through which their action constrains independent strategies from developing countries). But, this issue is far from settled. After reviewing the subject one expert recently argued against broad generalizations when he stated that: "(...) the potential of fiscal decentralization for improving economic and political performance must be evaluated in terms of the specific circumstances that characterize the current state of a developing nation" [Oates (1999, p. 1.143)].

At a more theoretical level, we note that, although providing general guidance for the assignment of functions and revenues among different levels of government, the theory of federalism does not define a precise optimal extent of decentralization. So policy makers tend to be on their own when making this choice, relying mostly on pragmatic and political answers to specific challenges, with history having been found to have a bearing in most cases during many times—except when institutional change enters the picture in a significant way. Again, Brazil is no exception. Indeed, one of the conclusions of a recent survey on fiscal decentralization in Brazil reads:

> "Historically, Brazilian experience with fiscal federalism has been marked by ups and downs in the degree of fiscal decentralization. Satisfactory conciliation between the need to ensure a reasonable degree of financial autonomy for sub national governments, on the one hand, and the requirement of coordinating fiscal instruments in order to serve national interests, on the other, has not yet

36. Pinheiro (2003) shows that Brazilian judges tend to consider non-economic matters when deciding about issues concerning the regulation of public utilities, and believe that they should go into the merit of the disputes—in contrast with just guaranteeing that due process was respected—even when these were the object of decisions taken by the board of regulatory agencies. The slowness and politization of judicial decisions are elements that increase the risk of private infrastructure investment, and making the Judiciary more agile, predictable and impartial would help reduce the risk and increase investment.

been attained. The 1990s did not bring about a consolidated model of federalism but a transition process characterized by attempts to correct the aftermath of both excessive centralization and immoderate decentralization experienced in sequence in the past. The preservation of fiscal decentralization may require the imposition of restrictions on the autonomy of subnational governments, this time for economic rather than for political reasons" [Mora and Varsano (2001, p. 5)].

Over the past several decades Brazil's history is marked by a too frequent alternation and unresolved tension between centralism and decentralization. The tax reform in the late 1960s led to the concentration of tax revenues and spending at the federal level. In the following years, state governments tried to compensate for their low capacity for tax collection by increasing SOE spending, partly financed by foreign loans, and with intensive use of state banks, both as sources of loans and as government bonds bearers, to bypass fiscal restrictions. In the early eighties, growing current expenditures, the states contracted their investment spending and restricted social policies. Pressed by the subnational units, in 1983 the federal government started an effective revenue decentralization process, which culminated with the 1988 Constitution. The constitution ended 20 years of political and fiscal centralism, enhancing fiscal autonomy of states and municipalities and decentralizing tax revenues.[37] But the 1988 Constitution was much shyer in decentralizing expenditures, leading to a fiscal imbalance at the federal level and the resurgence of a fiscal crisis as expenditures were transferred to the Federal level.[38]

The fiscal crisis in Brazil was, particularly after the new constitution was enacted, important in stimulating changes in the development strategy—and some forms of market reform—as it became clear that the state would not be able to finance the huge amounts of additional physical capital needed in infrastructure, energy and, in general, the activities in which the state had been directly involved in providing goods and services since the late 1940s—an argument that supported the privatization process in the 1990s. Many policy makers and managers of SOEs gradually recognized—after the fiscal crisis of the 1980s and the fiscal decentralization after 1988—that the federal government would not be able for the foreseeable future to finance their rapidly growing investment needs. Investment would therefore have to come from the private sector and privatization became a pragmatic measure to gain access to private investment.

Despite the re-concentration of revenues in the late 1990s, resulting from the greater reliance of the federal government on social contributions (which are not shared with subnational units), Mora and Varsano (2001) note a continued reinforcement of decentralized policy implementation and cooperation among government levels, and yet, concurrently, the reduction in the fiscal autonomy of

37. States were conferred a power which they did not have before: that of setting the rates of their respective value added taxes, the Imposto sobre Circulação de Mercadorias e Prestação de Serviços (ICMS); federal government power to grant exemptions from state and municipal taxes was eliminated; and the imposition of conditions or restrictions on the distribution and on the use of shared revenue was forbidden.

38. The Brazilian Constitution determines which activities should be performed or regulated exclusively by the Union and by the municipalities. States may carry out all those functions that are not interdicted to them by the Constitution. Several activities are executed simultaneously by the three levels of government.

Brazilian states and municipalities.[39] The perception behind this trend is that devolution and cooperation among different levels of government increase the efficiency of public entities.

It also facilitates implementation of social policies in a context of wide intranational income inequality. Lower autonomy, in turn, reflects the need to reach fiscal discipline.[40] In what follows we discuss how the simultaneous, contradictory trends of re-centralization of revenues and devolution of responsibilities reflect the federal government's pragmatic reaction to political pressures from lower levels of government and to changing macroeconomic conditions. Therefore, the reduction in the federal government's revenue resulting from the changes introduced by the 1988 Constitution led to an unsustainable fiscal situation and made adjustments necessary. The obvious one, consistent with the goal of devolution, would have been the decentralization of responsibilities. But the states resisted, leading to a disorderly process in which the federal government simply discontinued some activities to adjust its budget.

Decentralization of responsibilities was also hindered by the fact that the constitution established that social security and education activities were to be financed by revenues collected at the federal level.The federal government sought to boost its tax proceeds, by creating new taxes and raising rates on social contributions (a kind of tax that is not shared with subnational governments), with three important effects: *a*) they counterbalanced decentralization promoted by the constitution and, indeed, brought about some re-centralization; *b*) the quality of the tax system worsened;[41] and *c*) as no compensating tax reduction occurred in states and municipalities, total tax burden increased to new peaks (see Figure 2).

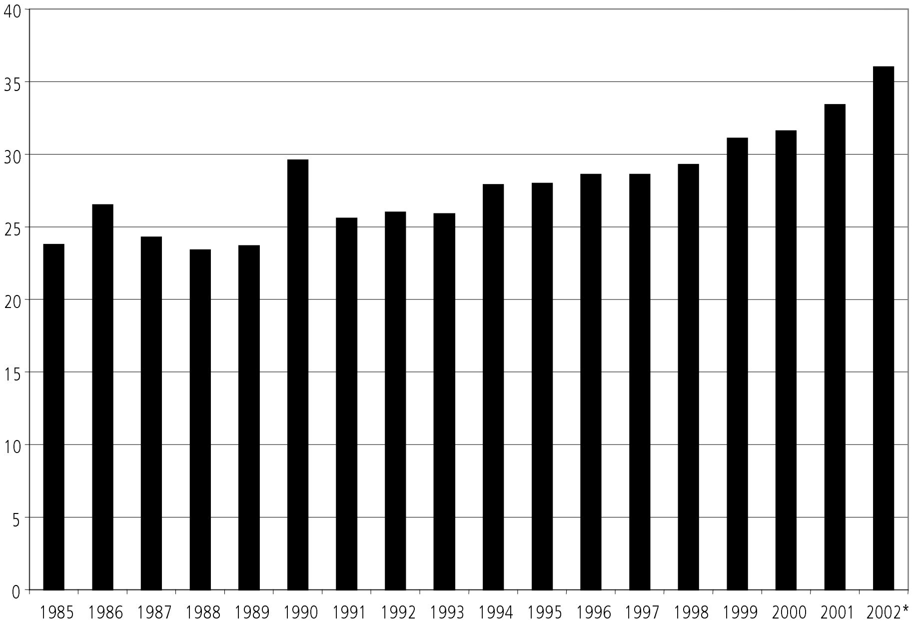
The increased tax burden was also necessary to meet increased expenditures arising from changes in the social security regime of civil servants and increased sub-national borrowing in previous periods. To deal with this last issue and discipline overall expenditures the Brazilian government recently enacted the Fiscal Responsibility Law. We deal with each of these three issues in turn.

39. Much of the remainder of this section is based on Mora and Varsano (2001).

40. The need for a tax reform that improves the quality of the tax system and prevents fiscal war among states is also clear from their analysis and a matter of Congressional concern. There is also a growing concern in Brazil about: *a*) the impact of taxation on economic efficiency and on the competitiveness of private firms; and *b*) the for international tax harmonization, due to increased openness of the economy and to regional economic integration. The present tax reform proposal, now in Congress, deals timidly with the first of these issues.

41. The income tax and the Imposto sobre Produtos Industrializados (IPI), a partial value added tax on industrialized products, are good quality federal taxes. They are the main sources of financing for all federal expenditures but those related to social security activities. Forty four percent of their revenue is set apart for Fundo de Participação dos Estados (FPE) and Fundo de Participação dos Municípios (FPM), the major federal tax sharing devices. Furthermore, another 10% of the IPI proceeds are shared with states.

FIGURE 2
BRAZIL: TAX BURDEN — 1985-2002



The Social Security Regime of Civil Servants

Prior to the 1988 Constitution, two different regimes applied to labor relations between government and its employees. Some employees were hired according to the same rules prevailing for the private sector (*CLT regime*), while others were hired under legal rules specific of the public sector (*statutory regime*). For the first group, retirement proceeds and pensions for surviving dependents were equal to those paid to private employees. Their value is subject to a ceiling. For the second group, full final salaries were paid after retirement and to surviving spouses. The constitution unified the public employment regimes. After its regulation, the *single juridical regime* has applied to all public sector labor relations. In this regime, like in the case of the *statutory regime*, retired and active servants perceive equal remuneration. This change brought about a short run positive cash flow to state and municipal finances but a huge long-term imbalance.

Civil servants social insurance policy has been traditionally conceived as an extension of personnel policy. There is not a pension fund based on sound actuarial calculations. Employees pay a contribution, which is not earmarked to a retirement plan and is actuarially insufficient to finance the payment of full wages that civil servants are entitled to receive for the whole life. In the case of states, retirement and pension payments amounted, on average, in 1997, to 30% of total personnel expenditures or, equivalently, to around 20% of states' net current revenue. Though it troubles almost all states, the social insurance problem is more severe in those were debt service payments are also large.

