



DEMOCRACY WORKS | CONFERENCE PAPER | 2013

# Brazil: Democracy and Growth

by Marcos de Barros Lisboa  
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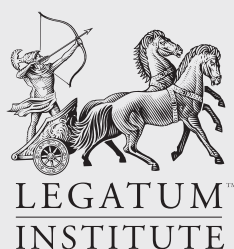
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## Executive Summary

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In the last two decades, there has been much new literature relating to institutions and growth. Douglas North and his co-authors analysed the role of institutions and their effect on economic behaviour and historical events. Later, this tradition was successfully continued in growth theory to explain the differences in income among countries. Aspects as diverse as the rule of law and judicial traditions, regulatory framework, and several institutional factors that affect the market environment have been examined to explain growth and the difference in national incomes. Democracy, however, does not seem to be one of these aspects once a country's fixed effects are taken into account.

Brazilian history displays a similar lack of correlation between growth rate and democracy. That aside, we argue that several other aspects of Brazil's democracy and growth experience are related, in particular the role of the government in the economic development process, something that has strong links to Brazil's colonization process. Engelmann and Sokolov provide the basic approach to understanding the relationship between the colonization process in Latin America and its countries's later institutional and economic development. Brazil's colonization, in particular, resulted in an institutional framework where rent-seeking behaviour was largely sanctioned by state policies.

Government in Brazil, more than in other countries in a similar stage of development, works as a transfer mechanism, granting privileges to selected groups by means of protection barriers to competition and the transfer of resources collected either through inflation or taxes. Its political institutions are consistent with its economic development and maintain several mechanisms that enforce the transfer system.

Since its colonial period, Brazil has experienced many political cycles, and can be considered to have been a troubled democracy since it became a republic. During this long period, the rent-seeking mechanisms were not only preserved but enhanced, being seen as an essential aspect of the country's development project. It is the same case in the twentieth century, where we see the continued implementation of transfer mechanism programmes, though the beneficiaries of these vary through political cycles. Political bargaining and contingencies might have determined the firms elected to receive privileges,

but the general transfer policy of benefiting a few selected sectors reflects the widespread view that the priorities of government protection and intervention should be to promote growth.

For a political and economic process to be sustainable, society's beliefs must be consistent with those of the existing institutions, as well as the general principles governing economic policies and their outcome, as proposed by Graif. If a system consistently fails to deliver what society expects, the political debate will turn to reforms.

In the case of Brazil, the transfer model largely met most of its goals until the end of 1970s. On average, growth rates were high, however, inequality of income was equally high. The provision of standard public goods, such as education and health services, was behind some countries much poorer than Brazil. Furthermore, the distortions introduced in order to guarantee privileges and transfers in an unsound fiscal environment led to an unstable macroeconomy, frequently subject to external shocks or internal crises. Following Olson, one important reason for the survival of such a perverse mechanism that limits growth potential, was the lack of transparency of its underlying costs to society, either by taxes or high inflation. Benefits, on the other hand, were concentrated and very visible for the ones who received them.

A remarkable aspect of Brazilian politics in the last century was that the vast majority of society, irrespective of its political inclinations, favoured bold government transfers to specific interest groups in the belief that such policy was the path to development. There were many political divisions, for example, income distribution in the 1960s and 1970s was seen as an outcome of political bargaining and there was deep divergence on how the government should interfere in it. Nevertheless, the main components of economic policy and the role of government as growth promoter, granting protection to selected sectors, were not subject to major disagreement.

Systems and institutions were likely to change when their promises were systematically unfulfilled. Even though there is a lack of correlation between economic growth and political regimes in Brazil, major changes of political regime or economic reforms have occurred in hand with economic crises. The unstable macroeconomic framework associated with distortions introduced by the transfer model led to frequent crises. The large observed volatility of

economic indicators translated into great political instability and cyclical change of political regimes, without clear improvement to institutions and advancement towards democracy.

Authoritarian regimes followed the crises of 1929 and of the early 1960s. Democracy followed the difficult economic transition of the late 1970s and early 1980s. Economic reforms were adopted in the 1930s as well as the late 1960s in the sequence of the change in regime: in the 1930s, enhancing government transfers, in the 1960s, moving in the opposite direction and creating institutions and better fundamentals for a market economy to work. The oil crises led to a reversal of fortune and government coordination of economic growth was developed to an extreme.

This evidence suggests that economic crises create conditions for regime shifts. Moreover, it induces economic reforms, strengthening or weakening the transfer model. Crises have happened, in particular, when the financing of transfers faced obstacles. The model was dependent on external resources and public spending, financed by taxes and high inflation.

By the late 1970s, the transfer model showed signs of exhaustion. Pressure for the inclusion of new groups was simultaneous to the increasing costs of financing public deficit through inflation—systems became dysfunctional. The economic and political crises of the 1980s led to democratization and, later, to fiscal discipline and stabilization. Democratization meant that new interest groups became eligible for government transfers, and inflation stability required an increasing tax burden to finance these.

The aftermath of the crises were marked by several reforms to the core of the transfer model that characterized the Brazilian economy for so long. Privatization, regulatory agencies, and reform of the pension system were, among others, at the centre of political discussion. The extreme crises of the previous decade inspired an unprecedented reform debate, including the discussion of liberal reforms that intended to prevent some of the pitfalls of the traditional model, such as unsustainable public debt or increasing inflation. At the same time, democracy and the emergence of new interest groups, mostly minorities and lower-income groups that had long been excluded from the main government transfers, created a need for the transfer mechanisms to continue.

The overwhelming nature of hard economic times allowed transfer mechanisms to resume their course in Brazil. Concessions of privileges to the usual suspects and, more recently, to new ones, have systematically increased. The growing allowance of government protection and benefits to special groups are testing their limits: transfers require benefits for some at the expense of others.

The democratization process of the last 30 years was accompanied by several reforms that improved the financing mechanisms of government expenditure. Reforms in democratic regimes may be more delicate to negotiate but provide more protection against discretionary change. On the other hand, the lack of transparency of total social costs associated with government transfers has allowed them continuous growth over time.

More recently, we have observed a new expansion of mechanisms for protection benefits and transfers that are intended to foster growth. The distortions introduced and their diffuse impacts on economic activity indicate the need for a more transparent debate on the allocation of public recourses and their burden on society—one that finally makes clear the social costs of such transfers and their alternative allocation. Unfortunately, it may be the case that reforms to government transfers and concessions of privileges will continue while economic growth remains low.

## 1. Introduction

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Democracy is a relatively recent achievement in Brazilian history. Since the end of the colonial era in the late nineteenth century, the country has experienced two long periods of dictatorship: 1930–45 and 1964–85. For most of last century, political participation was rather limited; evolution towards democracy was convoluted, moving forward and backwards up until the mid 1980s when mass democracy was finally established.

Brazil's economic development has been equally convoluted. In the last century, many years of strong economic growth were followed by severe economic crises. Fiscal and external disequilibrium were common, as was high inflation. The government played a central role in the country's economic development, financing public and private investment, coordinating production decisions, providing protection to selected sectors, and setting prices.

Broad government intervention has been a major feature of Brazil's history. For many decades government economic intervention has been accepted as essential to assure foreign investment and economic growth. Economic development was regarded as a national project to be led by public policies carried out by government agencies. This has been true under both democratic and undemocratic government.

Economic literature defines 'rent-seeking' as the process by which certain groups obtain privileges and benefits from government agencies. It is commonly understood as a means by which private interests obtain special favours from government agencies, often by obscure mechanisms and negotiations. In this paper, we propose the term 'institutionalized rent-seeking' in order to broaden the original meaning. This extended meaning refers to the existence of discriminatory policies intended to provide privileges to or benefit specific groups, often imposing non-transparent costs upon the rest of society.

There are three factors that contribute to a nation being more disposed to rent-seeking. First, discriminatory policies are perceived to be a legitimate and essential aspect of public policy in order to foster economic growth and to mediate social and economic interaction. It is thought that the role of government is to select companies or sectors to benefit from specific public policies in order to promote development. Second, political pressure by organized minorities may be as influential as economic ones. Minority groups, for example, long seen as underrepresented in the political arena, have had their demands for specific policies and benefits increasingly satisfied by government agencies's intervention. We call this phenomenon reverse capture: instead of public agencies captured by a regulated industry, public agencies are captured by organized minorities. Third, the existence of special-interest groups may be the outcome of public policy and not its cause. Government policies may intend, for example, to provide temporary protection or incentive in order to develop a particular economic sector; however, the later removal of these protections and incentives may face the opposition of the companies and employers created by the policy itself. If development policy has failed, and sectors have not become competitive, political opposition

may be even stronger, as removing privileges could mean the collapse of several companies as well as unemployment.

In the case of Brazil, government intervention to protect selected sectors and provide specific benefits has been seen as a legitimate, and necessary, mechanism to induce economic development. Several public agencies were created in the last century in order to provide stimulus to private investment, to coordinate economic decisions, to intervene in specific markets, and to provide protections from external competition. The range of regulated sectors was quite impressive up to re-democratization in the mid 1980s. Much more than the specific regulated sectors, what distinguishes Brazil from other countries is the extensive reach and detailed aspects of its government intervention.

In the first half of last century, Brazil's underdevelopment was understood as a consequence of a coordination failure. The country was mostly an agricultural economy and the absence of a broad industrial sector was perceived as a restriction to economic development. Moreover, there was a lack of long-term funding for investment, so economic policy aimed to provide incentives and protections to selected sectors. Governments also coordinated private arrangements in order to assure market demand, as well as infrastructure and access to inputs and capital goods. Private sector growth thus became the outcome of government intervention.

Under democracy, rent-seeking behaviour was not restricted to economically powerful groups but was also found among other kinds of groups whose welfare was thought to be key to the government's legitimacy. Discretionary policies, specific protections, and money transfers from public agencies were understood to be legitimate mechanisms to allocate resources and foster economic and social development. Either way, the underlying costs of these types of government interventions were not and are not easily perceived due to their diffuse nature and lack of government transparency. And while benefits are tangible for the ones who receive them, the social costs of the benefits are not.

Over time, incentives, protections, and privileges have proliferated in Brazil and now go far beyond the usual tax incentives and cash transfers embedded in government budgets. Instruments such as subsidized loans, protectionism, price controls, off-budget money transfers, and mandatory cross-subsidies in credit markets via earmarked loans are not accounted for in budgets and are often used by government agencies without disclosing their impact on the rest of society.

This is a distinctive feature of Brazil's political processes: government agencies are able to provide privileges and benefits without going through the usual political representation and public budget deliberation. Furthermore, in several cases there is no accountability of costs imposed, much less control analysis of public-policy targets and their actual outcomes.

The political process behind these government interventions is decentralized in several cases. Organized civil society points out the need to protect some specific group, for example, they might call for the extension of health insurance, or for the regulation of market prices, and government agencies are then mobilized in order



to implement measures that meet these demands. These policies provoke little public comment or debate. In the case of the credit market, for example, there is little discussion on the cross-subsidy implied by subsidized loans that penalize the remaining credit operations.

Rent-seeking, once established, is difficult to stop: beneficiaries fight against change and become a significant obstacle to reform; the diffused nature of the costs weakens political opposition; and even policies that were intended for a short period, once introduced, create special-interest groups that defend the programme's maintenance. The result is a large state that fails to deliver adequate income distribution and growth.

At the same time, there is an inevitable conflict between rent-seeking and democratic institutions as opacity renders democratic deliberation on public policy impossible. In addition, rent-seeking by definition limits access to government benefits to certain groups, as privilege, by its own nature, has to be conceded to only a few. Finally, rent-seeking creates economic distortions which ultimately produce lower growth and limit the improvement of income distribution. Government failure to constrain budgets and make choices based on nationally agreed priorities exhausts resources. In Brazil, the national tax burden has risen from around 25% of GDP in the mid 1980s to be currently 37%, higher than the tax burdens observed in most developing countries.

The Brazilian state is now at a crossroads. Taxation cannot be increased much further, but social demands are still high, especially after years of excesses in fiscal policy, higher inflation, low growth, and, more recently, social unrest. Demands for better public services, especially healthcare and education are particularly high. This agenda requires far more efficient government intervention and far more careful political choices. It also requires a different kind of public debate, one that, so far, Brazil's political parties do not appear to be sufficiently well prepared to hold.

