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ECONOMIES IN TRANSITION | FEBRUARY 2015

Building Coalitions For Reform In Brazil

President Rousseff's Daunting Challenges

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INTRODUCTION

Having achieved investment grade status in 2008, Brazil seemed to be on the right track towards reforms that would guarantee economic growth and prosperity. The country benefited from the international commodity super-cycle and achieved a high growth rate in 2010. Social inclusion also improved considerably, poverty and inequality were reduced and the standard of government rose. In 2009 *The Economist* put the country on its cover with the headline "Brazil takes off."[1] In the wake of the 2008 international financial crisis, the Rousseff government embarked on a host of statist measures that deeply affected the investment climate in the country. In Dilma Rousseff's first term, a reversal of expectations and criticism of corruption within government led to an unprecedented wave of protests and widespread discontent. With a stagnant economy and the prospect of recession, Brazil returned to the cover of the *The Economist* four years later, but the headline had changed dramatically: "Brazil's future: has Brazil blown it?" [2]

Putting Brazil back on the right track will require a daunting reform programme for the president, who was re-elected in October 2014 for a second term. Fragmentation in Congress has increased and the presidential party, the Workers' Party (PT), lost 18 seats. In addition, Rousseff has been sworn in amid a major corruption scandal that affects Brazil's largest firm, the Petrobrás. Having been elected with a left-of-centre and anti-neoliberal platform, Rousseff has begun to implement a radical policy switch and is facing a formidable political backlash as a consequence. She has seen her popularity sink to 23% in her first month in office, compared to a 42% approval rating in December 2014.

This paper focuses on the constraints and possibilities arising from this reform programme in a political culture shaped by multi-party coalitions, weak parties and strong presidents. Which factors will influence the relationship between political parties, civil society and business groups in the post-election scenario? What lessons can be learned from attempts to reform Brazil in a post-authoritarian era?

FROM CARDOSO TO ROUSSEFF: TOWARDS GOOD GOVERNANCE

Brazil's transition to democracy in the 1980s was marked by two key events: the election of a new civil government in 1985 and the formation of a constituent assembly that drafted the new democratic charter in 1987-8. Although the basic constitutional structure—including the electoral rules, the federal government, and presidential system—was left intact in the constitution of 1988, checks and balances were fortified and the presidency acquired new powers. The legislature also saw many of its powers restored and expanded. Social and individual rights were strengthened. The constitutional charter, however, maintained much of the institutional structure that underpinned state-led development in the Vargas era and during the military regime. The institutions associated with the era of import substitution industrialisation (ISI) were left unscathed.

Between 1985 and 1993, the new democratic Brazil experienced hyperinflation and a balance of payments crisis that led to a default on its sovereign debt. In this period a president was impeached following a corruption scandal, yet no major institutional instability ensued. It was under Cardoso that hyperinflation was finally quelled, the fiscal crisis controlled, and a number of constitutional amendments introduced. Inflation fell from 2075% to 3.2% between 1994 and 1998. This impressive progress was the combined result of Cardoso's leadership and the window of opportunity resulting from the fiscal collapse of the ISI model.

The constitutional amendments eliminated many statist provisions, including state monopolies in oil exploration and telecommunications. This paved the way to large-scale privatisation. Protectionist provisions (including special treatment of domestic firms) were also eliminated and trade was liberalised. Amid the turmoil in international markets in Russia and Asia in the late 1990s, Cardoso successfully implemented and consolidated the Real Plan—a flagship programme of monetary reform involving the introduction of a new currency. The Real Plan produced short-term gains for urban consumers (resulting from the elimination of inflation, low tariffs on imports and expansion of services such as telecommunications) but also imposed costs on public sectors that flourished under the former ISI model. Over time, business redeployed assets to newly opened sectors and consumers enjoyed the benefits of a stable currency and price stabilisation. Nevertheless, privatisation also caused job losses, while high interest rates and fiscal austerity hurt households and families, particularly during Cardoso's second term of office (1999-2002).