Civil servant social insurance is in a process of reform in all levels of government. The basic proposal is to create a new retirement plan in which receipts and payments are actuarially balanced. The trend is to depart from the present pay-as-you- go system to a hybrid one in which retirement and pension payments by the government would be limited to a ceiling, and the civil servants, upon additional contribution to a pension fund, would be able to get an income complementation.[42]

Subnational borrowing is an issue that presents the characteristics of a typical federative relation, in view of the important role played by the federal government. First, the federal government—and, more specifically, the Federal Senate—is responsible for regulating subnational borrowing. Second, it has generally been the lender of last resort to subnational units, also acting as guarantor of state foreign debt. And third, central government has traditionally bailed out subnational units when these find themselves in financial distress, either through the National Treasure or the Central Bank.

Subnational debt was practically nonexistent until the mid--1960s. After 1964, several institutional changes, including the introduction of price indexation, turned public indebtedness possible. Concurrently, fiscal centralism contributed to make indebtedness attractive as a way of bypassing fiscal constraints. Nevertheless, it was only after 1975, when the debt control legislation was changed, that conditions for significant expansion of subnational debt appeared, leading to a significant expansion in the stock of state debt. Paradoxically, by relaxing their budget constraint in that way, they became more dependent on the federal government. At that time, debt took mainly the form of loans provided by foreign and public financial institutions.

Loans from federal banks were earmarked to types of expenditure that interested the federal government. And, as debt accumulated, given the state's own low revenue capacity, the state became more dependent on federal grants to balance their fiscal accounts. In the beginning of the 1980s, as a result of the international shortage of lending funds, Brazil resorted to the IMF. The IMF agreement required that a fiscal adjustment process took place. For the states, this meant the rupture of their financing standard, since the availability of loans and voluntary grants from the federal government was severely restricted. In many cases, local state banks then became the main source of funds, being intensively (mis)used to finance state government expenditures, until becoming insolvent and having to be rescued by the Central Bank. The more developed states were able to raise part of the needed funds by issuing bonds and finding in the market bearers other than their own state banks.

When the National Constituent Assembly was installed, in 1987, state indebtedness was already perceived as a macroeconomic problem. Despite demands from subnational governments, the Assembly was not able to insert in the new constitution a solution for the state debt problem. Perception that subnational borrowing became a national problem was half the way to a bailout. After some political pressure, the federal government assumed states' and municipalities' foreign debt in 1989 and refinanced it to these units.[43]

---

42. Indeed, this is one of the aspects dealt with the present proposal of civil service pension reform now in Congress.

43. A second round of negotiation that had started in 1991 resulted, in 1993, in the rescheduling of the debt contracted with federal institutions. Despite the legal constraints then introduced, state debt in bonds continued to grow fast due to the very high interest rates prevailing in the 1990s. Between 1992 and 1996, debt in bonds increased at an average annual rate of 19,6% while debt previously refinanced by the federal government grew at a rate of only 3% per annum. This time, tight monetary policy practiced during the nineties, rather than excessive state expenditures, was the origin of financial distress.

In the late 1990s debt was again rescheduled. Federal-state negotiations were case-by-case; but, in all cases, refinancing conditions were again very favorable to the states. On the other hand, a down payment amounting to 20% of the rescheduled debt had to be made. This clause practically obliged privatization of state owned enterprises in order to raise the necessary funds. As a counterpart of refinancing, the agreements bind states to an in depth reform of the public sector and to a severe fiscal adjustment. They have established that missions, composed by National Treasury Secretariat technicians, will monitor state accounts to verify the attainment of contract clauses and discuss the situation of state finances and the required adjustments. So far, it has succeeded in avoiding the need for new bailouts.[44]

The Fiscal Responsibility Law (FRL) is deemed to be the single most important instrument for imposing tax discipline and macroeconomic management in contemporary Brazil. Together with the Fiscal and Financial Restructuring Program, it represents an important change in the nature of intergovernmental fiscal relations. The simple limitation imposed on subnational borrowing was replaced by a comprehensive monitoring of fiscal and financial accounts, which intends to prevent excessive borrowing and, thus, financial crises. This new approach was strengthened by the enactment, in 2000, of the FRL, a landmark in Brazilian public finance.[45]

In sum, despite privatization, the fiscal crisis continues to be a dominant force in shaping Brazil's growth alternatives as the burden of the debt imposes severe restrictions on public spending—something that is likely to continue for a long time in the future. Therefore, the process of fiscal reform has not been able to this date to overcome the constraints posed by the fiscal crisis, despite the fact that the tax burden increased substantially throughout the 1990s (as shown in Figure 2). In good measure, this occurred as a response to the fact that reforms attempted at during the Cardoso Era (e.g., public and private pension reforms) were not completed. In part it was due to the very stabilization strategy pursued, in which the Treasury accumulated debt to support the value of the domestic currency. This implies that state retrenchment in Brazil was a limited and partial phenomenon only, as it concerns the role of the state as producer of goods and services—but not its role as tax collector and expenditures manager.[46]

44. Of course, these agreements point out a reduction of state fiscal autonomy. But, paradoxically, the Fiscal and Financial Restructuring Program was essential for the consolidation of decentralization. First, rationalization of expenditures improved public sector efficiency. Second, and most important, had the agreements not been in effect, state liabilities would tie up a significant parcel of state resources to debt service payments.

45. The FRL introduces the concepts of fiscal transparency and accountability in the practices of the Brazilian public sector. It established a new paradigm, consistent with fiscal sustainability, which helps to consolidate price stability insofar as it sets up the conditions to attain long run fiscal equilibrium. In this sense, it is an instrument of macroeconomic management. It also contributes to solidify the decentralization process, for it prevents irresponsible fiscal and financial management. All these benefits have some costs. One of them is a further reduction in the fiscal autonomy of sub national governments.

46. A project of (partial) tax reform is presently under discussion in the Brazilian congress. It is believed that its impacts on the tax burden will be limited, if any. The objective is to improve the quality of the tax system.

5 THE ECONOMIC IMPACT OF MARKET REFORMS

5.1 IMPACTS ON GROWTH AND PRODUCTIVITY

The outcomes of reform in Latin America were in general positive, but less significant than initially expected [Collier, Dollar and Stern (2000), Hausmann and Rodrik (2002), Lindauer and Pritchett (2002), and Stallings and Peres (2000)]. Until the mid-1990s, it was estimated that, although only partially implemented, the reforms had increased the long-run growth rate of Latin America GDP by 2 percentage points. More recent studies have reduced these estimates substantially and conclude that a significant part of this impact was transitory, reflecting once and for all gains with implementation of the reforms.[47]

The trends in Brazil followed closely those observed in the rest of the region. After a difficult start, with a contraction of GDP in 1990-1992, the economy expanded vigorously in 1993-1997, and was expected to enter a cycle of rapid growth by the end of the decade. Actually, Brazil grew an average 1.6% p.a. in 1998-2002. Moreover, after a substantial decline in poverty with the end of high inflation in 1994, little progress was accomplished in reducing the serious social inequalities in Brazil, with no significant progress in improving income distribution or reducing poverty rates [Barros, Henriques and Mendonça (2000)].

Trade Liberalization and Growth

A recent appraisal of results of the liberalization process in Brazil concludes by noting that the links between trade and growth are less obvious than they appear to be [Moreira (2003)]. Indeed, Brazil's poor growth performance in the 1990s contrasts with results of the trade liberalization process experienced in the same period. The Figure 3 illustrates this aspect by showing that imports as a percent of GDP (all measured in nominal terms) rose from approximately 4% in the beginning of the decade to nearly two and a half times that value in the beginning of the next decade. Total trade as a percent of GDP rose from 10% in 1990 to nearly 24% in 2002. In turn, GDP growth, as it is well known, was on average below the 3% per year mark in the same period.

Table 6 decomposes GDP growth in 1931-2002 on its main supply-side determinants. In 1981-1993 GDP growth rates declined to only a fifth of what they were in 1964-1980. This decline resulted essentially from: *a*) a lower growth rate in capital accumulation (that is, low investment rates); *b*) a substantial drop in annual TFP growth, from 1.7% to minus 0.7%t, reflecting declines in both labor and capital productivity; and *c*) a slower expansion in employment, partly as a result of demographic transformations. Thus, of the 6.2 percentage points decline in the rate of growth, about half resulted from the lower pace of capital accumulation, with the

47. Lora and Panizza (2002,p. 17) conclude that, "contrary to what we found in the 1997 study, we now find that the reforms had only a temporary effect on growth. Our estimates imply that in the period of fastest reform, 1991-1993, reforms accelerated annual growth by 1.3 percentage point. However, when the reform process started decelerating, the growth effect dropped substantially, and in the period from 1997 to 1999 it accounted for only 0.6 percentage point of additional growth".

sharp fall in TFP growth answering for 2.4 percentage points, and the lower increase in employment for 0.5 percentage point.