## 2. Growth versus democracy in the economic literature

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In the last two decades, following Douglass North's contribution, academic research has systematically pointed out the importance of institutions for economic growth, this being the most successful hypothesis for explaining the differences in income among countries. Rule of law, judicial systems, and market regulations have also been shown to be relevant to explain income disparities among countries.<sup>4</sup>

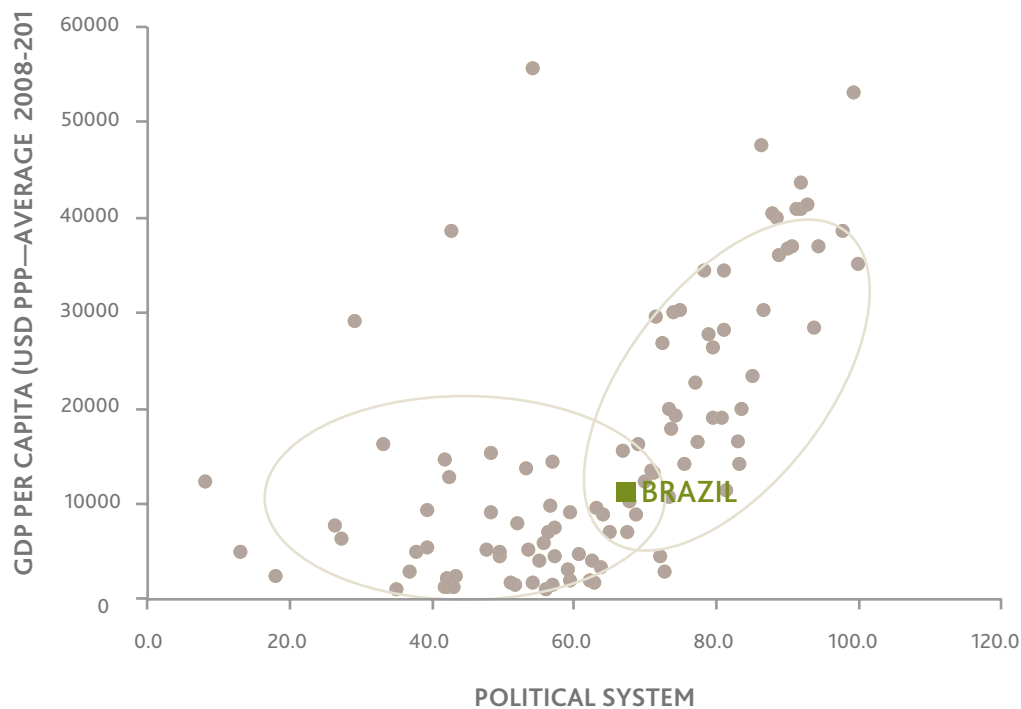
Institutions and general rules delimit incentives for individual behaviour, including production and investment, which ultimately lead to growth.<sup>5</sup> Research shows that adequate institutions for growth are the ones that secure property rights, provide a stable economic environment, and produce efficient incentives for private decisions.

One might expect that democracy would be an additional factor, but that does not seem to be the case. The relationship between democracy and per-capita income is

a curious one. Among poor countries there seems to be a great diversity of political regimes or degrees of democracy, while in richer countries, the diversity is reduced, with a much clearer relationship between democracy and income (see chart 1). The more distant a country is from the technological frontier, the less predictable its political regime seems to be. Richer countries, on the other hand, tend to have fully established democratic regimes. Democracy seems to be a fate for most of the rich, even though it alone does not indicate the future of the poor.

CHART 1: POLITICAL SYSTEM VERSUS GDP PER CAPITA

SOURCE: IMF, GLOBAL DEMOCRACY RANKING



Lipset (1959) proposed a causality relationship between economic development and democracy.<sup>6</sup> He believed that a constitution and the stability of democratic regimes could depend on the development of institutions as well as on social and economic conditions such as prosperity, education, the existence of a middle class, the absence of severe inequalities, rules allowing opposition parties and freedom of speech, and a set of beliefs accepting the rule of law and human rights.<sup>7</sup> Empirical evidence, however, does not support any hypothesis of causality between democracy and growth.<sup>8</sup>

Acemoglu, Johnson, Robinson, and Yared (2008) show that the relationship between democracy and growth becomes non-significant once one allows for a country's fixed effects.<sup>9</sup> This suggests the existence of invariant factors that affect

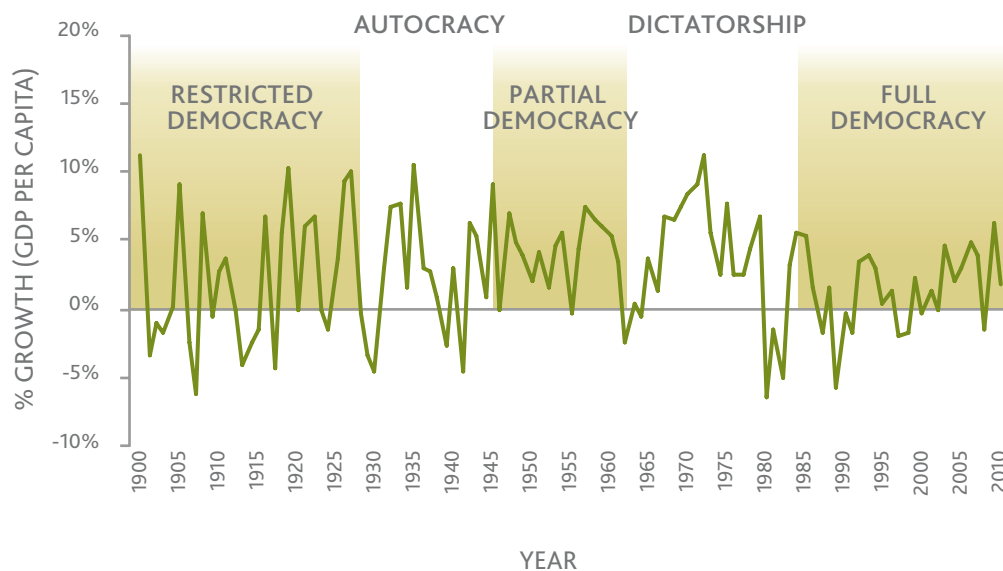
the evolution of both growth and democracy over time, and once these specific factors are taken into account there is no causality between both variables. Acemoglu et al. propose that it more likely due to historical reasons that some countries have fostered institutions that protect the rule of law, property rights, and growth, and have also experienced at the same time more democratic participation and social inclusive policies related to such sectors as education.

The absence of correlation between democracy and growth is also a feature of the Brazilian experience (see chart 2). Democracy and authoritarian regimes alternated a few times in the last century, and business cycles have been unusually wide. Periods of robust economic development have been followed by severe crises and years of low economic growth.

Institutions, however, are the outcome of society's choices, and people prefer to be rich than poor. If there are institutions that provide more income in the long run, why should one choose to receive less? Why do some countries choose a set of rules that lead to a Pareto inferior equilibrium? Why are specific institutions established in certain countries and not in others?

CHART 2: GDP PER CAPITA GROWTH VERSUS POLITICAL SYSTEM

SOURCE: IPEA, IBGE



### 3. Colonization, development and the origins of rent-seeking

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At the root of the political and economic choices made by Brazil throughout its history is its colonial past, which distinguishes Brazil and other Latin-American countries from North America. In a series of influential papers, Engerman and Sokoloff proposed that natural endowments and population size were decisive to the pattern of the colonization process—exploration versus settlement—that ultimately shaped institutions and influenced importantly the future economic development of American colonies.<sup>10</sup> Following a similar path, Acemoglu, Johnson, and Robinson (2001, 2002) investigated the relevance of the colonization model to explain income differentials among American countries nowadays, seeing as institutions built in the colonial period have persisted over time.

The climate and conditions of North America induced settlement and the production for local consumption, while reproducing several aspects of life in Europe. The model that prevailed was one of a more egalitarian society with smallholdings trading with neighbours, and a competitive production of grains that led to specialization, logistics, innovation, and gains of productivity<sup>11</sup> Settlers adopted institutions to protect property rights and guarantee the enforcement of contracts, and introduced institutions that replicated their European counterparts. Society started in a more egalitarian way, and initiatives that threatened this backdrop were limited in their success.

In contrast, tropical areas provided favourable conditions to efficiently produce goods that were valuable to Europe by exploration of land and use of labour. The intention of colonizers was not to settle, but to explore and harvest natural resources. Colonization induced large-scale production and controls that enabled income appropriation by local elites. This growth model required institutions to enforce rent-seeking mechanisms that resulted in an unequal society and concentrated access to political power. Government rent-seeking mechanisms were an essential part of this model. It is interesting to note that more than half of the Portuguese government's income in this colonization period came from transfers from Brazil, according to Mattoso (1993).<sup>12</sup>

At the end of the colonial period, American colonies displayed a surprising division—there were two Americas. In the north, settlers produced mostly for domestic consumption, and society was more egalitarian. The several areas in the south were richer due to trade with Europe—the Caribbean had the highest per-capita income, overcoming North America until the nineteenth century<sup>13</sup>—but society was unequal. After many of these southern nations achieved independence, however, development paths inverted and tropical areas underperformed economically in comparison to North America, a pattern that persisted during the twentieth century. Institutions that were adequate during colonial periods persisted after independence movements but proved to be less suitable for market economies. Acemoglu, Johnson, and Robinson (2002) appropriately referred to this process as a “Reversal of Fortune”.

If growth trajectories inverted, the same cannot be said about political participation and income distribution. In former exploration colonies, such as Brazil, high inequality and restricted political participation remained after the colonial period,<sup>14</sup> along with poor access to education.<sup>15</sup>

Why have sub-optimal colonial institutions persisted? Why did tropical areas choose not to follow the path of the North American institutions that proved to be more successful after the late nineteenth century? Why has Latin America fallen behind? Why have some democracies flourished and revealed themselves to be resilient while others have proved to be very susceptible to current events?

Where institutions and incentives rule individual behaviour, people make choices to maximize their welfare. Whether that suggests a Pareto inferior equilibrium or not, it is either because people do not perceive the benefits of changing the rules or because some groups that would be worse off in the new environment, and who have veto power, can obstruct changes, especially if society has no credible way to compensate them for possible losses. This pattern of behaviour seems to apply to rent-seeking societies, which rely on institutions that concede special benefits and privileges to a selected few and restrict the participation of remaining social groups.<sup>16</sup> This design ultimately helps to explain the survival of this inferior equilibrium.

In Brazil, rent-seeking is quite standard, despite its sub-optimal outcome. Its long prevalence has several sources. First, the practice of rent-seeking reflects widespread beliefs and supports the status quo.<sup>17</sup> Second, there is a good deal of uncertainty about alternative policies and practices—for example, many worry about the specific consequences of trade liberation on their particular market.<sup>18</sup> Third, rent-seeking policies create politically vocal groups that depend on those policies and react to proposed changes. Fourth, the opacity and hidden costs of benefits makes it more difficult to hold a public discussion based on cost-benefit analysis of policies, even after re-democratization.

With rent-seeking the norm, rules and procedures are adjusted to beneficiaries's needs, and the cost of the benefits is diffused throughout society. There is almost no timely enforceable evaluation of policies's outcomes, and privileges, once conceded, are somewhat protected from public discussion, fixed by several legal mechanisms that make future change more difficult.<sup>19</sup>

## 4. Historical perspective

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Brazil has experienced many political cycles since colonial times. Yet throughout this long period rent-seeking mechanisms were not only preserved but enhanced—they were accepted as essential to the country's development. The purpose of government, many believed, was to provide protection, incentives, and benefits to selected sectors in order to promote growth.

After 1929, these assumptions became explicit. Economic development became primarily a government responsibility. This was not unique to Brazil: many countries in the 1930s and '40s leaned towards protecting their economies.

The spread of nationalism and an international economic crisis during this time persuaded governments to encourage domestic production and lower dependency on trading.<sup>20</sup>

During the long Vargas dictatorship (1930–45), political rights were limited and government increasingly assumed the role of mediating both economic and political decisions and conflicts. Government agencies monitored and played an important role in investment decisions and resource allocation, as well as in mediating social conflicts—special courts and rules severely limited private agents's scope to negotiate in sectors such as the labour market. Intervention in the economic sphere was equally widespread: government agencies introduced restrictions that limited the market's ability to allocate goods and services, and the government arbitrated prices in several markets as well. The invisible hand of Adam Smith was replaced by a clearly visible government hand, however diffuse and opaque.<sup>21</sup>

After World War II, under a restricted or 'elite' democracy, Brazil again chose a strategy that put government at the centre of its development project, following many other developing countries in Latin America. The ideological framework that provided a justification for the government's intervention was called National Developmentalism.<sup>22</sup> According to this view, underdevelopment was the outcome of a lack of coordination and of resources to finance private investments. The public sector was meant to overcome these limitations by granting protection and adequate incentives to selected economic sectors.

Industry was the sector selected for protection. In the 1950s, income generated by export agriculture was transferred to the industrial sector through many mechanisms, including taxation on several agricultural goods and a complex system of multiple exchange rates. Along with trade barriers, these mechanisms protected the industrial sector from external competition and provided incentives to import inputs and capital goods.<sup>23</sup> Beyond that, the government also coordinated production and investment decisions with the private sector. Several public monopolies were created, from oil to reinsurance, and state-owned companies provided utility services. The government also supplied infrastructure and banks.<sup>24</sup>

Government funds in Brazil financed both private and public investments, such as the construction of a new capital, Brasília. Nevertheless, forced savings and increasing indirect taxes did not prevent large public deficits and inflation acceleration. However, high inflation was considered the result of supply restrictions, rather than excess demand, that was to be tamed via monetary and fiscal discipline.<sup>25</sup> Therefore, policy recommendation was to stimulate investment and production in order to relieve these restrictions.