The new orthodoxy that came to characterise macroeconomic management rested on the adoption of flexible exchange rates, inflation targeting and a commitment to primary fiscal surpluses. This recipe—known as the tripé (tripod)—allowed Brazil to experience economic stability and made possible greater social inclusion. More importantly, Cardoso successfully built a reform coalition involving business, the middle classes and urban consumers. In Congress, Cardoso managed to secure the support of a stable four-party coalition that was crucial in passing the reform agenda.

Cardoso's coalition management rested on the political insulation of key ministries (finance, planning and budgeting, education and health) and the allocation of peripheral ministries to coalition parties. This power-sharing was effective; Cardoso's party, the Social Democracy Party (PSDB), controlled 25% of seats in the coalition and held 28% of ministries. The coalescence rate—a measure of the congruence between seats and portfolios—was 62.1 (significantly higher than under subsequent PT governments). Cardoso engaged in low-cost "pork for policy" games with his junior coalition partners, which prevented the government from degenerating into clientelism. While internationally acclaimed, Cardoso faced fierce internal opposition from the PT and the political losers of market reforms.

Facing a confidence crisis during the presidential race, in which he was the front-runner, the then opposition candidate from the PT, Lula da Silva, famously promised to honour contracts and the tripé.[3] During Lula's administration (2003-2010) there was continuity in macroeconomic management and social policy. Brazil acquired international recognition for these accomplishments while preserving an active legislature and an independent judiciary. Indeed, in the early 2000s the country was a showcase for successful governance. The victory of the PT in the 2002 presidential election reinforced this: Brazil represented a paradigm of peaceful power alteration in Latin America.