FIGURE 3
OPENING UP THE ECONOMY: IMPORTS AND EXPORTS — 1980-2002

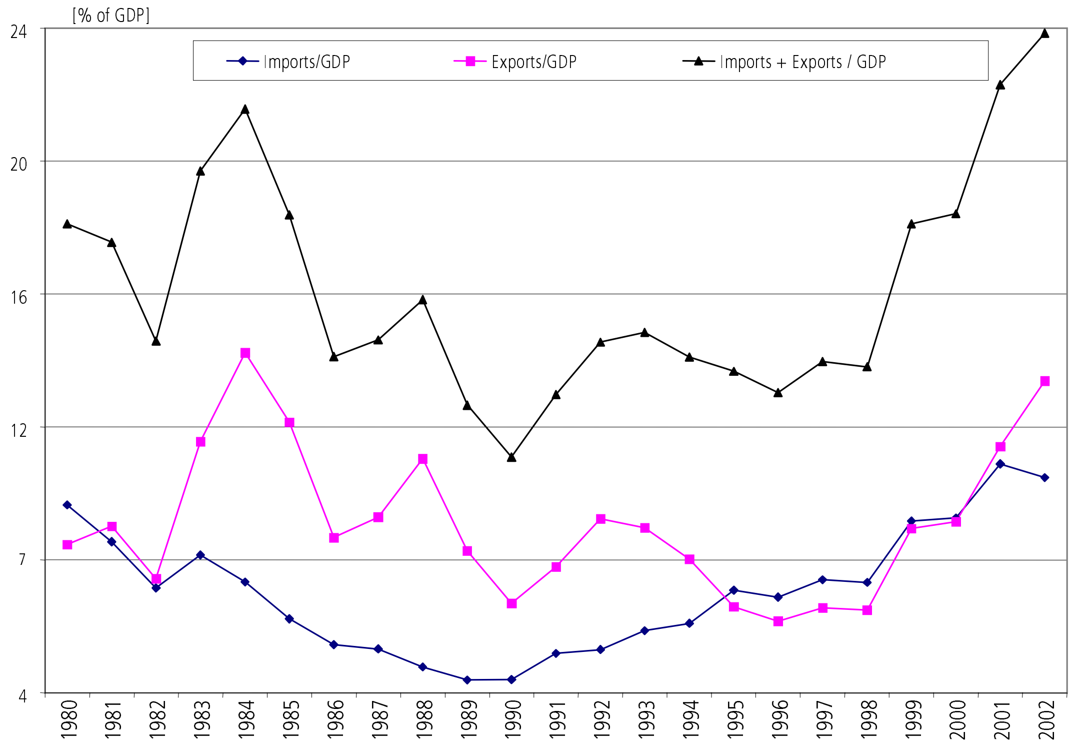


TABLE 6
BREAKDOWN OF GDP GROWTH: CONTRIBUTIONS OF CAPITAL, LABOR AND TOTAL FACTOR PRODUCTIVITY
[%]

Period	GDP growth A=B+C+D	Contributions to GDP growth of[a] Capital (B)	Labor (C)	Total factor productivity (D)
1931-1950	5.1	2.7	0.9	1.6
1951-1963	6.9	4.3	1.4	1.1
1964-1980	7.8	4.5	1.6	1.7
1981-1993	1.6	1.3	1.1	−0.7
1994-2002	2.7	1.1	0.5	1.1

Sources: Pinheiro (2003).

[a] Using a typical Solow decomposition, with constant returns to scale and capital and labor output elasticities of 0.5.

The decomposition in Table 6 shows that the reforms of the 1990s, in addition to having succeeded in their own focused objectives, were also able to accelerate GDP growth. They failed, however, in putting the economy back on a path of accelerated growth similar to that observed in the previous five decades, or, for that matter, close to the rates foreseen early in the decade. Note, also, that all the increase in the growth rate resulted from a rise in TFP growth, whose contribution to output growth increased by 1.8 percentage point (thus, in excess of the 1.1 percentage point rise in

GDP growth). In particular, the productivity of both capital and labor increased in this period. The contributions of capital and labor, on the other hand, declined. These results are in line with the finding of Lora e Panizza (2002) that the gains from first-generation reforms stemmed entirely from a rise in TFP growth, with no impact on the rate of investment.

Comparing the 1964-1980 and 1994-2002 periods, we observe that two thirds of the fall in GDP growth was due to the slower expansion of the capital stock. Indeed, it is possible to show that it was the failure to foster a return to rates of capital accumulation similar to those observed before the debt crisis that explains the failure to bring per capita GDP growth to the levels observed in 1930-1980.[48] This suggests that, in a certain sense, the problem of low growth in Brazil is simple to understand: the country is not investing enough to increase its capital stock at the pace necessary for fast GDP growth, and the reforms have not succeeded in increasing the rate of investment.

If Brazil is to repeat the excellent performance of 1930-1980, or the record growth of 1964-1980, it will have to combine: *a*) a significant reduction in the relative cost of investment with *b*) an increase in national savings; and *c*) policies that sustain or even accelerate TFP growth [Pinheiro (2003)]. Most of these measures depend on complementary, institutional reforms, that is, on second generation reforms to increase competition, reduce information asymmetries, guarantee property rights, and strengthen contract enforcement. Several factors contributed to the dismal impact of reforms on capital accumulation: *a*) macro instability; and *b*) low security. While the former reflects the incomplete fiscal adjustment, the latter is essentially the result of a incomplete institutional reforms and a lack of political commitment to Brazil's new (implicit) development strategy. Possibly, the most important channel through which institutional reforms can accelerate growth in Brazil is by lowering the cost and risk of investment. But these reforms are also likely to boost TFP growth.

There is now some consensus on the idea that the growth impacts of the enacted (incomplete) reforms were mainly reflected in productivity advances (see next section). Effects on physical capital accumulation were negligible in Brazil, as investment rates have been low for many years.

Labor Productivity

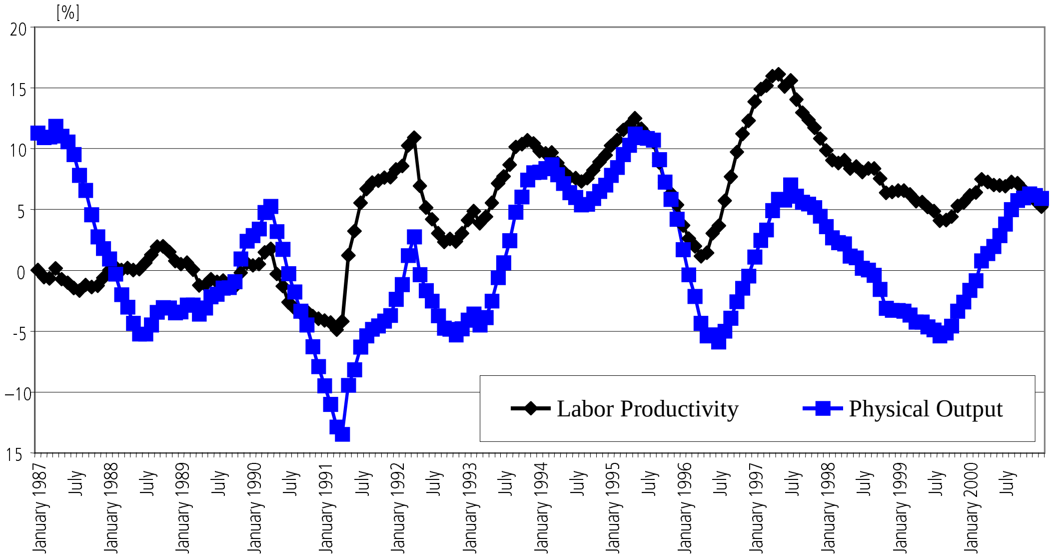
Most studies on productivity growth in Brazil since the mid-1980s have concentrated on the manufacturing sector. Although there is no overall agreement about the magnitude of such growth—mostly due to differences in data sets—there is a perception, confirmed by individual sector studies, that productivity grew substantially in many manufacturing and public utility industries in the 1990s. This growth was in sharp contrast with the record of the 1980s.[49] Indeed, despite high output growth in the mid-1980s, labor productivity stagnated in 1986-1990, reading in 1990 an annualized negative rate of almost 5%, as a result of a failed stabilization

48. Even the low growth of employment in 1994-2002 can probably be partly blamed on the low level of capital accumulation, on account of the imperfect substitution between labor and capital.

49. This reversal becomes even more remarkable when one considers the low and irregular growth of GDP in the 1990s and that employment levels were not substantially sacrificed.

attempt in President Collor's inauguration year [based on Bonelli (2002)]. After that, labor productivity growth accelerated, peaking at more than 15% (annualized) in mid-1997. However, at this point the Asian crisis hit Brazil, and output growth started to fall, bringing productivity growth down with it.[50]

FIGURE 4
OUTPUT AND PRODUCTIVITY GROWTH IN MANUFACTURING—JANUARY 1987-DECEMBER 2000



Import liberalization is believed to have been one of the main driving forces behind the acceleration of productivity growth in the 1990s. The underlying (admittedly simple) model is one in which, faced with the threat of increasing imports, firms react by raising productivity. Trade liberalization also spurred productivity growth by allowing access to better (imported) raw materials, parts and components and forcing the least productive firms out of business. The exit of low productivity firms raises average productivity not only by eliminating those on the bottom, but also by increasing the productivity of the remaining firms.[51]

Different studies have confirmed empirically that in Brazil trade liberalization had a positive effect on productivity growth.[52] However, issues of timing (how long does it take for the effects of liberalization to be felt on individual industries?), degree of data aggregation (either at the firm or at the sector level), availability (and type) of data, and how to represent empirically the liberalization process make it very difficult to perform direct tests of the hypotheses. In what follows we show some additional evidence in that regard. To start with, it seems advisable to exclude non-tradable

50. Thus, labor productivity growth in manufacturing was strongest while import liberalization was being implemented, weakening somewhat afterwards. This result is consistent with the finding of Lora and Panizza (2002), that part of the impact of reforms on growth was transitory, and deserves a closer examination.

51. This point was explored by Muendler (2001).

52. This issue has been tackled by, among others, Hay (1997), Rossi and Ferreira (1999), Muendler (2001) and Lisboa, Menezes-Filho and Schor (2002). Except for Rossi and Ferreira, all the other authors rely on micro data (at the firm level) to test to what extent the increased use of imported material in production led to productivity increases. The answers are positive in all studies cited, but emphasize different aspects of increased imported inputs use.

sectors from the analysis, namely: services, communications, construction, public utilities, commerce, transportation, government, real estate, and financial intermediaries.