By the late 1950s, macroeconomic imbalances led to high inflation and severe external restrictions. The Cold War added pressure to an already difficult economic and political environment; political instability and social unrest increased, with claims for more equality. The combination of privileges and benefits to specific groups and sectors, the lack of accountability of public resources, macroeconomic instability, and growing social demands became explosive. The worsening of

economic and political conditions in the early 1960s led to a military coup in 1964, which resulted in a 21-years-long dictatorship.

Yet economic crisis and political centralization were the ingredients for unexpected economic reforms in the mid 1960s. Several liberal market-oriented reforms were carried out along with government spending control. For example, the creation of the Central Bank, the regulation of capital markets, and the introduction of several credit instruments. Liberal reforms induced productivity gains and, in conjunction with a favourable external environment, fostered growth for the next few years.<sup>26</sup>

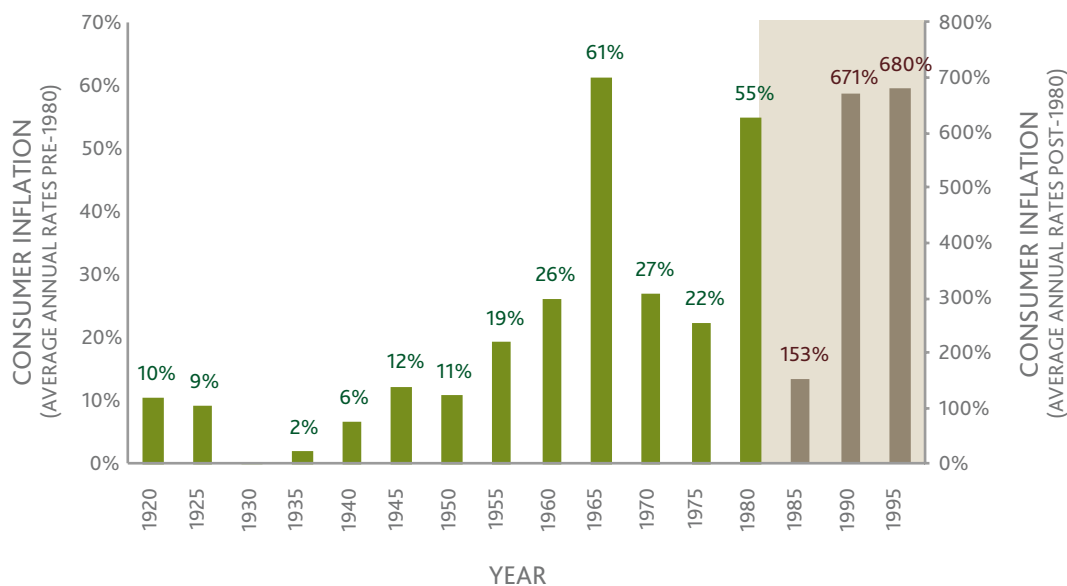
When growth rebounded in the late 1960s, the usual instruments of economic policy, such as strong government intervention, incentives, concessions of privileges, and price controls, resumed and intensified. Fiscal policies became increasingly expansionary, leading to inflation acceleration and rising current-account deficit. The macro policy regime was clearly one of fiscal dominance, meaning the inflationary financing of fiscal deficits. As a response, the government created several instruments to introduce the indexation of the economy, aiming at postponing macro policy adjustments.

Government reaction to the severe mid 1970s was to 'double the bet' and reinforce the National Developmentalism project, this time supporting imports substitution. Sectors chosen to receive government funding and protection ranged from the naval industry to capital goods, basic sectors, and infrastructure.

The government's method for coping with inflation was to strengthen the indexation mechanism instead of promoting a fiscal consolidation, which turned inflation dysfunctional in the 1980s. Chart 2 shows the evolution of annual inflation at five-year intervals. Due to the impressive increase of inflation after

CHART 3: CONSUMER INFLATION (AVERAGE ANNUAL RATES)

SOURCE: UPTO 1944: IPEADATA; 1945-1995: AVERAGE CPI RIO DE JANEIRO (FGV) AND SÃO PAULO (FIPE)



1980, the three previous five-year intervals have a different scale on the right side.

Indexation, however, was not the only government finance mechanism. Brazil distinguishes itself with the existence of many financing apparatus designed to provide privileges but hide benefits away from public scrutiny. This lack of transparency of costs and of valuation of outcomes is a common feature of rent-seeking models, as emphasized by Buchanan (1967).<sup>27</sup>

National Developmentalism delivered robust growth until the end of 1970s, but produced an unstable macroeconomic environment, frequently rocked by external shocks or internal crises.<sup>28</sup> On average, growth rates were robust—close to 7% a year, from the early 1950s to the late 1970s—however, these numbers may also reflect a rapidly growing population. Growth rates per worker were high but not superior to other developing countries at that period, such as South Korea.<sup>29</sup> Inequality of income was high and worsened significantly in the 1970s. The provision of standard public goods, such as education and health-care services, lagged behind some much poorer countries. In the beginning of the 1980s, on the back of Volcker's monetary tightening, a severe crisis erupted and the growth model collapsed. On the political side, social pressure led to re-democratization and waves of deep and broad reforms.

## 5. Re-democratization

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The regime shift in the mid 1980s led to the 1988 constitution and the creation of democratic institutions. Larger social participation—some 10,000 unions were created—and more vocal social demands began to play an important role in shaping the economic agenda. Public pressure for price stabilization, higher economic growth, and more social equality was high.

In the first ten years of democracy, debate and policy actions were concentrated on price-stabilization strategies that limited the scope for a broader economic agenda. Moreover, the political environment was troubled due to a stream of unsuccessful stabilization plans that culminated with the resignation of President Collor (1990–92)—the first president democratically elected by direct voting—amid a severe economic crisis and a corruption scandal. Still, some important market-oriented reforms were implemented in the period: gradual trade and financial liberalization, the start of a privatization program, and the creation of consumer protection agencies.

Popular demand for macroeconomic stability led to the election of President Cardoso (1995–2002), the finance minister who had launched the successful stabilization plan, Plano Real, in 1994. The consolidation and sustainability of low inflation required a sound fiscal regime and led to several reforms, including the pension system and a broad privatization program, followed by the creation of regulatory agencies.

Taming macroeconomic volatility was critical for accelerating growth and improving income distribution. Some experiments for improving income distribution started in this period, such as cash transfer policies and restoring the

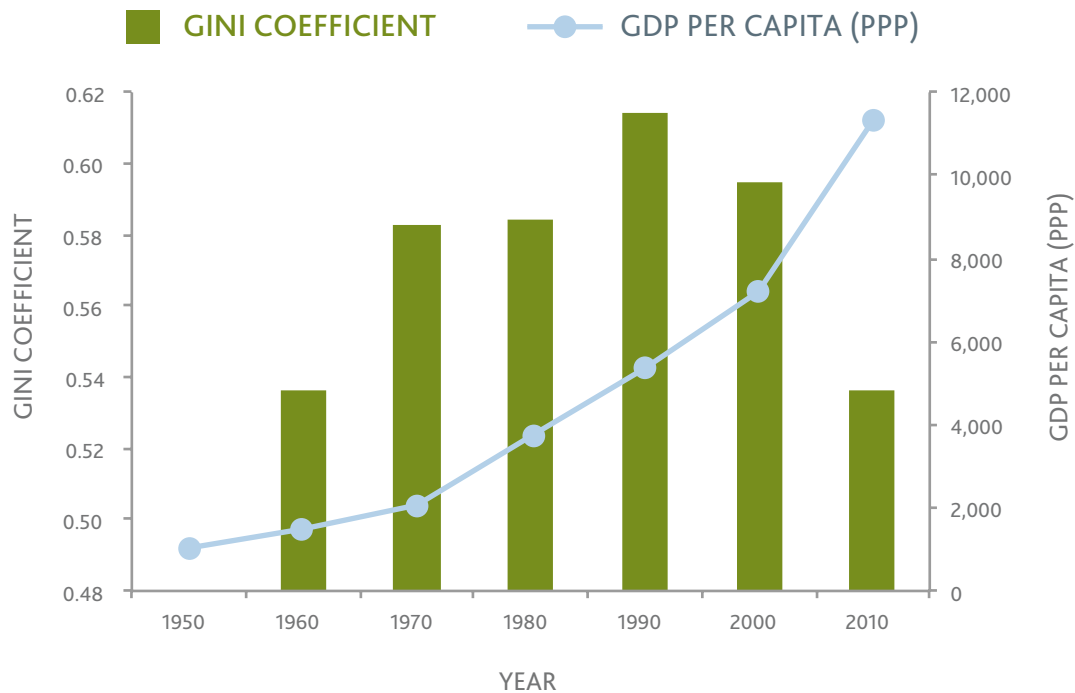


purchase power of the minimum wage. A particularly successful program was Bolsa Escola, which provided cash transfers to low-income families with children at school. Later in President Lula's government (2003–10), some of those cash transfer programs were unified in a single program called Bolsa Familia.

The severe economic crisis of 2002 was met by a surprisingly orthodox economic policy in Lula's first administration. The government focused on macroeconomic stability and promoted several market-oriented reforms in the credit and capital markets. Available evidence suggests these reforms successfully improved market efficiency and led to fast credit expansion. Microeconomic reforms played a central role in stimulating the formalization of the economy, granting firms access to capital markets and promoting the emergence of the new middle class. Furthermore, the government focused on the expansion of social policies that had already been initiated under the Cardoso administration. The result of this broad set of structural reforms was a rebound of investment, productivity gains<sup>30</sup>, and improvement in income distribution, as displayed in chart 4.<sup>31</sup>

CHART 4: GINI COEFFICIENT

SOURCE: IPEA



Re-democratization led to an expansion of government transfers, as government benefits were granted to new social groups that had been less vocal in the political arena and had not received benefits in the past. Government budget allocations to social spending increased in the late 1980s, and increased further in the twenty-first century. Social spending helped reduce income inequality between 2000 and 2005. The Gini index dropped 1.2% per year between 2001 and 2005 and income from the poorest 20% grew 5 percentage points above average income. Barros, Carvalho, and Franco (2007b) estimate that half of inequality reduction derived from non-labour income.<sup>32</sup>

Aside from the focus on social policies, democracy was also important for the promotion of solid economic reforms. Surprisingly, some economic reforms of the 1960s and early 2000s were quite similar, including liberal, market-oriented, and pro-growth reforms as well as institutional reforms designed to provide adequate regulations similar to the ones observed in developed economies. The process of making the reforms, however, was different, as reforms under democracy require negotiations and evolve more slowly. Still, the later reforms have proved to be more solid and resilient, being a part of natural political development rather than a response to a crisis.

The most important example of successful reform is the consolidation of the fiscal regime. In the 1960s, fiscal stability was always temporary, but in the 1990s social demand for low inflation required fiscal discipline. The latter was implemented via a broad set of instruments, including privatization, renegotiation and consolidation of state public debt, (partial) social-security reform, the introduction of primary fiscal-surplus rules for the federal government, and the creation of the Fiscal Responsibility Law that restrains fiscal policy at all government levels. Another example of successful reform involves Brazil's central bank. Under dictatorship, the central bank was legally established in 1964, given autonomy, but single-handedly dismissed in 1968 by the president. In contrast, under democracy, autonomy to the central bank was not granted, but the monetary authority appeared de facto independent, which was an essential element of the inflation target regime established in 1999. More recently, the mood has changed again. During Lula's second administration, economic policy slowly moved from the path initiated in Cardoso's administration back towards the old National Developmentalism. This particularly became the case after the global crisis of 2008.

Old habits die hard and government reaction to crises, as in the mid 1970s, has been increasing intervention and resuscitating the old rent-seeking mechanisms. Recently, market distortions and transfer programmes, such as tax incentives and protection to selected sectors and groups, have been reintroduced. Monetary transfers have proliferated, as democratization creates new interest groups eligible for government programmes, with many of the benefit schemes being hastily organised and lacking clear diagnoses or monitoring of results. State banks credit concessions increased significantly in the last six years in order to finance private sector investment. The Brazilian Development Bank's (BNDES) credit alone came close to 11% of GDP in this last decade. It was the government's, and a larger part of society's, belief that by restoring old incentives Brazil would be able to

overcome the difficult external scenario. Six years later, the economic outcome has frustrated several analysts and government officers.

Total factor productivity and commodity prices were the main drivers of economic growth in Lula's government. Since the external crises of 2009, productivity growth and economic growth have reduced, and the introduction of several market distortions, the uncertainty about economic policy, and government commitment to contracts have led to a more volatile macroeconomic environment. Fiscal policy was relaxed and monetary policy was slow to react to higher inflation (though inflation was far from the levels observed in last century), while economic growth disappointed. The backdrop of macroeconomic deterioration has added to the failure of government agencies to deliver public services of acceptable quality, despite the high tax burden.