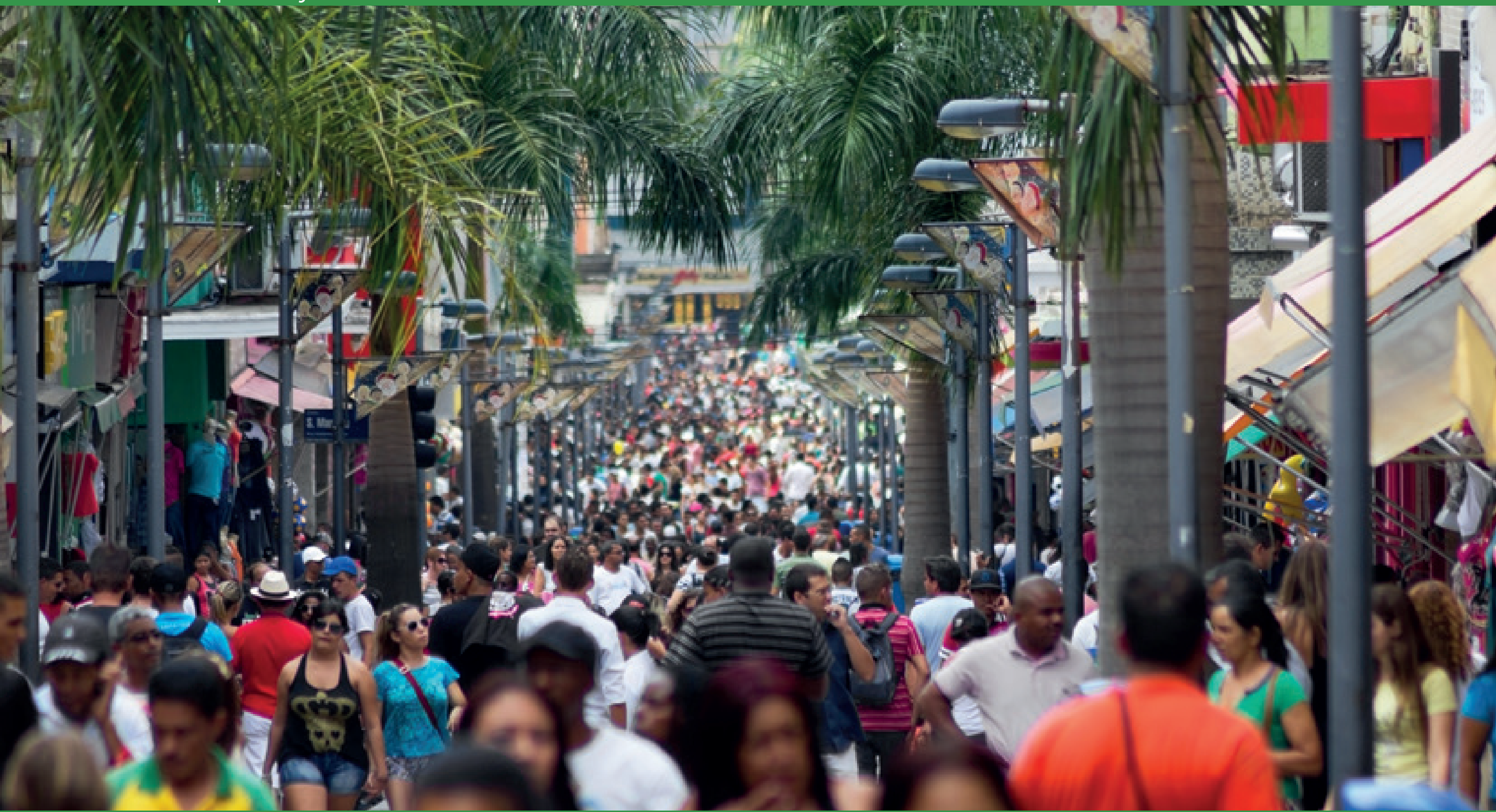
The new development model combined a commitment to pluralistic democracy with responsible fiscal management and social inclusion. This outcome is surprising, considering the prevailing view of Brazil in the late 1980s and 1990s as an unreformed, deadlocked democracy.[4] Previously, the country had been regarded as an unpromising model because it exhibited a deadly combination of presidentialism, party fragmentation, predatory federalism and open-list proportional representation. Cardoso's success showed that coalitional presidentialism did not lead inexorably to deadlock. The key to success was the strengthening of checks and balances and the emergence of a highly competitive party system, which ultimately led to power alternation. The autonomous judiciary and vibrant independent media helped sustain competitiveness in the political system and prevent the abuse of power.

During the Lula years (2003-2010) Brazil enjoyed the benefits of the commodity boom (2000-2009). An explosion in demand from China boosted exports, particularly in mining and agricultural goods, and helped sustain GDP and job growth. In 2008 Lula boasted that by the time the 'tsunami' unleashed by Lehman Brothers' collapse hit his country's shores it would dwindle to a 'little ripple'. In reality, the international financial crisis represented a shock to the system and provided a window of opportunity for the return of developmentalism. The global spread of fiscal stimuli policies legitimised the new approach. Although there was no popular demand for the return to the ISI model, the PT's factions supporting the old policy gained the upper hand. There was internal support for state intervention by industrialists, social movements and unions; voters, however, were worried about inflation.

The Lula government used the National Development Bank (BNDES) as its main tool in the new macroeconomic strategy, which the government labelled the New Economic Matrix. It consisted primarily of measures to expand credit (in the form of mortgages, consumer credit and loans to private and public companies) via state-owned banks—such as BNDES and Caixa—as well as fiscal spending and tax expenditure to counteract the fall in demand resulting from the crisis. From 2004 to 2010, bank credit to the private sector more than doubled as a percentage of GDP, while BNDES expanded its leading position in the long-term market as a result of its much increased counter-cyclical financing.[5] The BNDES saw its lending grow by an annual rate of 25% and Caixa by almost double this rate. Treasury loans, which imply a heavy subsidy, have become increasingly important and currently are BNDES' main source of funds, and by extension are a source of fiscal pressure.[6] Moreover, the government virtually abandoned one of the pillars of the tripé, the generation of fiscal surpluses.