Taking the remaining 31 sectors in the National Accounts, we found no general association between productivity growth and indicators of trade liberalization and/or import penetration ratios and their respective rates of change. This contrasts with the available literature. Rossi Jr. and Ferreira's (1999) pioneering study, for instance, established that there was a close (negative) association between productivity growth and changes in import tariff protection at the two-digit level of aggregation for 18 manufacturing industries. To probe deeper into the available data, we divided the 31 tradable sectors into different groups according to the degree of import penetration and their change over time.[53] We identified six different groups. The first group was characterized by little change over time in the (generally low) import coefficients. This group comprises natural resources intensive sectors, in which Brazil has an international comparative advantage. In all cases productivity growth was small. Mining and, to a lesser extent, agriculture were the only exception. Other sectors in this first group presented no surprises: import competition was weak, as expected, due to low import penetration ratios, and there was no actual threat from imports to induce better productivity performance.

The second group comprises sectors in which the import coefficients were low in the beginning of the decade, when import liberalization began, and increased as the decade progressed. Was this enough to spur high productivity growth? Bonelli's (2002) results suggest that not necessarily so. In fact, very different sector outcomes characterize this group. The sectors with best performance were steel (where privatization was the main driving force leading to the annual average 9.8% growth in productivity) and oil refining for domestic use. All other sectors, except for non-metallic (construction) minerals, had a lackluster productivity performance, despite large increases in import penetration ratios. These results suggest that small absolute increases in import penetration may be insufficient to generate a real threat to domestic producers, and so induce high productivity growth.

The next group consists of two sectors. In the case of chemicals (excluding petrochemicals), there was a high, but fairly constant, import penetration ratio together with a reasonably high rate of productivity change. Since imports increased substantially, this means that rising imports were concomitant to rising domestic production and fast productivity growth. The other sector, which recorded an unexpectedly favorable performance: oil and gas extraction, in which the share of imports in total supply decreased markedly during the 1990s, and the incumbent and virtual monopolist was able to increase productivity at a very fast rate during the decade. The threat of new entry in the sector, notably after the legal monopoly enjoyed by Petrobras was discontinued in 1995, seems to be have been the main driving force behind this positive performance.

A fourth group consists of sectors in which import penetration was already above average at the beginning of the decade and increased markedly with trade

53. Import penetration is defined here as the ratio of imports to imports plus domestic production. Data come from the Brazilian System of National Accounts.

liberalization. These were the sectors mostly directly affected by trade liberalization. We divided this group into two sub-groups: metals and the so-called metal-mechanic industries compose one, while the chemicals group of industries forms the other. Except for the very heterogeneous miscellaneous and metal products sectors, all the remaining sectors experienced increased import competition and very fast productivity change, thus behaving. as expected. Note that most sectors in this group are characterized by the presence and leadership of transnational corporations (TNCs).

The results for the chemicals and textiles group are not as clear as for the previous one: only rubber products, oil refining and petrochemicals, and miscellaneous chemical products behaved as expected, facing rising import competition via strong productivity growth. Pharmaceuticals, cleansing and related products is a sector dominated by foreign firms that displayed only modest productivity increases. Plastics are a very small and heterogeneous sector: it is difficult to predict what its behavior should have been, due to the extreme variety of products it produces. Finally, the domestic textiles sector has been strongly affected by rising imports up to the second half of the decade. But it has also been able to withstand competition, displaying modest productivity increases over the decade.

It seems safe to conclude that productivity growth has been the answer to increased import competition in only a limited number of sectors. The Brazilian experience in this respect has been one of extremely varied responses. To same extent this reflects the fact that it is difficult to separate out effects of trade liberalization, privatization and other reforms on performance. Nevertheless, it is tempting to attribute the improved productivity results of many sectors in selected periods to the (incomplete) reforms of the 1990s. The high volatility in output growth, exchange and interest rates that characterized the 1990s may also have affected individual sectors differently.

Looking at average growth rates of labor productivity in separate periods we see some evidence in support to this view. The first period includes the beginnings of trade liberalization and coincides, in part, with the recession of the early 1990s. It is followed by a period that includes the first years after the launching of the Real stabilization plan. The third period covers the aftermath of the Asian, Russian and Argentinean crises, as well as the change of exchange rate regime that took place in 1999 and the associated fall in output growth. Productivity growth varied considerably across periods and sectors:

a) Around the average expansion of 0.33% in labor productivity between 1990 and 1993 we find a group of manufacturing sectors with high rates of labor productivity growth. As the previous analysis suggested, many of these were either subjected to increased competition from imports or sectors characterized by privatization.

b) Between 1993 and 1997, productivity performance improves, in part as result of stabilization, in part due to privatization (public utilities). Trade liberalization is thought to have played a relatively smaller role during this particular period. For the economy as a whole labor productivity increased 2.6% per year. But very high rates characterized public utilities, steel, electronic equipment, cars, and rubber products.

c) Between 1997 and 2001, in turn, the productivity performance was mediocre, with productivity remained virtually stagnant for the economy as a whole. The only success history in this particular period was agriculture's. This confirms the conclusion that the impact of reforms on productivity change was not sustainable—in the sense of continuing labor productivity growth over time. One possible (admittedly partial) explanation has to do with the substitution of imported raw materials, components and machinery and equipment by domestically produced ones, characterized by lower quality and performance, in general.

Therefore, the mid-1990s were marked by intense labor productivity growth, especially when compared to the 1980s, helping to boost aggregate output growth in this period. A group of manufacturing industries was primarily responsible for this improved performance, helped by public utilities and, especially, telecommunications. Privatization, import competition and an improved macroeconomic performance were the main factors responsible for this record. Thus, reforms are behind the success cases.

5.2 IMPACTS ON POVERTY AND INEQUALITY

Much of the criticism of the first and second generation reforms in Latin America revolve around their disputed impact on social conditions in the region. Although social indicators improved in most Latin American countries during the 1990s, these improvements were largely unconnected to the reforms. Moreover, poverty and inequality indicators changed little during this period.

Evidence on the impact of reforms on inequality and poverty is mixed. Birdsall and de la Torre (2001, p. 4-5) make a favorable assessment of the social impact of the Washington Consensus reforms . They conclude that without the reforms social conditions would probably be worse. But they also acknowledge that per capita income grew a mere 1.5% per year, unemployment rose, poverty remained widespread, and "a sharp rise in crime and violence undermined the quality of life everywhere in the region" (p. 7). Lora and Panizza (2002) review some of the literature on the social impact of reforms and also find the evidence mixed. To some extent, the results are mixed because they come from different studies concentrating on different reforms, and the impact of these reforms is likely heterogeneous. Morley (2001) concludes that the effects of the different reforms on income distribution, some negative and others positive, tended in aggregate to cancel each other out, with the end result that inequality changed little.

Two lines of research that elaborate on the issue of reforms, growth, inequality and poverty look at *a*) the link between growth and poverty reduction, and *b*) the importance and nature of policies directly targeted at reducing inequality and poverty. The main conclusions of this literature are that growth has a positive but variable influence on poverty reduction, and that in countries like Brazil a substantial decline in poverty over the medium term will require policies directly targeted to this end.

In an influential paper, Dollar and Kraay (2000) estimated that income of the poor (defined as the bottom quintile of the population) rises proportionately one-for-one with per capita GDP. They also find that fiscal discipline, and in particular low inflation, and institutionalized rule of the law benefit the income of the poor as much as per capita income. Ravallion (2001) also finds on average no significant correlation between per capita growth and inequality, as observed by Dollar and Kraay (2000), but concludes that, while on average this correlation is close to 0, it varies considerably from country to country. In contrast, Foster and Szekely (2002) conclude that income of the poor grows less than proportionately as average income increases. A similar result is derived for Brazil by Menezes-Filho and Thomas (2001) who compared the growth of average household income and the average income of the bottom quartile of the population in 1982-1998.

With inequality essentially unchanged, growth in per capita income, albeit low, has been the main driving force behind poverty alleviation in Brazil. According to Barros, Henriques and Mendonça (2000), since 1977 the decline in poverty has resulted essentially from economic growth, with 84% of the decrease between 1993 and 1995 deriving from the increase in per capita incomes. This situation has led Morley (2001) to assert that given the insensitivity of income "distribution to feasible policy measures, the main problem facing the region at present is not how to improve the distribution but rather how to increase the growth rate".

Brazil is a well known for its unequal distribution of income and high incidence of poverty. Both have changed in the 1990s, largely as a result of the Real stabilization plan. When inflation rates suddenly decreased in 1994, real incomes abruptly increased. The gains were proportionately larger for the poorest segments in the population than for the richer, segments which were better able to protect their earnings against inflation. Poverty incidence decreased simultaneously, but the impact on inequality was not as pronounced as the impact on poverty incidence. To the extent that reducing inflation is considered part of the package of market reforms, it had a dramatic impact on poverty. But one disturbing aspect of this process was that poverty reduction seems to have been a short-lived, once-and-for-all phenomenon.

The Table 7 illustrates how after 1994 poverty incidence remained practically unchanged. Thus, virtually all the gain occurred between 1993 and 1995, when the number of poor decreased by 9 million and that of indigents by 6 million. After 1995 poverty rates remained fairly constant and even increased slightly in 1999.

TABLE 7
BRAZIL: POVERTY INCIDENCE—SELECTED YEARS
[percent of total population and absolute numbers]

Years	Indigents[a]		Poor	
	Percent	Number (million)	percent	Number (million)
1989	20.7	29.3	42.9	60.7
1990	21.4	30.8	43.8	63.2
1992	19.3	27.1	40.8	57.3
1993	19.5	27.8	41.7	59.4
1995	14.6	21.6	33.9	50.2
1996	15.0	22.4	33.5	50.1
1997	14.8	22.5	33.9	51.5
1998	14.1	21.7	32.8	50.3
1999	14.5	22.6	34.1	53.1

Source: Barros, Henriques and Mendonça (2000).
[a] The number of indigents is based on a poverty line that is half the corresponding line for poor.