The low quality of public services is at the centre of debate in Brazil today—the tax burden is high but the quality of spending is low. This backdrop is reflected in the low position of Brazil in global rankings for government effectiveness, even taking into account spending-to-GDP ratio. The low effectiveness of government policies in turn reinforces rent-seeking patterns of social policies, as the government looks for shortcuts to compensate the poor.

Society has reacted intensely to the threats to what had become the status quo, surprising analysts and politicians. Social unrest, reflected in more than 700 protests in more than 300 cities in June 2013, suggests that the Brazilian government needs to resume pro-growth reforms that have been paralyzed since the middle of last decade, and to improve the effectiveness of government policies in order to reconcile social demands for better-quality public services and fiscal discipline. Signs of a legitimacy crisis are brewing and might be a reflection of government failure to understand and deliver society's demands against a backdrop of a political system that needs reforms to improve social representation.

Democracy and rent-seeking have come into inevitable conflict. The widespread concession of special treatments, tax breaks, subsidized loans, and economic distortions reduces efficiency and economic growth and angers the public. There is a sense of frustration with public policy and the very modest economic recovery after a few years of low growth.

## 6. Evolution of education

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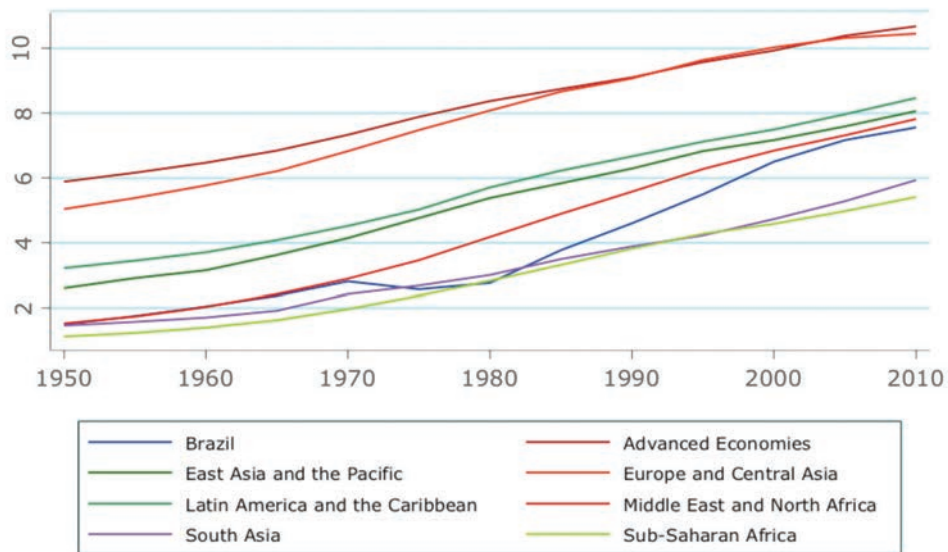
One important benefit of democracy was the increase of public investment in education which was achieved through the 1988 constitution establishing universal access to education. Rising female participation in the labour market and in the political arena was one driver for this shift in the economic agenda.

Since the middle of last century there is much evidence of the impact of education on income and growth.<sup>34</sup> Furthermore, in an impressive sequence of studies, Langoni (1973, 1974) showed the significant importance of education in explaining Brazilian income inequality at that time.<sup>35</sup> Despite the evidence, education was not a priority for Brazil through most of the twentieth century; mass education

played no role in National Developmentalism. Industrialization was understood as the outcome of capital accumulation and labour, regardless of its quality.<sup>36</sup> Knowledge was required only to the extent that it provided access to new technologies, and so the priorities of education investment were universities and research and development.<sup>37</sup>

Government spending on education in Brazil had been historically low compared to other developing countries, resulting in higher illiteracy ratios and low labour productivity. In the 1950s, public expenditure in education amounted to 1.4% of GDP, fluctuating around 2.7% during 1965–85.<sup>38</sup> According to Pessoa (2008), in the 1950s six out of ten children aged seven to 14 were not in school. Years of low concern for public education left their marks. Chart 4 shows the poor evolution of education in Brazil.

CHART 5: YEARS OF SCHOOLING  
SOURCE: BARRO AND LEE (2012)



Under democracy, government spending on education climbed to close to 3.8% of GDP in 1990, accelerating to 4.5% in 2005, and reaching 5.7% in 2009, which compares to 5.8% of GDP in OECD countries. As a share of total public spending, expenditure in education accounted for 16.8% in Brazil versus a 13% average in OECD countries, ranging from less than 10% in the Czech Republic, Italy, Japan, and the Slovak Republic, to more than 19% in Chile, Mexico, and New Zealand. These figures put Brazil in a more favourable position, at least in terms of spending.

TABLE 1: PUBLIC EXPENDITURE ON EDUCATION

SOURCE: OECD (EDUCATION AT A GLANCE, 2012)

	% OF TOTAL PUBLIC EXPENDITURE				% OF GDP			
	1995	2000	2005	2009	1995	2000	2005	2009
<b>OECD</b>	11.7	12.6	13	13	5.3	5.2	5.3	5.8
<b>EU21</b>	10.4	11.4	11.8	11.5	5.3	5.1	5.3	5.8
<b>BRAZIL</b>	11.2	10.5	14.5	16.8	3.9	3.5	4.5	5.7

Democracy, therefore, may have led to a more transparent and collectively decided transfer mechanism, one that is fully accounted for in the government's budget and subject to social scrutiny. This means that democracy may have led to the development of mechanisms more similar to the ones observed in developed economies.

Despite the increase in education investment, Brazil has not yet experienced success in terms of closing the education gap, like South Korea or even Chile have. The catch-up in terms of years of schooling is still yet to be seen. Moreover, there has been a lot of questioning of the quality of education spending, as the performance of Brazilian students in international evaluation lags far behind peer countries. From this perspective, Brazil's challenge is to improve the quality of spending rather than increase the budget for education. The priority in the last two decades was to provide universal access to education. Now it is time to provide egalitarian access to good-quality education.

A major challenge for public policy is to understand the reasons for such a poor outcome of public spending on education, its incentives, and regulations. Why do Brazil's schools perform so badly and their pedagogical tools seem to be so ineffective? How should incentives and regulations change to foster a more efficient use of public resources? These seem to be the challenges ahead.

## 7. Rent-seeking mechanisms and democracy

Government intervention via rent-seeking mechanisms is broadly accepted by Brazilian society. It is seen not as transitory second-best policy, but as a strategic tool to promote growth. The root of this belief might be the colonial period's legacy of high inequality among different sectors of society. Brazilian democracy was built and shaped under this belief as well as this government *modus operandi*. As long as new groups appear in the political arena, claims for more equality have been met with more rent-seeking policies, which work as shortcuts to meet social demands.

Following Olson (1971), one important reason for the survival of such a perverse mechanism has been the lack of transparency of rent-seeking's costs to society, which is in turn diffuse. Benefits, on the other hand, are concentrated and very visible for those who receive them. Aggravating factors are the limited political participation of most of society, as well as the government agencies that provide

privileges and benefits to selected groups away from public scrutiny. Diffuse costs and concentrated benefits are at the core of the persistence of rent-seeking mechanisms.

Rent-seeking in Brazil manifests itself in several ways. We have divided them into four main areas. First, there is a very complex system of tax and transfers, characterized by several rules and exemptions that mask the beneficiaries of privileges. Second, there are mandatory tax-transfer mechanisms that do not go through government budgets. Third, several cross-subsidies, via price control and forced allocations of funds, provide specific benefits under hidden mechanisms. Fourth, trade and non-trade barriers limit competition at the expense of consumers, who are then affected by higher prices and a worsening quality of goods. All these mechanisms contradict the idealised benefits of direct government transfers. In the following sub-sections, we describe a few of these mechanisms.

## 7.1 RENT-SEEKING: TAXES AND TRANSFERS

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Large government does not necessarily mean inefficiency. In many developed economies, at least until the end of the last century, as long as there was a transparent process in which tax-transfer mechanisms were widely debated and evaluated, they were accepted. In many countries there is a permanent concern with the monitoring of their impact, leading to frequent reforms.<sup>39</sup>

The effectiveness of the fiscal policy in promoting long-term growth depends on the quality of spending and the complexity of the tax system, and Brazil fails on both fronts.<sup>40</sup> Rent-seeking weakens the effectiveness of fiscal policy as it reduces the resources available for investment and social spending and produces a distortive tax system.

Historically, spending on education, health care, and income distribution had been rather low in Brazil (even in comparison to other developing countries) and not entirely subject to democratic scrutiny.<sup>41</sup> The tax burden was also low, hovering at around 10% of GDP until the 1940s and increasing to 20% in the 1970s as governments increased their intervention in the economy. Once inflation stabilized and the expansion of government transfers increased, the tax burden scaled up to 25% of GDP in the 1990s. Government spending in Brazil reached 40% of GDP in 2012, according to the IMF, while the tax burden was close to 37%, as displayed in chart 6.<sup>42</sup>

Comparing these figures to countries with similar income per capita, one can see that Brazil has become a higher-spending, higher-taxation country.

CHART 6: TAX BURDEN (% GDP)

SOURCE: UP TO 1980: FECOMERCIO. 1990 ONWARD IBPT

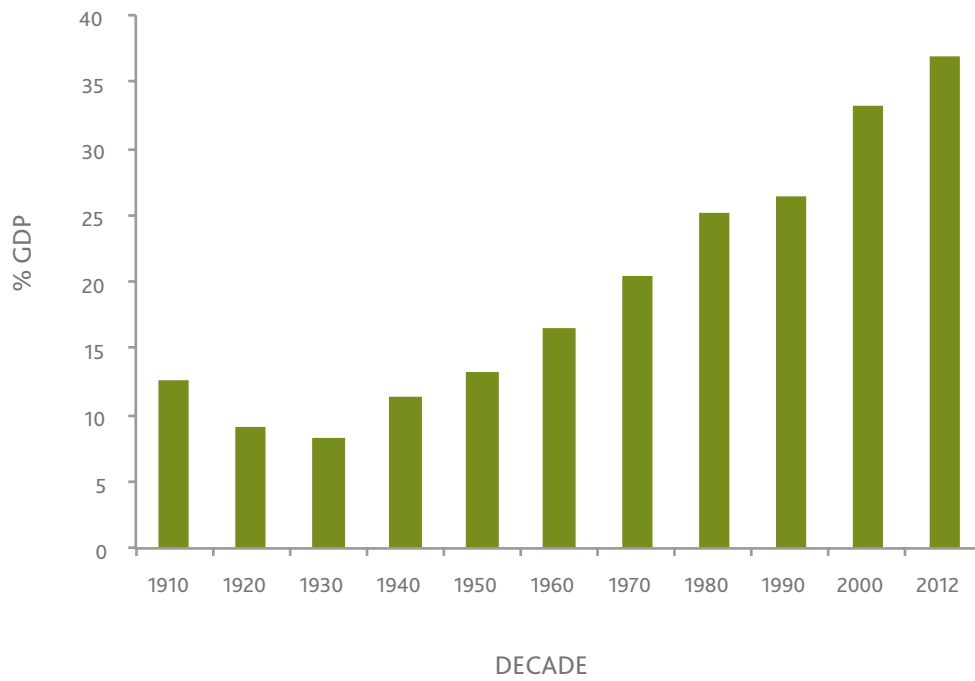


TABLE 2: TOTAL TAX REVENUE (% GDP) 2012

SOURCE: IMF.

Brazil	37.2
Argentina	40.3
Chile	23.9
China	22.6
India	19.1
Israel	38.9
Korea	23.3
Mexico	23.6
Turkey	34.7
South Africa	27.9

According to the “Global Competitiveness Report, 2012–2013”, Brazil ranked last in a sample of 144 countries in the area of extent and effect of taxation, and 131st on total tax rate, an item intended to measure total taxes incident on production and labour.

The complexity of Brazilian tax rules is overwhelming. The tax system embeds myriad rules, exceptions, and exemptions that cause excessive bureaucracy and distortions that hurt growth.<sup>43</sup> From 1988 (when Brazil promulgated its new constitution) to 2011, in the federal government alone, there were close to 156,000 new norms—including six constitutional amendments, more than 4,700 new laws, and 1,162 provisional measures—and more than 130,000 complementary norms.<sup>44</sup> The outcome is a complex system with several different tax rules for specific sectors and products, and several compensation schemes for different taxes that might have to be paid by the same company. According to a 2012 report of the federal court of auditors (Tribunal de Contas da União, or the TCU), federal tax exemptions amounted to R\$215.5 billion including credit benefits provided by BNDES, which accounts for 5% of GDP.