In the 2010 presidential election the PT candidate, Dilma Rousseff, came to power in an election in which she benefited greatly from the short-term gains that followed the interventionist turn in the economy, such as high growth and low unemployment. Unemployment reached a record low of 4.6%, although employment generation had diminished sharply. Interventionism, however, led to severe macroeconomic imbalances, which ultimately resulted in a stagnant economy. In 2010 the Brazilian growth rate climbed to 7.5%, then fell sharply to 1% in 2012 and 0.4% in 2014. More importantly, a recession is predicted for 2015 and 2016. The government resorted to 'creative accounting' to mask the increasing fiscal deterioration—the budget

Campinas city's commercial street— Treze de Maio



deficit reached 7% in early 2015—that ensued from the concession of heavy subsidies to energy, oil and transportation and the extensive use of public banks to expand subsidised credit. The interventionist turn also affected regulatory policy and decisions on infrastructure concessions. The impact on foreign direct investment was dramatic, because the government's increasingly interventionist stance has led to a confidence crisis. Foreign direct investment fell by 2.4% in 2014 and is no longer sufficient to cover the current account deficit of the balance of payments that reached 4.2% in 2014.[7]

In the oil sector, representing 13% of the Brazilian economy, political interference is at the centre of the new interventionism. The discovery of the pré sal (ultra-deep oil reserves) in 2007 was also tantamount to an external shock to the economy. When Brazil started pumping oil from the pré sal fields in 2010, the country was predicted to be in the top five largest oil producers by 2020 ("Filling up the future", *The Economist*, 5 November 2011). Because of its strategic and geopolitical role, the government was able to overcome resistance to the reversal of existing rules for oil production (introduced under Cardoso, which required concessions to be sold at auctions in which any company, Brazilian or foreign, could bid equally). They were replaced by much stricter domestic content rules than those stipulated in the Oil Law (1997) and by the partilha regime (in which Petrobrás, the oil giant, is required to be a partner in all pré sal operations). The massive capital requirements for the pré sal operations led Petrobrás to embark on the largest market capitalisation in world history (US$70 billion). The politicisation and explosive expansion of Petrobrás under the administrations of Lula and Rousseff led to a multi-billion dollar corruption scandal that dominated the final stages of the electoral campaign in 2014. This scandal has also dominated Rousseff's second administration.

Corruption, along with a deteriorating macroeconomic situation, the increasingly critical fiscal position, the rise in inflation and the stagnant economy, adversely affected Rousseff's re-election bid but did not prevent her from winning by a slim margin. In the most competitive race of the previous seven presidential elections, Rousseff was elected with 52% of the vote. In a classic instance of 'pocket-book vote', Brazilians responded retrospectively to gains in their welfare associated with previous (yet declining) growth, relatively low (but rising) inflation, and high (but unsustainable) social spending and low unemployment.

Rousseff's campaign employed the rhetoric of developmentalism and anti-neoliberalism. She also stressed the PT's record of social inclusion under Lula and her administration. She used strong language regarding her opponent's future monetary and fiscal policy–only to announce, once elected, her opponent's agenda as her own. In one of the most remarkable cases of policy switch in Latin America, the president has adopted measures targeted at eliminating subsidies and implementing harsh monetary policies to reduce inflation. She signalled her commitment to restoring government credibility by appointing a Chicago-trained economist and CEO of Brazil's largest asset management firm, Bradesco Asset Management, as Finance Minister.