However, Barros, Henriques and Mendonça (2000) argue that relying only on economic growth to reduce poverty may result on sustained high poverty for yet some decades. They estimate that in Brazil a 3% annual increase in per capita GDP reduces the poverty rate by roughly one percentage point, so that it would take 25 years of annual 3% growth in per capita income to reduce the poverty rate below 15% , down from a rate of 34% in 1999. As we argued in Section 4, though, even this growth rate in per capita GDP is beyond the reach of Brazil, unless it succeeds in substantially accelerating capital accumulation and TFP growth.

The relationship between trade liberalization and inequality has not been subject to much empirical investigation in Brazil because of the extreme difficulty in establishing the appropriate links and isolating the effect of liberalization from the many others that have a bearing upon inequality. One of the few exceptions is the study by Barros, Corseuil and Cury (2000). They concluded that the trade opening did not significantly affect poverty in Brazil in the period up to 1995. The authors used a CGE model to simulate conditions in 1985 departing from a 1995 baseline. In their own words, "with respect to inequality the results are not uniform (across simulations). Small positive changes in the Theil and Gini indices indicate a worsening of income distribution brought about, mainly, by a sharp fall in rural families incomes. This does not occur in all simulations, though" (p. 291). The authors used the same methodology to investigate the relationship between trade liberalization and poverty incidence and discovered that, "all poverty indicators deteriorated, whatever the poverty line adopted" (p. 290). In contrast, a recent study by Menezes-Filho (2003, p. 1) on the impacts of trade liberalization on wage inequality reached quite different conclusions: "skill earnings differentials fell during the period of trade liberalization (...) supply alone was not responsible for this behavior (...). We also present evidence consistent with the view that trade liberalization was responsible for part of the decline in these differentials". These results from studies of trade liberalization, poverty, and inequality are still preliminary and inconclusive.

Overall, the impact of reforms on poverty was rather small.[54] There are two main channels through which reforms might affect poverty: *a*) income growth; and *b*) via income distribution changes. In both cases the results of the reforms were relatively unimportant in Brazil, as has been the case as well in other developing countries.[55]

6 PROBLEMS OF INCOMPLETE REFORM

Three interpretations have emerged to explain the poor outcomes of the "Washington Consensus development strategy". The first sees the ensuing lack of growth as a result of a lack of depth in the reform process. That is, the reforms did not produce the expected results because they were not pursued far enough. As evidence, it is pointed out that countries that went deeper into the reform process—Chile and Mexico, for instance—are among the ones that have performed better in the last ten years, whereas the countries that reformed less—such as Paraguay—rank

54. For an extended discussion, see Morley (2001).

55. See, for instance, Bourguignon (2002).

among the poorer performers [see Stallings and Peres (2000)]. Moreover, it is clear that the reform process remains unconcluded in many countries [Lora and Panizza (2002)]. In Brazil, for instance, the economy remains relatively closed, privatization stopped midway in various sectors, and low inflation has not translated into macro stability, with much left to be done in the fiscal area.

A second interpretation, sometimes referred to as the Augmented Washington Consensus, links the small gains with respect to output growth to a lack of breadth in the reform process.[56] According to this view, the reforms of the original Consensus were positive and necessary, but for them to yield the expected acceleration in GDP growth they need to be complemented by a second round of reforms, geared to create, strengthen and improve institutions.[57] Lora and Panizza (2002), for instance, show that the structural reforms of the 1990s were more successful in accelerating growth in countries with better institutions. An extensive literature based on cross-country regressions also shows that good institutions help to boost growth.[58]

At the risk of oversimplification, we may say that the vision represented by the Augmented Washington Consensus may be summarized in several propositions. First, a stable economy with correct prices is an important stimulus to growth. Without it economic activity and investment becomes riskier and less productive. So, it is correct and advisable to pursue the policies advocated in the Washington Consensus. Furthermore, risk and relative prices are also affected by a country's institutional apparatus, so stability and openness do not guarantee a rapid pace of capital accumulation and productivity growth. That is, the Consensus reforms may be insufficient to generate growth, for they transfer decision making to markets that may be plagued by institutional failures. So reforms that create, strengthen and improve institutions may also be necessary. Lastly, the state can do more to foster development by correcting institutional failures than by trying to mitigate their effect through planning and command. That is, state intervention is an institutional arrangement that as a rule generates outcomes that are inferior to those that can be obtained through the correction of the institutional failures responsible for increasing risk and transactions costs, and in this way distorting relative prices.

A third interpretation blames the poor outcomes of the reform process on the attempt to implement a single set of policies to all developing countries, irrespectively of their individual characteristics and stage of development. According to this view, there are not universal models to be adopted in all countries at all times, and individual countries should seek their own development strategy. Starting from a set of "universal laws"—that is, policies broadly accepted to favor development, such as macroeconomic stability and the rule of law—each country should design its own

56. We borrow the term Augmented Washington Consensus from Lindauer and Pritchett (2002, 13).

57. The literature on institutional reform is now very large. These second-generation of reforms were first articulated by Naim (1994), who gives a list of such reforms and notes that they are much more complex, technically and politically than first-generation reforms. Other representative studies include Burki and Perry (1998), the World Development Reports 1996, 1997 and 2002, and the papers presented in the Second Global Conference of the Global Development Network (www.gdnet.org). Williamson (2003) discusses how institutional reforms complement first-generation, Washington Consensus reforms. In its 2003 Global Outlook, the IMF gives a favorable but less enthusiastic evaluation of the potential impact of institutional reforms on growth [IMF (2003)].

58. For a review, see Aron (2000).

development model, tailoring it to its own characteristics, level of development and current conditions [Rodrik (2002)].

All three interpretations are useful to understand the challenge of fostering development in Brazil at present. Several structural reforms remain unconcluded in Brazil, and they need to either be pushed forward—which, as a rule, remains the best course of action—or substituted by an alternative policy or institutional model. Fiscal discipline is not consolidated; the tax system has worsened, rather than improved, financial markets have been only marginally reformed; the state retrenchment process remains unfinished and so on.[59] According to Williamson (2003, p. 7), "the most egregious omission has been to fail to make the labor market more flexible". The reform measures already implemented demand, on the other hand, that the institutional apparatus be changed so as to account for a greater participation of the private sector in investment, production and finance. And the design, sequencing and shape of these structural and institutional reforms need to account for the specificities of Brazil—a country that is distant from the main economic centers, and larger, more unequal, urbanized, resource-rich and industrialized than most other developing countries.[60]

Burki and Perry (1998) and World Bank (2001) list among the institutions that should be the object of a second round of reforms the judiciary, the laws and organizations that regulate the financial system, the education system and the public sector. Fighting corruption and strengthening the rule of law are also often included in the core reforms of the AWC. Some institutional reforms are easier and more rapid to implement. And, as noted by Williamson (2003, p. 11), "Institutional reforms tend to be even more country-specific than other sorts of reform".

In our view, a development strategy for a middle-income, relatively industrialized country such as Brazil should contemplate a number of institutional reform areas. In particular, it is necessary to adapt the institutional apparatus to the structural transformations undergone by Brazil in the 1990s, which reduced state intervention and opened up the economy, while the country was consolidating a democratic regime and becoming more urban. It seems especially important to:[61]

a) Strengthen the protection to property rights, both from administrative expropriation and the action of private agents (e.g., crime).

b) Reduce asymmetries of information.

c) Improve the quality of competition and regulatory agencies, notably in infrastructure and capital markets.

---

59. In some of these areas, such as fiscal consolidation, there are ongoing efforts to finish reforms. In others, as is the case o privatization, governments no longer seem to see Washington Consensus reforms as appropriate.

60. See North (2000) for remarks about the limits of such approach, notably regarding it normative implications.

61. The World Bank (2002) proposes a broadly applicable list of roles institutions should play that is consistent with our own list for Brazil. It argues in favor of three roles for market-supporting institutions: increase market competition, define and enforce property rights and contracts, and channel information about market conditions, goods, and participants. Although not stressed in the report, information sharing institutions can also play a key role in enforcing contracts [Pinheiro and Moura (2003)].

d) Encourage competition, punishing anti-competitive conducts (e.g., cartels) and creating more competitive market structures. In particular, competition and regulatory agencies should foster competition more forcefully.

The agenda on strengthening property rights, notably in some specific areas, must be a priority. Two critical areas are the financial sector, with the strengthening of the collateral as a way to reduce interest spreads; and infrastructure, so as to reduce the risk of private investors in expanding capacity. The strengthening of property rights can also contribute to the development of small businesses and the tendency to retain profits, increasing savings, as indicated in the study of Johnson, McMillan and Woodruff (2002) for the case of transition economies in Eastern Europe. In particular, these authors have observed that weak property rights discourage firms from investing their profits in their own business, while with well defined and protected property rights access to finance becomes less important to allow the expansion of small companies.

De Soto (2000) argues along similar lines with respect to making the assets held by the poor, or simply in poor countries, more productive. According to him, in the absence of adequate registries to make property of assets known and transferable—and, in the limit, legal—these cannot be used as collateral in credit operations, turning them, in his words, “dead capital”, in the sense that they yield relatively little benefit to the economy. De Soto contrasts this situation with that of assets held by individuals and companies in rich countries, whose ownership is well defined and protected, allowing these assets to be used to raise finance. According to the author, it is the good definition of ownership rights in developed countries, and the consequent ability to exploit all the potential usefulness of capital, that allowed them to reach their current level of wealth and prosperity.