Re-democratization helped to increase the distribution of the tax revenue among Brazil’s states.<sup>45</sup> Democracy also increased meaningful monetary transfers to low-income people, for example, pensions to agricultural workers and other informal workers and several cash transfer programs to low-income families in the second half of the 1990s. Later, in the first half of the 2000s, some of those programs were unified and extended under Bolsa-Família,<sup>46</sup> a moderately successful program that amounted to 0.5% of GDP in 2012 and helped to reduce income inequality.

Despite the success of some targeted social policies, total social spending still fails to improve income distribution in comparison to other countries. According to Immervoll et al. (2009), the Brazilian government spends more than two-thirds of tax revenue on social programs. This compares to OECD averages, but nevertheless, Brazil still fails significantly to reduce income inequality and poverty as has occurred in more developed countries. The main reason for this is the social-security system that focuses on a relatively small group of beneficiaries.<sup>47</sup> Pensions account for 85% of total cash transfers to households (about 11% of GDP), which in turn represents almost one-quarter of household disposable income. This percentage is above the OECD average, despite Brazil’s much younger population, but benefits are too concentrated, with ratios far above the EU countries.<sup>48</sup>

Souza (2012) reached a more pessimistic result when analysing the net impact of government actions on income distribution. Using 2008–09 data, his study shows that government intervention worsens income distribution because wealthier public servants are the beneficiaries of more generous social security. Whereas government action explains one-third of income inequality in Brazil, one-fifth stems from pensions. The author mentions that this magnitude could be underestimated as it includes progressive direct taxes and contributions, but does not include indirect taxes, which are regressive.<sup>49</sup> In line with those findings, Afonso, Soares, and Castro (2013) compare the Index of Human Development (IHD) of several countries against their respective tax burden and show that Brazil lags behind.



It is worth mentioning another important example of rent-seeking and its results: the economic area of Manaus (Zona Franca de Manaus or ZFM).<sup>50</sup> The ZFM contains about 600 industrial companies, mainly working in electronics and chemicals, and employs 400,000 workers. ZFM was formally created in 1967, with a broad set of tax breaks aimed at promoting regional development. Incentives were supposed to end by 1997. Nevertheless, they have been continuously renewed since then, and in 2003 the federal government postponed their end until 2023. Fiscal incentives for this area were estimated to be at least R\$24 billion for 2011 or 0.6% of GDP, as this amount does not comprise other municipal and state incentives (for example, lower property tax or lower value-added tax on goods produced in other regions and sold in ZFM).

Companies in the ZFM operate like maquiladoras, basically assembling and packaging products, generating little value added, and requiring imports of inputs far above the country's average. Furthermore, ZFM looks like an enclave without strong ties to the country's production chain. It survives based upon a captive domestic demand as trade barriers protect local production. The outcome in terms of exports is disappointing when compared to the Mexican experience: exports stand for less than 3% of the different companies' turnovers.

The companies that are part of the ZFM have no incentives to invest, as they depend on permanent government protection. The ZFM has persisted, despite its failure to promote regional development and reduce social inequality, at the expense of the society.

## 7.2. RENT-SEEKING: COMPULSORY MONEY TRANSFERS OUTSIDE GOVERNMENT BUDGET

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A remarkable feature of Brazilian rent-seeking is the government's ability to create tax-like contributions required to be paid by individuals and firms, and to transfer resources directly to special interest groups. These mechanisms do not go through the government budget and are not subject to congress discussion or society scrutiny. An example is Sistema S, a pseudo-tax which takes the form of a compulsory contribution on a given firms' payroll that is directly transferred to 11 private institutions that support labour-force education, cultural events, and other things. In 2010, funds allocated to Sistema S amounted to at least 0.3% of GDP, according to Afonso, Soares, and Castro (2013).

Another example is the workers's mandatory savings fund, called FGTS, which collected close to 1.7% of GDP in 2010, according to the same authors. Each year registered workers must save an amount equivalent to a monthly wage that is then kept in a fund managed by a government agency. These resources are used as funding for investments in several areas. Workers can only use these resources when retiring or under specific circumstances, for example, upon termination of employment or for financing housing acquisition. This fund pays interest below market rate.

It is interesting to notice that as informality has been historically high in Brazil, most individuals are not under supposed government protection. Therefore,

FGTS as well as Sistema S are usually seen as benefits to formal workers and an advantage over informal jobs rather than a burden on wages. There is no transparent mechanism to evaluate the cost-benefit of these instruments or their opportunity cost.

### 7.3. RENT-SEEKING: CROSS-SUBSIDIES

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The phenomenon of cross-subsidy is common. In areas as widespread as the regulation of the health-insurance market, the supply of infrastructure services, and even access to cultural goods, there are legally introduced distortions that provide benefits to small groups, without transparency, at the expense of society.

In several cases, relative prices are moved away from their efficient level and negative incentives are introduced. The most peculiar ones are discounts on the prices of cultural events. Prices vary according to age and occupation: students and elderly are entitled to half-price tickets, but at the expense of others who pay higher prices. Half tickets have been increasingly extended to a large number of groups who don't necessarily have need for the discount, for example, people who donate blood.

Cross-subsidies also weigh on the credit market, creating many negative implications in terms of resource allocations and effectiveness of monetary policy. Government intervention in the financial market is very peculiar in Brazil. From independence to the late twentieth century, many public banks were created and evolved into a large network of both federal and state banks. It was not completely successful as those banks were often used to finance private and public sectors under questionable conditions. Many of them, like Banco do Brasil, have gone bankrupt a number of times, as in the severe crisis of the states's public banks in the late 1990s that resulted in losses close to 6% of GDP, according to Lundberg (2011). The arbitrary use of public banks, their social costs, and macroeconomic impacts are subjects yet to be detailed in Brazil's economic history.

Financial markets are also affected by cross-subsidies in private-sector loans.<sup>51</sup> Regulations severely restrict the amount of deposits available for funding non-earmarked credit operations. Reserve requirements on demand deposits are close to 50% against less than 10% in most countries. Besides, there are several earmarked loans, charging interest rates below the market, which, if we exclude BNDES loans, stand for 20% of credit outstanding (as of 2012). Non-earmarked loans charge much higher interest rates to consumers, in part to compensate for the subsidy embedded in earmarked operations. In 2012, spreads on the former reached 20% versus 3.5% of the latter.

BNDES is included in the set of distortions in the financial market. It is also an example of how institutions survive, adapting to new circumstances and, in this case, reinforcing the rent-seeking scheme. Established in 1952, the BNDE (BNDES since 1982) initially focused on developing infrastructure. Later, in the 1960s and '70s, BNDE widened its role by becoming a majority shareholder in many companies. Through the 1970s, BNDE shifted to financing private companies, using new instruments, financing machinery acquisitions, serving as guarantor in credit

operations abroad, and investing directly in the equity of domestic companies. In 1982, it created BNDESPAR, a private investment arm to manage those holdings. In the 1990s privatization program, BNDES played a central role. Aside from being an operational agent, it provided financing for the buyers in some of the transactions and purchased minority stakes through BNDESPAR, aiming to attract private players to the auctions. BNDES remained strategically important even after the liberalization and privatization wave of the 1990s. During Lula's government, BNDES was involved in several large-scale operations aiming at building 'national champions', large Brazilian companies that were built up to compete against international companies in world markets.

Time has passed, capital markets in Brazil have developed significantly, but BNDES has persisted and it has become even larger. It has changed its role over time, adapting finance mechanisms and its funding sources as well. BNDES has clearly deviated from its role to finance projects with a high social return that would not be funded otherwise.

Since the disruption of the global crisis in 2008, BNDES loans have been a supposedly anti-cyclical tool. Loans increased dramatically, reaching 11% of GDP at the end of 2012 from around 6% prior to the crisis, relying on enhanced cash by the treasury. According to the TCU, the implicit subsidy to the BNDES would have totalled R\$22.8 billion in 2011 (around US\$10 billion). Additionally, BNDES has lately been a source of resources to the treasury via anticipation of dividends payment. As a result, Basel Indexing has been decreasing, reaching 14.5% in March 2013 from 20.6% at the end of 2011.

The BNDES system amounts to US\$333 billion of assets versus US\$338 billion of the World Bank. BNDES is the third largest development bank in the world, following the China Development Bank (US\$751 billion) and Germany's Kreditaltamt für Weidaruftan (US\$596 billion). BNDES does not comply with the key design attributes for a successful industrial policy defended by Rodrick (2007), which are 'embeddedness', carrots-and-sticks, and accountability. Governments make top-down decisions on sectors to be protected with no adequate involvement of the private sector. BNDES encourages investments in non-traditional areas (the carrot), but fails to weed out unsuccessful projects (the stick); and the public does not have access to the performance of these operations. There is no transparency on BNDES operations; no available data on total subsidies provided, benefited companies or sectors, or the bank's cost-benefit of policies. Furthermore, evaluation of the outcomes of BNDES investment decisions is also unavailable.

When it comes to assessing the impact of BNDES on the national economy, conclusions are disappointing. According to Musacchio and Lazzarini (2013), BNDES picks 'winners' but neither invests in capital-intensive projects nor in projects that improve their performance. Regarding loans, the only significant impact is the reduction on firms's financial expenses, without any consistent effect in terms of investment or performance. Moreover, the authors point out that firms benefited by BNDES and donations by firms to elected political candidates are connected.

Another criticism is the distortions generated by the bank's funding model. As discussed by Musacchio and Lazzarini, BNDES funding changed over time: from government transfers and monetary deposits with inflationary implications in the very beginning; to payroll taxes intended to finance an unemployment insurance program consolidated in 1990, where BNDES would pay in return the so-called federal long-term interest rate, below the central bank's interest rate. From the 1980s to 2008, BNDES relied significantly on retained earnings, basically the return on investments in securities using BNDESPAR. Since 2009, a huge amount of funding has been coming from treasury transfers via public debt issuance.

BNDES's role changed over time without society participation on this decision (even indirectly via congress decisions), because BNDES does not appear in the government budget. Society has no clarity on the cost-benefit of BNDES policies, because there is no transparency of its policies. Society's understanding of BNDES's activities remains basically restricted to its support of cultural activities, disclosed via institutional marketing, that in the end masks its impact on the economy.

#### 7.4 RENT-SEEKING: TRADE PROTECTIONISM

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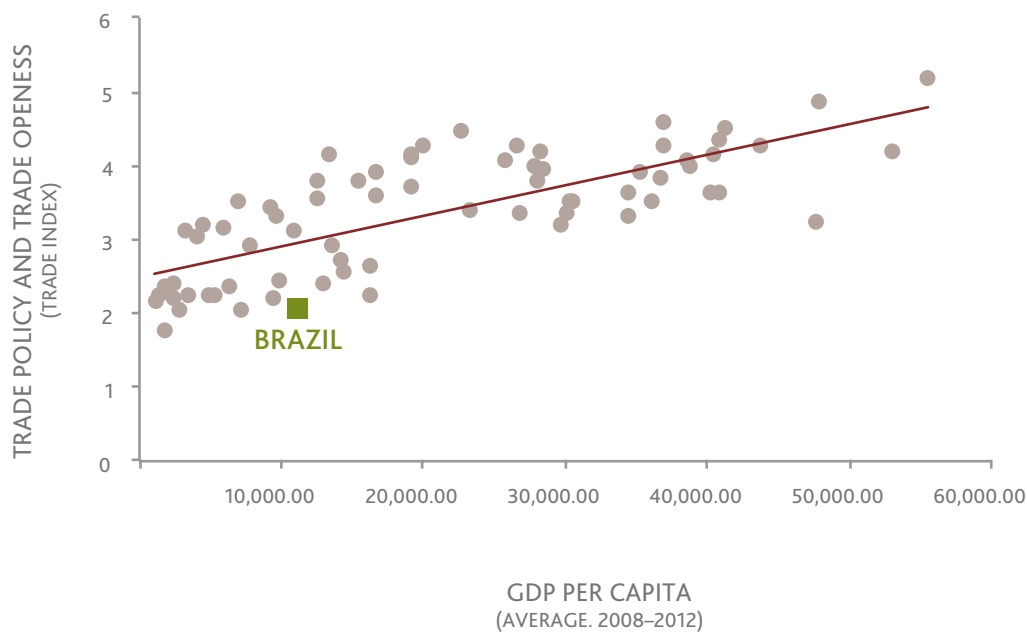
There is an additional mechanism of rent-seeking: trade protectionism to specific sectors, characterized by higher import tariffs and non-tariff barriers in comparison to other countries, which are also complex and, in several cases, severely limit foreign products access to the Brazilian market.<sup>52</sup>

After World War II, the imports substitution model, a strategy to promote the industrialization of the country, resulted in a reduction in trade flows. Decades of protectionism took its toll in terms of low productivity gains and poor external competitiveness of Brazilian manufacturing, which in turn has been frequently used as an excuse for keeping barriers. The collapse of this growth model in the 1980s resulted in efforts, under democracy, to open the economy to trade. However, Brazil still remains a very closed economy, with a complex structure of tariffs and non-tariff barriers that involves income transfers from buyers, consumers, or other firms, to the protected sectors.<sup>53</sup> Nominal tariffs are high in Brazil compared to other countries and they have a wide dispersion, ranging from close to zero to 35% in the late 2000s (Moreira, forthcoming). Effective tariffs have an even wider dispersion, ranging from close to -5% to an impressive 180% in 2005, having increased since the late 1990s. Furthermore, trade protection has steadily increased since earlier 2000.<sup>54</sup>

Brazil stands in the group of the most-closed economies in global ranking in terms of trade openness and trade policy, measured by the level and complexity of tariffs, non-tariff barriers, and efficiency of import procedures, as shown in chart 6. Low trade openness in itself does not argue against Brazil, because large countries tend to be more closed, but Brazilian experience distinguishes itself due to the significant trade barriers adopted.