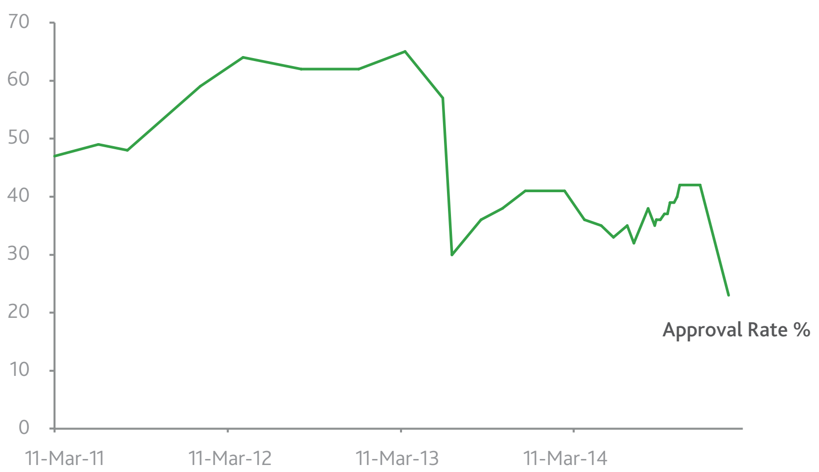
CURRENT CHALLENGES: BUILDING COALITIONS TO REFORM

Rousseff's slim victory means that she has no clear reform mandate. However, she has reversed her economic policies and this may have two consequences. Her policy switch has caused embarrassment within her party, particularly on the far left of the PT. A similar policy switch in 2003, when Lula proposed a social security reform along the lines that Cardoso had embarked on led, to the creation of the Party of Solidarity and Socialism (PSOL) by defectors. This latest policy reversal may have wider political costs because it threatens social security beneficiaries and pensioners.

The corruption scandal is also a major problem for the government. Petrobrás symbolises Brazilian nationalism: the campaign for the nationalisation of oil and the creation of Petrobrás is one of the most remarkable mass movements in Brazilian history. The scandal involves key members of Rousseff's coalition, including the treasurer of her own party, who is accused of receiving bribes from the country's largest construction firms. Several of the wealthiest members of the Brazilian corporate world are among the 30 individuals who have been indicted, many of whom are now in jail. The new round of indictments involves senior politicians, including the president of the Senate. As a former chairwoman of Petrobrás and Minister of Energy, Rousseff is herself in the spotlight, although no evidence of her involvement has yet emerged.

The combination of a major corruption scandal and a stagnant economy along with a severe energy crisis has caused Rousseff's popularity to tumble to 23% from 65% in March 2013 (See Figure 1). In a recent opinion poll, 44% of respondents rated her government as 'bad' or 'very bad', the highest negative rating since the return to democracy. The PT's political crisis may lead to a strengthening of the radical left PSOL in the 2016 municipal elections and in the presidential race in 2018. The main beneficiary, however, is the opposition PSDB.