The Washington Consensus, in its original and augmented version, has been the object of much criticism, notably from those who argue against universal policy prescriptions and in favor of development strategies that emphasize individual country features and give a more prominent role to state intervention. Common arguments in favor of this view are the poor performance of Latin America in the 1990s and the fact that China and India were able to grow at relatively high rates while disregarding or even confronting the recommendations of the Consensus [see, for instance, Stiglitz (2002) and Lindauer and Pritchett (2002)].

Rodrik (2002), on the other hand, despite lining up with the critics of the Consensus, argues that there is a set of universal principles that should be part of any development strategy, although stressing that the institutional arrangements that give support to application of those principles need not reproduce those prevailing in more advance economies—for instance, monetary discipline is a universal principle that should be respected, but an independent central bank is not the only institutional arrangement able to assure it. Adelman (2000) shares most criticisms put forward by Rodrik (2002), Stiglitz (2002), and Lindauer and Pritchett (2002), but argues more strongly against development strategies based on universal policy prescriptions. According to Adelman (2000, p. 5-6), a development strategy needs to be multi-pronged, possibly change from one development stage to the next, and take into account the history and current situation of the country, considering that there are certain irreversibilities in the development process that create path-dependence. “Thus, while there are certain regularities and preferred time sequences in the development process, universal institutional and policy prescriptions are likely to be incorrect.”

As a rule, the discussion of the role of institutions or second-generation reforms in fostering development skips the issue of sequencing between the two generations of reforms, treating them almost as separate initiatives. This is not how this issue is treated here. As we see it, there is a strong complementarity between first- and second-generation reforms, in the sense that the first significantly increase the role of markets in the development process, while the second create the conditions for markets to function effectively. Thus, the strong presence of the state in the economy was in itself a response to institutional failure, and simply changing ownership or taking the state out of certain activities without addressing institutional weakness may worsen rather than improve things. Among other things, this highlights the importance of proper sequencing and raises a number of political issues that we can only briefly mention here.

Second generation reforms—in areas such as the Judiciary, public administration, and education, as well as fine tuning regulatory agencies—are more complex technically, institutionally, and politically [see Naim (1994) and Heredia and Schneider (2003)]. In addition, second generation reforms generally involve more actors, require more time, and have greater distance between reform policy and economic results. As such second generation reforms incur ongoing political costs, and, in the absence of visible short term benefits, make it difficult to hold together support coalitions. In this context, pragmatism is often an insufficient force to overcome political obstacles. Policy makers, and allies in business and civil society, may want to push reform in their specific sectors, but lack sufficient political projection to push broad reforms in, say, the judiciary or the executive bureaucracy overall.

Given the weak impetus of pragmatism, those pushing second generation reform may be attracted to packaging strategies in order to keep reforms moving. So, for example, policy makers often tied administrative reform to overall stabilization programs [see Schneider and Heredia (2003)]. This strategy has short run political advantages, but problems over the longer term. When, in this example, stabilization is achieved, then support for administrative reform correspondingly fades. The prevailing optimism was that first-stage reforms would create the constituency for second-generation reforms, but this is not the only possibility. It might also happen that the failure of first-generation reforms to spur growth, on account of missing (second-generation reform) institutions leads to a backslash in the reform process. We take up these issues in the next section that takes a preliminary look at constituencies and possible backlash in the Lula government.

7 EPILOGUE: MARKET REFORMS IN THE PT GOVERNMENT

It is now widely accepted that market reforms in Brazil did not yield the expected results. Investment and growth remain low, and income distribution and poverty levels changed little—with the noted exception in the aftermath of the Real Plan.

Several reasons account for that, two of which are paramount. First, the end of high inflation did not automatically bring enduring macro-stability. This was due in part to an excessive reliance on monetary policy (given an expansionist fiscal stance in 1995-1998) and to frequent external crises that led to high volatility in output growth. Second, and to some extent related to continuing macro instability, market reforms remained incomplete, in both depth and breadth.

From the last months of Cardoso's presidency in mid-2002 through mid-2003 expectations grew that changes in previous reforms would be likely in the near term. On the one hand, the poor results of market reforms in the 1990s in promoting growth reinforced pragmatic motives for rethinking previous reforms. On the other hand, Lula and the PT emerged as nearly invincible front-runners in the 2002 elections. As mentioned, the PT had traditionally opposed market—labeled "neoliberal"—reform and advocated a larger state presence and "developmentalist" industrial and trade policies instead. Throughout the 1990s the party members strongly criticized every market-oriented reform adopted as well as attempts at.

By mid-2003 expectations had changed dramatically. Most observers expected continued pragmatism, flexibility, and incrementalism in the economic policies of the new government. Continuity and apparent pragmatism were especially visible in macro policy as the new economic team increased already very high interest rates (early 2003) and reduced government expenditures beyond targets agreed with the IMF. In addition, the new government made few changes to trade policy, in part because devaluation of the Real in 2002, coupled with reduced domestic demand, generated major trade throughout 2003.

Another major surprise characterized regulatory agencies. Members of the new PT government, especially the ministers of Mines and Energy, and Communications, as well as President Lula himself, started out in late 2002 (before taking office) to make statements on the urgent need to overhaul the regulatory agencies created in the 1990s, especially in areas like electricity and telecommunications. However, the number of such statements dropped off rapidly after the first months of the new government. The tone softened markedly, as members of the new government settled in to their positions [Nunes, Costa, and Andrade (2003)].

What explains this continuity and apparent pragmatism? Answers can only be preliminary at this point, but a number of political and economic factors seem to be encouraging pragmatism and moderation. First, calming the fears of international investors and enhancing 'governability' became a major goal of PT policy makers. As Lula's lead grew during the 2002 election campaign, so to did the spread or risk premium on Brazil's international debt. Most observers interpret the very tight monetary and fiscal policies adopted by the new government in 2003 as an effort to restore confidence in international financial markets. In this regard, any serious reversal of prior market reforms—especially any change that infringed on the contracts and property rights of foreign firms—would be especially damaging to international confidence.

Second, the PT government, like most democratic governments before it, was a hodge-podge coalition of disparate parties that included not only traditional leftwing allies, but also centrist and center right parties that participated in previous reforming governments (PMDB) or supported neoliberal reform programmatically (PL). As is known, coalition government usually makes policy shifts slowly and incrementally (see Boix, 1997 on Europe). In the case of Lula's administration some members of the coalition had a stake in maintaining the market reforms of the 1990s.

Third, as part of Lula's strategy during the elections months, the PT made overtures to business, especially business elites in Sao Paulo. To the surprise of many, Lula appointed several top businessmen to cabinet positions, including industry and agriculture, and created a consultative body (CDES) where half of the 82 members were representatives from business [Schneider (2004)]. Presumably, these representatives of business would caution against any abrupt changes in economic policy and regulation.

Fourth, there are indirect signs that public opinion favor moderation. For starters, many of those who voted for Lula for president also voted for other parties for congress, thereby favoring divided government. There is also, as spelled out in Section 3, a long tradition of pragmatism that favors continuity. And, there are signs that public opinion is becoming more pro-market.[62]

Specific pressures in privatization may generate incentives to reorient or retrench, despite an initial overall pragmatic approach to economic policies. Already in the privatization pipeline are the remaining SOEs in the electricity sector, some state banks, the reinsurance monopoly and a large part of the sewage and water sector. When this phase is concluded, the state will still own some large assets in the oil and gas, transportation, and banking sectors.

Moreover, privatization still has a long way to go in the outsourcing of activities within the public sector: mail services, garbage collection, vehicle inspection etc. But the actual extent and speed of the expansion in the frontiers of privatization will depend on the role ascribed to the state in the policy framework of future governments and, no less importantly, the success of past privatization in enlarging supply, reducing prices and improving service quality.[63] Brazil has already taken important steps in establishing a regulatory environment targeted at achieving these results, but there is still much to be done.

Is there, on the other hand, any concrete possibility that the pendulum will swing the other way, that is, in the direction of a greater presence of the state in business? Generally pragmatic privatizations, even when widespread as was the case in Brazil, risk being less durable than sweeping privatization that reflects profound changes in elite and mass views about the role of the state. Looking at privatization worldwide, Feigenbaum, Henig and Hamnett (1999, p. 173) conclude that "Much of what has occurred to date has been shaped by pragmatic and tactical motives, and (...) may prove to be self-limiting, as the constituency for a backslash strengthens.

62. In a survey of 17 countries of Latin America in July and August 2003, 70% of Brazilian respondents, a higher percentage than any other country, agreed with the statement, "a market economy is the only system which can develop your country" (*Economist,* 1 November 2003, 34). Specific policies of privatization are much less popular, and majorities in all countries disagree with the statement that "the privatization of state companies has been beneficial". Yet again the margin of disapproval in Brazil was the lowest of all countries in the region.

63. The experience of privatization in electricity distribution, for instance, has been characterized by flaws to such an extent that the whole program has been tarnished. In part, this was due to the lack of a proper regulatory environment .

The coalition that has carried out privatization forward is more diverse and disunited in motive and interest than the rhetoric of the privatization revolution acknowledges”. Velasco (1997*a* and *b*) makes a similar assessment for the Brazilian case, highlighting the underlying tensions in the coalition that has managed Brazilian privatization.[64]

We can imagine at least three possible, and related, scenarios in which the pendulum might swing back to greater state ownership of productive enterprises. In the first scenario, regulation fails to encourage the levels of investment necessary to increase supply consistently with demand, generating shortages and harming consumers. In this case state actors may feel compelled to supply the necessary investment, progressively increasing its participation in supply, possibly to the point of again dominating the sector. This would be a pragmatic response, as in the 1940s and 1950s, to inadequate private investment.

Second, default on loans extended by public banks, particularly in infrastructure, put former SOEs back in the hands of the state, as happened with private firms in the 1970s and 1980s (in the BNDES’ “hospital”). Obviously this same risk exists with other loans by public banks, but the problem is composed in this case by the difficulty of liquidating public services companies or of selling them to third parties.