CHART 7: TRADE INDEX VS. GDP PER CAPITA

SOURCE: INTERNATIONAL CHAMBER OF COMMERCE, IMF

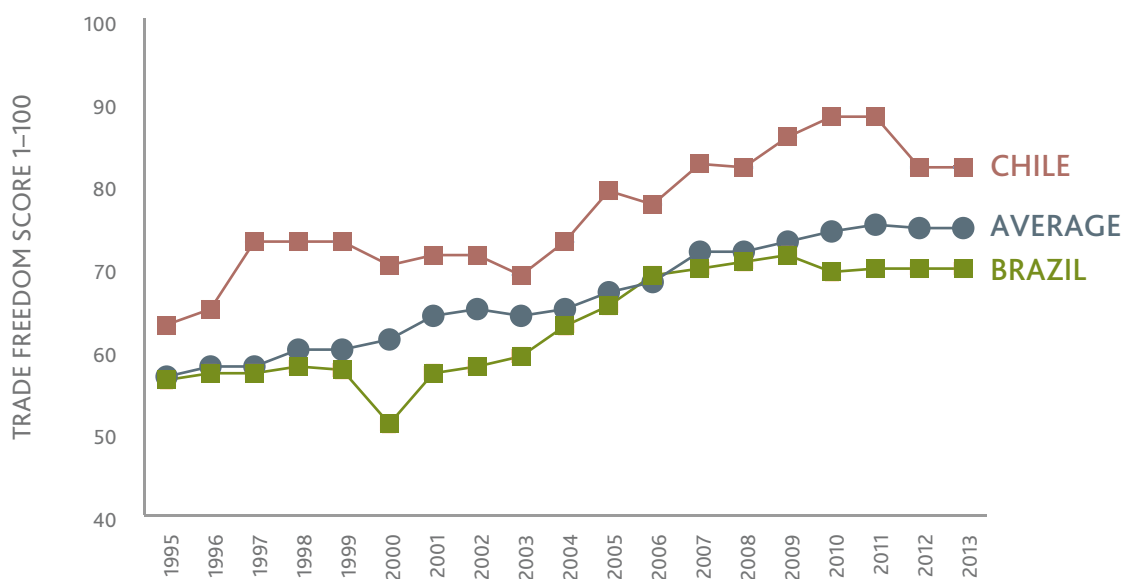


Moreover, the country has apparently worsened trading conditions in the aftermath of the global crisis in 2008, after important improvement last decade, with deterioration in the Index of Economic Freedom. This is even in comparison to Chile, an economy far more dependent on trade than Brazil (see chart 8).

Protectionism has rarely been a subject of public debate in Brazil, which aligns to some findings in the literature that show that the relation between democracy and protectionism is not straightforward and depends on country endowments. O'Rourke and Taylor (2006) show that in poorer regions such as Latin America, low capital-labour ratios along with high land-labour ratios led to raised tariffs, contrasting to the US's experience, as the country has high capital-labour ratio.<sup>55</sup>

CHART 8: TRADE FREEDOM SCORE (0-100)

SOURCE: HERITAGE FOUNDATION (INDEX OF ECONOMIC FREEDOM, 2013)



## 8. Democracy indicators: where does Brazil stand?

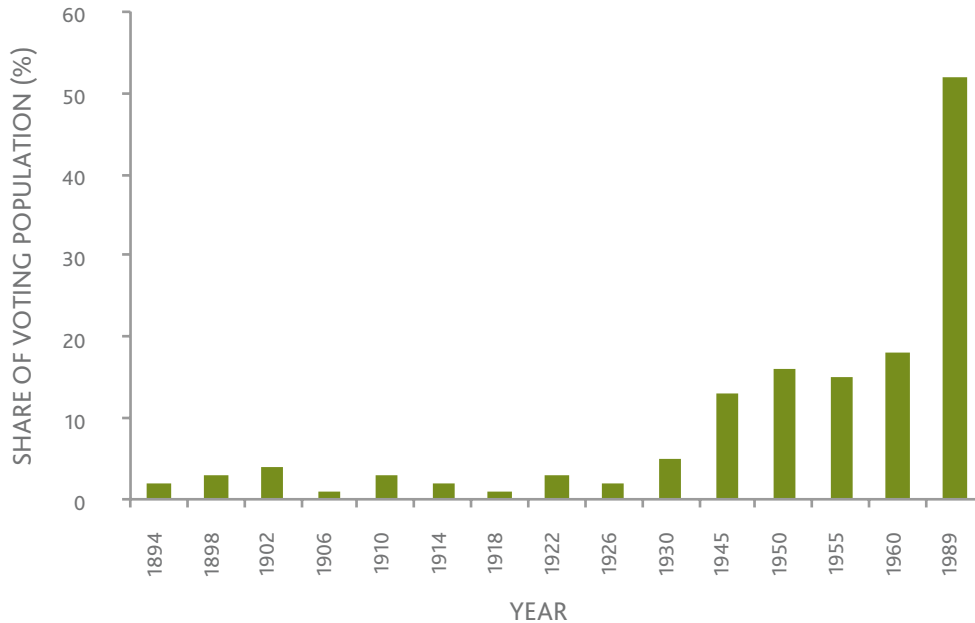
In 1824, the first Brazilian constitution established limited suffrage. Voting was restricted by wealth and literacy requirements. This backdrop changed slowly under the republic. The mandatory and secret vote was established only in 1934 amid significant political pressure. The female vote dates back to 1932; the illiterate vote appeared only in 1988.

Initially, the proportion of voting population was negligible, around 2% until 1934, climbing to only 18% in the '60s. Under re-democratization, it reached 50% of the population (see chart 8). In contrast, in the US and Canada the proportion of the population voting in 1880 was around 16% and it was already 40% in 1940.

Democracy, however, should not be only measured by the proportion of the voting population. There are several other relevant variables to evaluate the quality of democratic institutions, including social participation, civil rights, and freedom

CHART 9: PROPORTION OF VOTING POPULATION

SOURCE: NICOLAU, J . (2004).



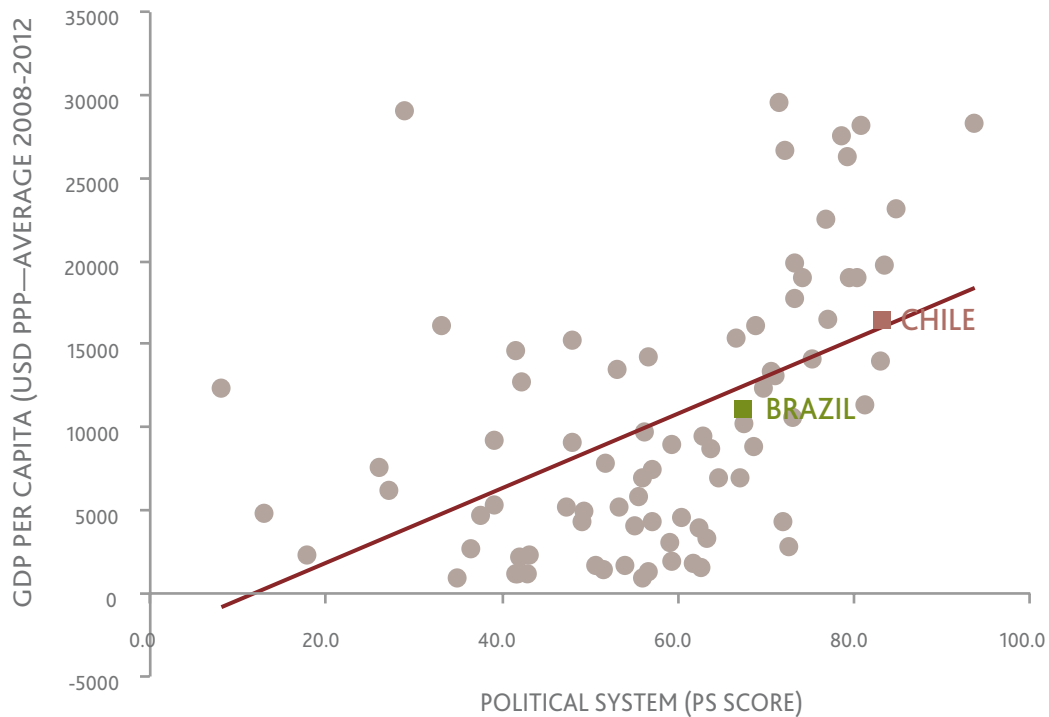
of expression. The construction of democracy rankings is significantly complex, especially because it should encompass several institutional aspects. The next step, as difficult as the first one, is to identify possible indicators to compose the index. That being said, conclusions from those indicators should be taken with a grain of salt.

There are few democracy rating indices available and the range is not large. The Global Democracy Ranking tries to measure the quality of democracy via the degree of freedom and some other characteristics of the political system, and the performance of non-political dimensions. We focus here on the political system, which would be the closest gauge for democratic institutions, leaving aside other indicators because they are more linked to economic and social indicators, in our opinion. The sub-index called Political System comprises: political rights (25%), civil liberties (25%), gender gap (25%), press freedom (10%), corruption perceptions (10%), change of the head of government in the last 13 years (2.5%), and political-party change of the head of government in the last 13 years (2.5%).

Brazil's Political System score against its GDP per capita can be considered today an intermediary position when compared to other non-developed countries (see chart 9). In other words, both variables look consistent to each other. Nevertheless, Brazil is far away from Chile, which stands at the number-one position in the ranking. This striking gap highlights the necessity to pursue the improvement of democratic and pro-growth institutions in Brazil.

CHART 10: POLITICAL SYSTEM VERSUS GDP PER CAPITA IN NON-DEVELOPED ECONOMIES

SOURCE: IMF, GLOBAL DEMOCRACY RANKING



The World Bank Governance Indicators project helps to shed light on this subject. The indicators comprise six dimensions of government: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.<sup>56</sup> Brazil's performance has not changed meaningfully since 1996, when the study began. One can see no striking improvement in any dimensions, except for some upgrade in 'voice and accountability', which measures citizens's ability to participate in selecting their government, as well as freedom of expression (see chart 10).

On the bleak side, 'regulatory quality', which measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development, has worsened since 1996 (see chart 11).



CHART 11: VOICE AND ACCOUNTABILITY  
SOURCE: WORLD BANK (GOVERNANCE INDICATORS, 2012)

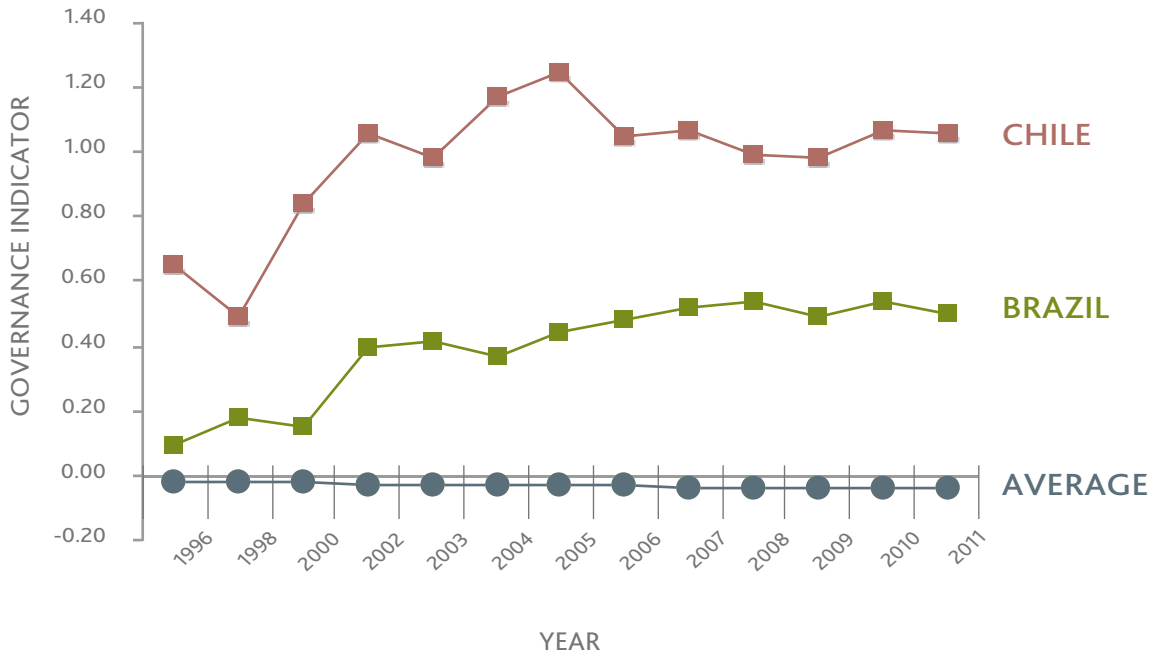
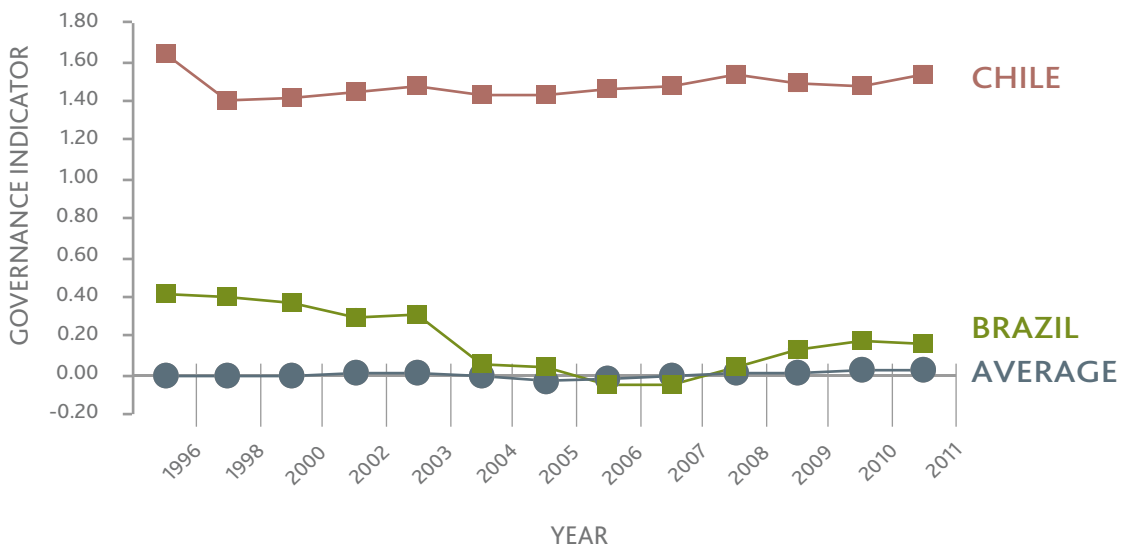


CHART 12: REGULATORY QUALITY  
SOURCE: WORLD BANK (GOVERNANCE INDICATORS, 2012)



'Government effectiveness', which measures the quality of public services and the degree of their independence from political pressures, has remained on the sidelines in Brazil (see chart 12). The dimension 'rule of law', which measures the quality of contract enforcement and property rights, has improved lately, but still fails to cross the global average (see chart 13).

It is worth mentioning that, for all dimensions, the differential to Chile, which is considered the benchmark for Latin-American countries, has not diminished. The main conclusion is that both countries look more democratic today, in terms of social participation in the political system ('voice and accountability'), but Brazil continues to slide in terms of governance indicators that are related to pro-growth institutions.

CHART 13: GOVERNMENT EFFECTIVENESS  
SOURCE: WORLD BANK (GOVERNANCE INDICATORS, 2012)

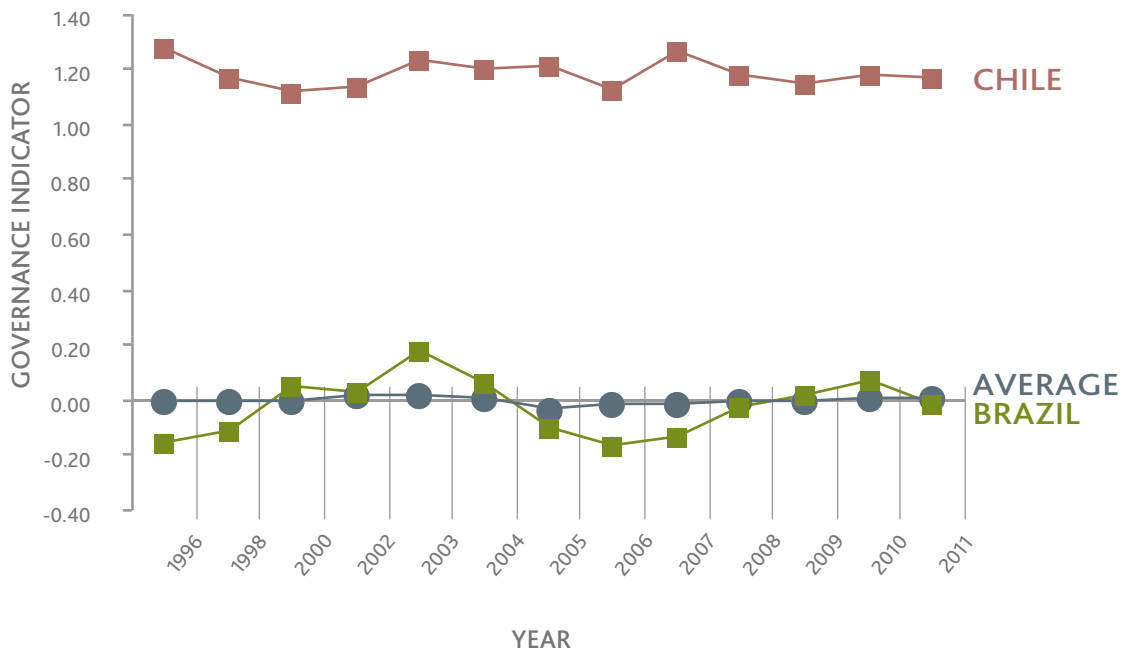
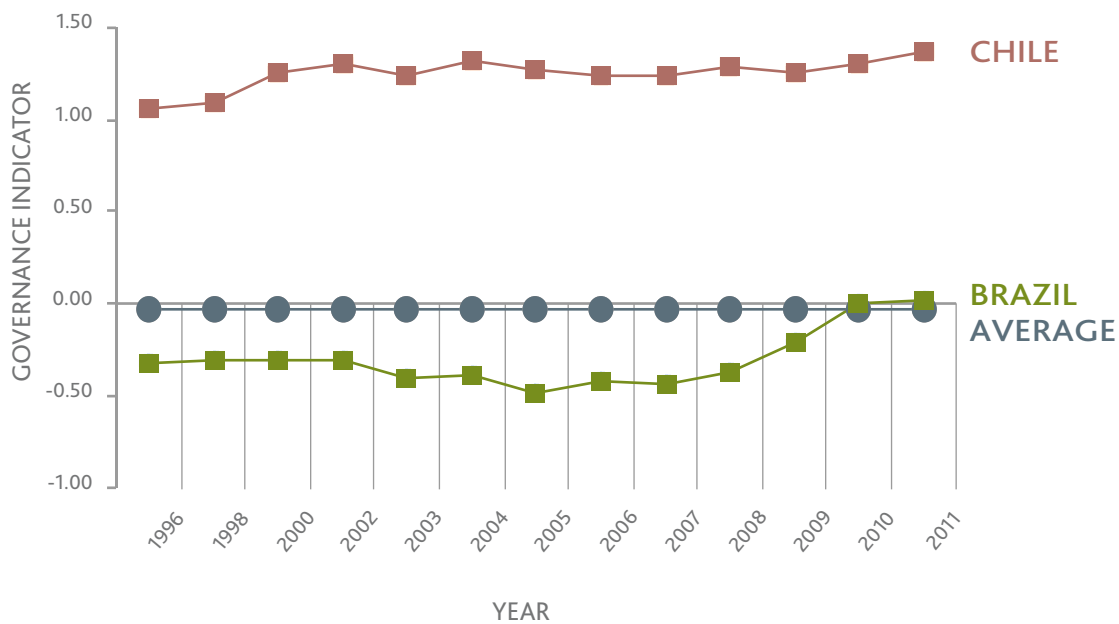


CHART 14: RULE OF LAW

SOURCE: WORLD BANK (GOVERNANCE INDICATORS, 2012)



One possible interpretation of these figures is that Brazilian democracy is still young and it is yet to be seen whether it can mature into the development and improvement of pro-growth institutions. From this perspective, it could be only a matter of time before Brazil closes the gap to meet Chile's indicators, and that the seeds for improvement are already sown. Alternatively, and possibly a more realistic view, is that democracy improved governance in Brazil, but there is still a long way to go once a broader concept of democracy is taken into account. Morlino (2011) considers not only (almost) universal adult suffrage, civil rights, and civil liberty, to be necessary, but also the absence of political actors able to block or control the arena of political decisions.

Aside from that, judging by Brazil's experience, the presence of political actors with veto power might not be the only threat to democratic institutions. The lack of transparency of government policies contributes significantly to weaken democracy, not only due to the higher risk of corruption and low government alternation, but also because widespread and opaque rent-seeking policies mean undemocratic economic decisions are made. Society does not effectively participate in economic decisions and does not take into account the costs and impacts of this. Rent-seeking institutions are preserved from an encompassing political debate.

## Concluding remarks

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A large government, with several agencies and intervention mechanisms, that mediates and regulates economic and social relations to an extent rarely observed in developed countries, seems to be a distinctive feature of Brazil's economic and political development. We propose the term rent-seeking to summarize society interaction with government agencies in which public policies are supposed to provide specific privileges and benefits, frequently by unusual mechanisms when compared to other countries. Rent-seeking also results in a peculiar political process where social demands are often decentralized and in many cases addressed without going through government budgetary channels, and the social costs of this are diffused over society.

This paper addresses four main issues, trying to answer the following questions:

First, why has a broad system of rent-seeking policies appeared? Extractive institutions and limited political participation seem to be the outcome of the colonization period in most Latin-American countries. It resulted, for a large part of Brazil's history, in a politically authoritarian regime and an economically interventionist government. The rules of the game in such a society reward political access to government policies.

Second, why has rent-seeking persisted after independence and increased significantly during this century? The dominant belief in Brazil was that government economic intervention was essential to overcome underdevelopment. It was the government's role to coordinate private investment decisions, to provide funds for several projects, as well as protections and benefits for selected sectors in order to foster growth. For many years the project was successful in promoting robust rates of growth and it was progressively enlarged. However, in the long-term it was also an unstable process. It led to macroeconomic imbalances and ultimately low productivity growth. Over time, excessive protections and the dissemination of benefits resulted in high social costs, in the forms of inflation, a high tax burden, and economic distortions eroding efficiency.

Third, why has mass democracy been unable to change this modus operandi of the economic system? Rent-seeking policies are opaque to society. Benefits from government interventions are tangible and result in vocal political groups that oppose withdrawing their benefits and protections. The diffuse nature of the cost of these benefits, however, lead to a fragile opposition to their maintenance. Some of those interventions are present in most developed countries; what distinguishes Brazil is the extensive reach they have assumed.

Brazil has been experiencing a democratization of privileges. In recent decades, specific benefits and discriminatory policies have been progressively extended to several groups. Benefits from such policies are well perceived but their economic and social impact is not. Furthermore, the interests of small groups and popular groups can appear aligned in many situations (though this is often superficial), which increases opposition to reforms. This is the case in reform of public servants. Any reform proposal faces significant resistance from all society, indistinctly, even if they do not affect popular groups.<sup>57</sup>

How could democracy help to promote reforms? In the democratic period, there have been demands to extend benefits for social groups long seen as underrepresented in the political arena. More recently, there have been demands for improving the quality of public services. Social movements have been challenging current policies and have started to question some concession of privileges and benefits to specific sectors. It is still a young movement, but a surprisingly strong one that, for the first time in many decades, calls for changes in government policies.

Re-democratization has been a game changer. The serious economic crises of the 1980s, characterized by severe public deficits, hyperinflation, and external crisis, led a decade of low growth and several failed stabilization policies. This resulted in several institutional reforms being beyond stabilization. Trade barriers were reduced, state-owned companies were privatized, and quite a few market-oriented reforms were implemented, not without fierce resistance. Ending special privileges and benefits affected several economic sectors and special groups. However, in the end, the reform agenda managed to balance the government budget and provide the necessary controls to ensure fiscal discipline. Furthermore, re-democratization also led to an important shift in social policies and, for the first time in Brazil's history, they became the centre of government policy debate. Access to public education was widely enlarged, and several social programs focused on lower-income families were introduced, as was public spending in this area.

Brazil's experience suggests that democracy might have contributed to the construction of more solid institutions, contrasting to those undertaken during the dictatorship, even though the pace of adjustments looks slower. Reforms in democratic regimes may be more difficult to negotiate, but they have proved to be more resilient.