Third, excessive protection to investors—e.g., against exchange rate devaluationmight cause political costs to be higher than nationalization. Recently, the state has been sued and condemned to financially compensate airlines, in billions of dollars, for the loss of profitability resulting from the government capping ticket prices below what the courts considered to be reasonable. This highlights the magnitude of contingent fiscal liabilities that may be created by legal or contractual clauses aimed at protecting investors from “excessive” risk. One should bear in mind the lessons from the experience of guarantees extended to railways and sugar plants in late XIX century. But while a scenario of re-nationalization is plausible, it is not likely, at least in the short-to medium term. For one, because public savings should stay low for several years—which makes a sustained policy of high public investment difficult to pursue. For another, privatization, like other reforms put in place in 1990s, created groups interested in maintaining the new status quo.

64. It has been widely overlooked that among the main results of privatization one can include high productivity change. Indeed, it is not by coincidence that the four leading sectors in terms of productivity growth in the 1990s were communications, steel, public utilities and chemicals (petrochemicals), all of which characterized by substantial asset privatization in the 1990s [see Bonelli (2002)].

BIBLIOGRAPHY

ADELMAN, I. Fifty years of economic development: what have we learned? *Paper presented at the Annual Conference on Economic Development*, World Bank, 2000.

ARON, J. Growth and institutions: a review of the evidence. *World Bank Research Observer*, v. 15, n. 1, 2000.

BACHA, E. Do consenso de Washington ao dissenso de Cambridge. In: CASTRO, A. C. (org.). *Desenvolvimento em debate: novos rumos do desenvolvimento no mundo.* BNDES, 2002.

BANCO CENTRAL .*Juros e spread bancário no Brasil*. Brasília: Departamento de Estudos e Pesquisa, 1999 (processed).

BARROS, R. P de, CORSEUIL, C. H., CURY, S. Abertura comercial e liberalização do fluxo de capitais no Brasil: impactos sobre a pobreza e a desigualdade. In: HENRIQUES, R. (org). *Desigualdade e pobreza no Brasil*. Rio de Janeiro: IPEA, dez. 2000.

BARROS, R. P. de, HENRIQUES, R., MENDONÇA, R. A estabilidade inaceitável: desigualdade e pobreza no Brasil. In: HENRIQUES, R. (org.). *Desigualdade e pobreza no Brasil.* Rio de Janeiro: IPEA, 2000.

BARROS, R. P. de et al. Impactos da distribuição de terra sobre a eficiência agrícola e a pobreza no Nordeste. In: HENRIQUES, R. (org.). *Desigualdade e pobreza no Brasil.* Rio de Janeiro: IPEA, 2000.

BAUMANN, R., RIVERO, J., ZAVATTIERO, Y. As tarifas de importações no Plano Real. *Pesquisa e Planejamento Econômico*, Rio de Janeiro: IPEA, dez. 1997.

BIRDSALL, N., DE LA TORRE, A. Washington contentious: economic policies for social Equito. *Latin America,* Washington, D.C.: Carnegie Endowment for International Peace and Inter-American Dialogue, 2001.

BOIX, C. Privatizing the public business sector in the eighties: economic performance, partisan responses, and divided governments. *British Journal of Political Science,* v.27, n. 4, p. 473-496, Oct. 1997.

BONELLI, R. A reestruturação industrial brasileira nos anos 90: reação empresarial e mercado de trabalho. *Brasil,* Organização Internacional do Trabalho (OIT) e Ministério do Trabalho e Emprego, São Paulo, SP: Editora 34, 1999.

——————. Productivity change in Brazil during the 1990s. *Working Paper Series*, n. CBS-35-02, University of Oxford: Center for Brazilian Studies, 2002.

BONELLI, R., MOTTA VEIGA, P. L. da, FERNANDES DE BRITTO, A. *As políticas industrial e de comércio exterior no Brasil: rumos e indefinições*. IPEA, nov. 1997 (Texto para Discussão, 527).

BOURGUIGNON, F. The growth elasticity of poverty reduction: explaining heterogeneity across countries and time periods. *Working Paper,* n. 2.002-03, Paris, France: Delta, 2002.

BURKI, S. J., PERRY, G. E. The long march: a reform agenda for Latin America and the Caribbean in the next decade. *World Bank Latin American and Caribbean Studies,* 1997.

——————. *Beyond the Washington consensus: institutions matter*. Washington, D.C.: World Bank, 1998.

CARDOSO, F. H. Associated-dependent development: theoretical and practical implications. In: STEPAN, A. (ed.). *Authoritarian Brazil.* New Haven: Yale University Press, 1973.

CARVALHO, M.A. *Privatização: aspectos fiscais e dívida pública.* Rio de Janeiro: Fundação Getulio Vargas, 2001 (Ms.C. Dissertation).

COLLIER, P., DOLLAR, D., STERN, N. Fifth years of development. *Paper presented at the Annual Bank Conference on Development Economics in Europe*, World Bank, p. 1-29, June 2000.

CORSEUIL, C. H., KUME, H. (eds.). A abertura comercial brasileira nos anos 1990: impactos sobre emprego e salário. Rio de Janeiro: MTE/IPEA, 2003.

DE SOTO, H. *The mistery of capital: why capitalism triumphs in the West and Fails everywhere else.* Basic Books, 2000.

DJANKOV, S. et al. The regulation of entry. National Bureau of Economic Research, *Working Paper,* n. 7.892, 2000.

DOCTOR, M. *The politics of port reform in Brazil: business lobbying and the legacy of corporatism* (1990-98). University of Oxford, 2000 (Ph.D. Dissertation).

DOLLAR, D., KRAAY, A. *Growth is good for the poor*. World Bank: Development Research Group, 2000.

FANELLI, J. M., POPOV., V. On the philosophical, political, and methodological underpinnings of reform. *Paper prepared for the Fourth Annual Global Development Conference Globalization and Equity.* Cairo, Egypt, 2003.

FEIGENBAUM, H., HENIG, J., HAMNETT, C. *Shrinking the state.* Cambridge University Press, 1999.

FISHLOW, A. Origins and consequences of import substitution in Brazil. In: DI MARCO, L. E. (ed.). *International economics and development: essays in honor of Raul Prebisch.* New York: Academic Press, 1972.

FORTES, M. Integração competitiva e privatização. *Folha de São Paulo*, 19 de outubro de 1994.

FOSTER, J., SZEKELY, M. *Is economic growth good for the poor? Tracking low incomes using general means*. IDB, 2002.

FRIEDMAN, T. *The lexus and the olive tree: understanding globalization.* New York: Farrar, Straus and Giroux, 1999.

HAUSMANN, R., RODRIK, D. *Economic development as self-discovery*. Harvard University: John F. Kennedy School of Government, 2002 (processed).

HEREDIA, B., SCHNEIDER, B. R. The political economy of administrative reform in developing countries. In: SCHNEIDER, B. R., HEREDIA, B. (eds.). *Reinventing leviathan*. Miami: North-South Center Press, 2003.

HORTA, M. H., PIANI, G., KUME, H. A política cambial e comercial. *Perspectivas da economia brasileira — 1992*. Rio de Janeiro: IPEA, 1991.

IMF. *World Economic Outlook* 2003. Washington, D.C., 2003. Acessível em:<www.imf.org>.

JOHNSON, S., McMILLAN, J., WOODRUFF, C. Property rights and finance. *American Economic Review*, v. 92, n. 5, 2002.

KUME, H., PIANI, G., BRÁZ DE SOUZA, C. F. A política brasileira de importação no período 1987-98: descrição e avaliação. In: CORSEUIL, C. H., KUME, H. (eds.). *A abertura comercial brasileira nos anos 1990: impactos sobre emprego e salário*. Rio de Janeiro: MTE/IPEA, 2003.

LAMOUNIER, B., MOURA, A. R. *Política econômica e abertura política no Brasil — 1973-1983*. São Paulo: Idesp, 1984 (Textos Idesp, 4).

LANDAUER, C. *Theory of national economic planning*. Berkeley: University of California Press, 1944.

LATINOBARÓMETRO. *The Economist, p. 37-38, July 28th.*, 2001.

LINDAUER, D., PRITCHETT, L. What's the big idea? The third generation of policies for economic growth. *Economía*, v. 3, n. 1, 2002.

LISBOA, M. B., MENEZES-FILHO, N., SCHOR, A. *Os efeitos da liberalização comercial sobre a produtividade: competição ou tecnologia*? Rio de Janeiro: FGV, mar. 2002 (Texto para Discussão).

LOYAZA, N. Aggregate growth in Brazil. *Brazil: the new growth agenda.* World Bank, 2001 (processed).

LORA, E. Structural reforms in Latin America: what has been reformed and how to measure it? *Working Paper,* n. 466, Inter-American Development Bank, 2001.

LORA, E., BARRERA, F. *A decade of structural reform in Latin America: growth, productivity, and investment are not what they used to be*. Inter-American Development Bank, 1997 (processed). Acessível em:<www.iadb.org>.

LORA, E., PANIZZA, U. *Structural reforms in Latin America under scrutiny*. Inter-American Development Bank, 2002 (Discussion Paper, 470).

MALAN, P. S., BONELLI, R. The Brazilian economy in the 1970s: old and new developments. *World Development*, v. 5, n. 1&2, 1977.

MANZETTI, L. *Privatization South American style*. New York: Oxford University Press, 1999.

MARISCAL, J. *Unfinished business: telecommunications reform in Mexico*. Praeger, 2002.

MARKWALD, R., PUGA, F. P. Focando a política de promoção de exportações. In: PINHEIRO, A. C., MARKWALD, R., PEREIRA, L. V. (orgs.). *O desafio das exportações.* BNDES, 2002.

MARTINS, L. *Expansão recente do estado no Brasil: seus problemas e seus atores*. Finep, 1977 (processed).

McKINSEY GLOBAL INSTITUTE. Produtividade: a chave do crescimento acelerado no Brasil. São Paulo/Washington, 1998.