Demand for public intervention, in an age of low tolerance for inflation and fiscal discipline, has led to a rising tax burden, which reached the impressive mark of 37% of GDP in 2012. Furthermore, reforms were partial and several government intervention mechanisms persisted, such as government-owned banks, large trade protections, and subsidized loans that are over 30% of the nation's total credit. As economic growth resumed in the last decade, the reformist impetus faded and the political pressure for government intervention was reinstated. Public agencies were provided additional resources to encourage development in specific sectors. Progressively, government has started a large development plan, ranging from the naval industry to oil and gas. This plan was widened after the global crisis of 2008.

There has been a new wave of expansion of old-style mechanisms to expand protection and transfers, especially for industry. BNDES loans have increased significantly, reaching 11% of GDP. It has also increased its minority equity allocations. Tax breaks have been provided to selected sectors along with the growing complexity of the tax system. Tariffs and non-tariff barriers have been raised to protect selected sectors. As a result, growth has been disappointing, and inflation has risen.

The disappointing economic behaviour and the widespread dissatisfaction with government concession of privileges have led to social unrest. Paradoxically, political movements are once again demanding specific benefits. It is not the

nature of strong government intervention that seems to be in dispute, but the ones who should be the beneficiaries. Several new groups have introduced new demands whose costs are to be diffused throughout society.

Ending the centrality of rent-seeking in Brazil is essential for increasing investment and growth potential. Local provision of specific privileges and benefits has introduced economic distortions and reduced productivity growth. Transparency seems to be essential to allow democratic institutions to discuss and deliberate over government policies and evaluate their outcomes.<sup>58</sup>

This paper, hopefully the beginning of a larger research project, summarizes a historical interpretation of Brazilian institutional development and its impact on several aspects of our political and economic model. At this stage of our research, we have provided some evidence that supports and exemplifies our main argument. There is still a lot of work to be done, such as collecting all the evidence on rent-seeking mechanisms, their economic effects and distortions, and assessing the role played by the political process in the development and accountability of the rent-seeking mechanisms.

Systematizing all tax-transfer mechanisms is a crucial first step to a full comprehension of the rent-seeking structure, in order to reassess government policies. This is particularly important taking into account the opacity of government policies. This effort will require estimation of non-monetary transfer policies such as subsidized credit loans and trade protections, including non-tariff ones. This is a large task, though a necessary one. These data could provide inputs for researches on: the evolution of policies over time, shifts in their focus as democracy evolved, their outcomes in terms of growth and equality, and lessons to be learned.

Several questions regarding the cost-benefit analysis remain unanswered whereas they should be part of democratic deliberations. Social costs and benefits of public policies should be transparent and subject to questioning. The same must be said about distortions caused by public policies that hurt productivity and economic growth. Confrontation of results and expectations is the best way out to economic reforms and evolution. This is particularly relevant for Brazil at the moment, when fiscal constraints and growing social demands need to be met, requiring reassessment of policies and priorities, according to democratic choices.

Transparency requires institutions that disclose costs and benefits, allowing social accountability. One such institution could be an independent and well-equipped agency responsible for monitoring public policies. Its objective would be to record policy targets and monitor their implementation, rather than approving projects and discussing their merits. Each new project would have to be submitted to the agency, with clear indications of purposes, expected outcomes, and costs. The agency research department could also compare government proposal policies to equivalent ones undertaken abroad. It could summarize the best public-policy practices in other countries and contribute to policy discussions in Brazil. The agency would be requested to provide information on policy targets and actual results annually, and the information, available to the budget commission in Congress, would be publically disclosed. Society must be able to evaluate whether the benefits are worth the cost.

A second proposal is that all concession of benefits and privileges must be identified as public transfers and be accounted for in the government budget, including all subsidized loans and transfers to the likes of Sistema S, ZFM, and FGTS. Implicit subsidies must be made explicit to society. Those receiving protections and privileges from the government must have their accounts disclosed. Society must know the beneficiaries and the results of such policies. This proposal would lead to full accountability.

Privileges, protections and transfers are always desired by those who receive them. Rent-seeking creates incentives for self-preservation by interest groups. If the individual social cost of each policy is small, while decisions are taken independently, society may not account for the total social costs, especially if they are hidden under market distortions. The myriad government agencies and instruments available allow benefits to be conceded independently and, in many cases, secretly. If there is no social accountability of costs and benefits, old privileges may persist and new ones are likely to appear.

Feeding a small termite may be a generous act at a negligible cost. If the termites are many, and society only decides on the survival of one at time, in the end, it may feed many. And many termites may erode a house.

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2. Insuper, Instituto de Ensino e Pesquisa.
3. Gibraltar Consulting.
4. See Pincus and Robinson (2011) and Acemoglu and Robinson (2012).
5. For a survey on growth evidence, see Aghion and Howitt (2009).
6. See Lipset (1993), Barro (1996), and Przeworski and Limogi (1993).
7. See Lipset (1993) for a detailed discussion of these conditions.
8. Barro (1996) studies a panel of several countries and controls for additional institutional factors such as a rule of law index and share of government consumption on GDP, and finds there is no significant impact of democracy on growth.
9. Fixed effects are time-independent effects that are possibly correlated with the regressor. If omitted, it biases the estimate of the independent variable impact on the estimation.
10. Engerman and Sokoloff (1997, 2012), and Sokoloff and Engerman (2000).
11. Sokoloff and Engerman (2000).
12. We learned the Mattoso evidence from Caldeira (1999, p. 229), which has a very original and provoking economic analysis of Brazil in colonial times.
13. For example, Cuba's per-capita income was 167% of the US's in 1700 and 122% in 1800, according to Sokoloff and Engerman (2000).
14. Sokoloff and Engerman (2000) present data on voting rules as well as literacy rates for several American countries in the nineteenth century.
15. Sokoloff and Engerman (2000) argue that the importance of public primary schools was recognized all over America in the late 1800s; however only in US and Canada were they actually implemented.
16. For an economic model of rent seeking see Barelli and Pessoa (2010).
17. According to Greif (2006), institutions should reflect society or decision-makers's beliefs for political and economic processes to be sustainable. Moreover, the system needs to deliver what is expected by society. Otherwise, questionings about rules and institutions will arise, leading to a reassessment of the policies undertaken.
18. See, for example, Rajan and Zingales (2006) for a theoretical model in which uncertainty prevents reforms.
19. Tullock (2005) proposed the first model of rent-seeking, a term later introduced independently by Krueger (1978). Tullock's works anticipate Douglass North's conjecture of the role of the Glorious Revolution in England's posterior economic development.
20. For a general overview of Brazilian development and the role of institutions and government policies, see Leff (1991). For a discussion of Brazil's response to 1929's crisis and the beginning of the National Developmentalism project, see Malan, Bonelli, Abreu, and Pereira (1980).
21. See Abreu (1990b).
22. Bielschowsky (1988) summarizes the National Developmentalism ideology.
23. For the economic history of this period, see Abreu (1990a).
24. For the history of the institutional development that supported national development in Brazil, see Campos (2004). By the end of the century, BNDES has become one of the largest development banks in the world. There is extensive literature on the role of government in promoting development and the reasons behind the few cases of success, but less debate around the more numerous cases of failure. Bhagwati and Panagariya (2013) discuss the failure of government intervention in India and provide some general discussion on public policy, growth, and development. See also Pack and Saggi (2006) and Robinson (2009). For the Latin America experience, see Edwards (2010). For a more optimistic view of some public interventions fostering growth, see Rodrick (2007).
25. For a survey of this economic perspective in Brazil up to the late 1970s, see Bielschowsky (1988, section 2.3.4) and Pinto, Assail, Prado e Marinho (1978).
26. For an empirical investigation of reforms and their impact on growth, see Veloso, Villela, and Giambiagi (2008). Lara Resende (1990) provides a description of economic policy at that time.
27. We thank Rozane Siqueira for this reference. A forthcoming paper by her and co-authors emphasizes the rent-seeking nature of government taxes and money transfers in Brazil.
28. Carneiro and Modiano (1990)
29. South Korea had a similar development project, largely based on industrial policy and government intervention. However, the government budget remained relatively balanced during most of the second half of last century, resulting in much lower inflation rates. The economic intervention was concomitant to large investment in education. Furthermore, benefits and protections were limited and coupled with foreign competition. Transparency of public benefits, accountability of policy outcomes, and social investment distinguish the South Korean experience from the Brazilian one. For an analysis of the Latin-American development process and some comparison to East Asia and South Korea for that matter, see Edwards (2010).
30. See Lisboa and Pessoa (2012) and Veloso, Villela, and Giambiagi (2008) for a survey on the evidence of impacts of the institutional reforms in productivity and growth during this period.
31. For a thorough analysis of the evolution of



- income distribution in Brazil in the last decades, see Barros, Foguel, and Ulyssea (2007a).
32. Barros, Carvalho, and Franco (2007) and Barros, Carvalho, Franco, and Mendonça (2007) analyse the reduction of income inequality and provide estimates on the impact of government policies on income inequality. Barros, Fogel, and Ulyssea (2007b) summarize the results.
33. We thank Marcos José Mendes for this contribution, including the term “arbiter of income transfer” to qualify government social policy.
34. Aghion and Durlaf (2009)
35. At first, Langoni composed the main determinants of the rate of return on education and alternative sectors investments. He showed that the highest rate of return was in the first years of education. Later, Langoni studied the main determinants of income inequality and concluded that education explained a large part of it.
36. For the lack of relevance of education on the economic debate at that time, see Bielschowsky (1988) where, despite its comprehensible analysis of the economic thought of the time, education is barely discussed. For a further discussion of the evidence, see Pessoa (2008).
37. For some of the consequences of this approach, see Schwartzman (2011).
38. For a survey of the debate on education and income inequality, see Lisboa and Menezes-Filho (2001).
39. Lindert (2004) provides an extensive quantitative analysis of this subject as well as the different behaviours of labour markets in these economies. Since the 1960s, social spending has moved increasingly towards pensions, which has led to debates of their net economic costs. For a recent analysis of tax reforms in developed countries in the last two decades and their concern on growth incentives, see Brys, Matthews and Owens (2011).
40. Lindert (2004) emphasizes the importance of transparency and democratic controls of taxes and government transfers in developed economies, where reforms and controls are implemented in order to reduce incentives contrary to economic activity. Brys, Matthews, and Owens (2011) discuss tax reforms in OECD countries in the last 30 years and the motivations behind them.
41. Ministério da Fazenda (2003) compares taxes and transfers to families in Brazil and other countries and shows that in the latter, income inequality is deeply reduced by government transfers, contrary to the former.
42. The level of complexity leads to many methodological debates in Brazil on how to evaluate the tax burden. In an impressive and complete work, Afonso, Soares, and Castro (2013) describe Brazil’s complex tax system.
43. For a complete and impressive description of Brazil’s complex tax rules, see Afonso, Soares, and Castro (2013).
44. Amaral et al. (2012)
45. See Afonso, Soares, and Castro (2013, pp. 77).
46. For a government discussion of income inequality and the benefits of such policies, see Ministério da Fazenda (2003).
47. Non-pension benefits display concentration indices comparable to those of some EU countries. Nevertheless, they represent only 1.5% of household disposable income versus around 15% in EU countries, so that their equalizing power is limited and far from enough to compensate pension benefits.
48. For similar results and a further analysis of the design of the Brazilian pension system and its impact on government transfers, see Rocha and Caetano (2008).
49. ‘Tax progressivity’ describes the way rate progresses from low to high income or expenditure, where the average tax rate is less than the marginal tax rate. Progressive taxes attempt to reduce the tax incidence of people with a lower ability-to-pay, as they shift the incidence increasingly to those with a higher ability-to-pay.
50. This session is based on Miranda (2013).
51. Private loans in Brazil have always been subject to several mechanism and price interventions. In late 1980s, for example, inflation correction of mortgage loans was limited to wage increases, which resulted in losses above 4% of GDP (Lundberg, 2011).
52. For an example, see Carrasco and Mello (2013).
53. Brazil relies on many technical requirements to restrict competition from abroad; technical norms that are very distinct from the ones used in other countries and bureaucratic manoeuvres that make it impossible to import some goods. Those barriers create higher costs for local consumers. For an example of such procedures and their costs, see Bacha (2012).
54. Moreira (forthcoming) summarizes several data on Brazil trade protections. Castilho, Ruiz, and Melo (s.d.) provide a careful analysis of Brazil evolution of effective tariffs in the earlier 2000s.
55. According to the authors, in countries in the New World with high land-labor ratios, democratization should have been associated to higher tariffs, except for those richer countries, such as the United States, where high capital-labor ratios mute this effect significantly.
56. The six aggregate indicators are based on 30 underlying data sources reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide.
57. We thank Marcos José Mendes for this contribution.
58. For a discussion on some recent setbacks in the institutional framework, see Pessoa (2013).

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