MENEZES-FILHO, N. Trade liberalization and inequality in Brazil. *Paper presented at the seminar Brazil: Risks and Opportunities of Integration into the World Economy*, São Paulo, SP: USP, Nov. 4, 2003 (processed).

MENEZES-FILHO, N., THOMAS, M. Household income growth and its distribution. *Brazil: the new growth agenda*. World Bank, 2001 (processed).

MORA, M., VARSANO, R. *Fiscal decentralization and subnational fiscal autonomy in Brazil: some facts of the nineties*. Rio de Janeiro: IPEA, 2001 (Discussion Paper, 854).

MOREIRA, M. M. Abertura e crescimento no Brasil: deu errado? *Paper presented at the seminar Brazil and the Risks and Opportunities of Integration into the World Economy*, sponsored by the IDB and Getulio Vargas Foundation, São Paulo, SP, Nov. 4, 2003.

MORLEY, S. Distribution and growth in Latin America in an era of structural reform. *Working Paper,* n. 66, International Food Policy Research Institute, 2001.

MUENDLER, M. *Productivity change among large Brazilian manufactures*. U.C. Berkeley, 2001, mimeo.

MURILLO, M. V. *Labor unions, partisan coalitions, and market reforms in Latin America*. Cambridge: Cambridge University Press, 2001.

__________. Political bias in policy convergence: privatization choices in Latin America. *World Politics,*v. 54, n. 4, p. 462-493, July 2002.

NAIM, M. Latin America: the second stage of reform. *Journal of Democracy*, v. 5, n. 4, 1994.

NESTOR, S., MAHBOODI, L. Privatization of public utilities: the OECD experience. In: PINHEIRO, A. C., FUKASAKU, K. (eds.). *Privatization in Brazil: the case of publicutilities*. BNDES-OECD, 1999, mimeo.

NORTH, D. Institutions and the performance of economies over time. *Paper presented at the II Annual Conference of the Global Development Conference*, Tokyo, Japan, Dec. 2000.

NUNES, E., COSTA, C., ANDRADE, H. *O governo Lula e as mudanças nas agências reguladoras*. Rio de Janeiro: Universidade Candido Mendes, Núcleo de Análise Interdisciplinar de Política Educacional e Regulatória (Naipe), 2003.

OATES, W. E. An essay on fiscal federalism. *Journal of Economic Literature*, v. XXXVII, Sep. 1999.

PESSANHA, C. F. *Estado e economia no Brasil: a campanha contra a estatização*. Iuperj, 1981 (Doctoral Thesis).

PINHEIRO, A. C. Os fundos de pensão e o financiamento do desenvolvimento: o papel do BNDES. *Revista do BNDES*, n. 2, 1994.

__________. Impactos microeconômicos da privatização. *Pesquisa e Planejamento Econômico*, Rio de Janeiro, v. 26, n. 3, p. 357-398, Dec. 1996*a.*

__________.*The Brazilian economy in the nineties: retrospect and policy challenges*. Depec/BNDES, Feb. 1996*b* mimeo.

__________. *Creditor rights, enforcement and the access to credit*. 2000*a* (processed).

__________.(org.). *O desafio das exportações.* BNDES, 2002*b*.

__________. *Regulatory reform in Brazilian infrastructure: where do we stand?* IPEA, 2003 (processed).

PINHEIRO, A. C., CABRAL, C. Credit markets in Brazil: the role of the judiciary and other institutions. In: PAGANO, M. (ed.). *Defusing default: incentives and institutions.* IDB, 2001.

PINHEIRO, A. C., FUKASAKU, K. (eds.). *Privatization in Brazil: the case of public utilities.* BNDES-OECD, 2000.

PINHEIRO, A. C., GIAMBIAGI, F. *The macroeconomic background and institutional framework of Brazilian privatization*. BNDES, 1999.

PINHEIRO, A. C., MOURA, A. Segmentation and the use of information in Brazilian credit markets. In: MILLER, M. (ed.). *Credit reporting systems and the international economy.* MIT Press, 2003.

PINHEIRO, A. C. et al. Brazilian economic growth in 1900-2000: lessons and policy implications. *Paper prepared for the Third Annual Conference, Global Development Network*, Rio de Janeiro, 2001.

RAVILLON, M. *Growth, inequality and poverty: Looking beyond averages*. World Bank: Development Research Group, 2001.

REZENDE, F. A empresa pública e a intervenção do estado na economia: ação suplementar à iniciativa privada — perspectivas em face da conjuntural atual. *A empresa pública no Brasil*, IPEA, 1980.

RODRIK, D. The rush to free trade in the developing world: why so late? Why now? Will it last? In: STURZENEGGER, F., TOMMASI, M. (eds.). *The political economy of reform.* MIT Press, 1998.

ROSSI Jr., J. L., FERREIRA, P. C. *Evolução da produtividade industrial brasileira e abertura comercial*. Rio de Janeiro: IPEA, 1999 (Texto para Discussão, 651).

__________. How far will international economic integration go? *Journal of Economic Perspectives*, v. 14, n. 1, 2000.

__________. Depois do neoliberalismo, o quê? In: CASTRO, A. C. (org.). *Desenvolvimento em debate: novos rumos do desenvolvimento no mundo.* Rio de Janeiro: BNDES, 2002.

SCHAMIS, H. E. *Re-forming the state: the politics of privatization in Latin America and Europe*. University of Michigan Press, 2002.

SCHNEIDER, B. R. The politics of privatization in Brazil and Mexico: variations on a statist theme. In: WATERBURY, J., SULEIMAN, E. (eds.). *The political economy of public sector reform and privatization*. Boulder, CO: Westview Press, 1990.

__________. *Politics within the state: elite bureaucrats and industrial policy in authoritarian Brazil.* University of Pittsburgh Press, 1991.

———. Privatization in the Collor government: triumph of liberalism or collapse of the developmental state? In: CHALMERS, D., SOUZA, M. do C. C. de, BORÓN, A. (eds.). *The right and democracy in Latin America*. New York: Praeger, 1992.

———. *Business politics and the state in 20th century Latin America.* New York: Cambridge University Press, 2004.

SHAPIRO, H. *Engines of growth: the state and transnational auto companies in Brazil.* Cambridge University Press, 1994.

SILVA, E. *The state and capital in Chile: business elites, technocrats, and market economics*. Boulder, CO: Westview, 1996.

STALLINGS, B., PERES, W. *Growth, employment, and equity: the impact of the economic reforms in Latin America and the Caribbean*. Washington, D.C.: Brookings Institution Press, 2000.

STIGLITZ, J. An agenda for development in the twenty-first century. *Annual Conference on Development Economics 1997.* World Bank, 1998.

———. Políticas de desenvolvimento no mundo da globalização. In: CASTRO, A. C. (org.). *Desenvolvimento em debate: novos rumos do desenvolvimento no mundo.* Rio de Janeiro: BNDES, 2002.

TEICHMAN, J. A. *The politics of freeing markets in Latin America: Chile, Argentina, and Mexico*. Chapel Hill: University of North Carolina Press, 2001, 288p.

THORP, R. *Economic management and economic development in Peru and Colombia*. Pittsburgh, P. A.: Basingstoke Macmillan, University of Pittsburgh Press, 1991, 238p.

TOPIK, S. *The political economy of the Brazilian state, 1889-1930*. Austin: University of Texas Press, 1987.

VEIGA, P. M. O viés antiexportador: mais além da política comercial. In: PINHEIRO, A. C., MARKWALD, R., PEREIRA, L. V. (orgs.). *O desafio das exportações.* Rio de Janeiro: BNDES, 2002.

VELASCO, L. *A economia política das políticas públicas: fatores que favoreceram as privatizações no período 1985/94*. Rio de Janeiro: BNDES, 1997*a* (Texto para Discussão, 54).

———. *A economia política das políticas públicas: as privatizações e a reforma do estado*. Rio de Janeiro: BNDES, 1997*b* (Texto para Discussão, 55).

WEYLAND, K. *The politics of market reform in fragile democracies: Argentina, Brazil, Peru, and Venezuela*. Princeton University Press, 2002.

WILLIAMSON, J. (ed.). *Latin American adjustment: how much has happened?*. Washington, D.C: Institute for International Economics, 1990.

———. *The Washington consensus and beyond*. Article commissioned by the Economic and Political Weekly, 2003.

WORLD BANK. *Brazil: prospects for privatization*. 1989 (processed).

———. From plan to market. Washington: *World Development Report*, 1996.

———. The state in a changing world. *World Development Report*, 1997.

———. *World Development Report, 2002*. 2001.

———. *Global economic prospects and the developing countries*. 2002.

[redacted]

EDITORIAL

Supervisão
Helena Rodarte Costa Valente

Revisão
André Pinheiro
Elisabete de Carvalho Soares
Lucia Duarte Moreira
Luiz Carlos Palhares
Miriam Nunes da Fonseca
Alejandro Augusto S. V. A. Poinho (estagiário)

Editoração
Carlos Henrique Santos Vianna
Joanna Silvestre Friques de Sousa
Roberto das Chagas Campos

Apoio Administrativo
Fabiana Pontes

Divulgação
Cesar Wilson E. Santos

Reprodução Gráfica
Edson Soares

Brasília
SBS – Quadra 1 – Bloco J – Ed. BNDES,
10º andar – 70076-900 – Brasília – DF
Fone: (61) 315-5336
Fax: (61) 315-5314
Correio eletrônico: editbsb@ipea.gov.br

Home page: http://www.ipea.gov.br

Rio de Janeiro
Av. Presidente Antônio Carlos, 51, 14º andar
20020-010 – Rio de Janeiro – RJ
Fone: (21) 3804-8118
Fax: (21) 2220-5533
Correio eletrônico: editrj@ipea.gov.br

Tiragem: 138 exemplares