Figure 1 Presidential approval ratings 2011-2015



Source: Datafolha

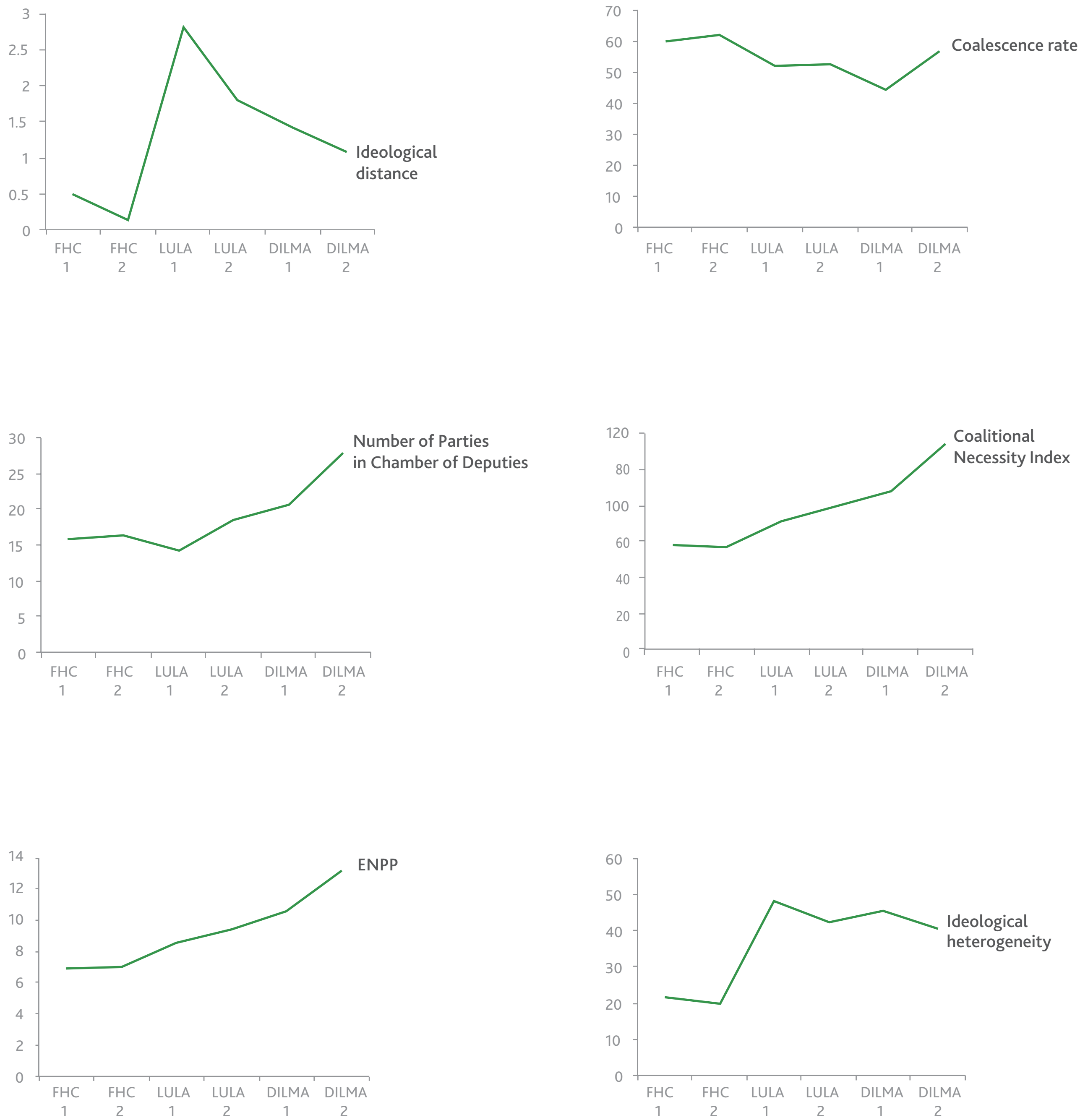
LEGISLATIVE COALITIONS

In her second term of office, the president is facing the most fragmented congress in Brazilian history (and arguably the second most fragmented legislature on record). The 54th Brazilian legislature consists of 28 congressional parties, up from 22 during the Lula years and 18 under Cardoso. The mean number of parties in the preceding administrations rose from 15.79 at the beginning of Lula's administrations to 16.29 at the end of the Cardoso years, climbing to 20.76 in Rousseff's first term. The effective number of political parties (ENPP) rose 30% from 8.5 in 1994 to 11.2 in 2010. After the elections of 2014, this figure is even higher: 13.2, a score that puts Brazil at the top of the world ranking.[8] Under Lula the number of parties in the coalition doubled from four to eight (see Figure 2). Under Rousseff the number of parties holding portfolios remained stable but the coalition expanded to include no fewer than 13 parties. Coalition management under Rousseff was similar to Lula's: the PT controlled 27% of seats in the coalition but 46% of ministerial positions (60% under Lula). The PT's presidents held a firm grip on portfolios–creating general discontent within the coalition, which led to illegal side payments.[9] In her new term of office, Rousseff apparently shared more ministerial portfolios than previous PT governments (including her own); the coalescence rate declined to 56.5. However, this is only apparent as she unsuccessfully embarked on a confrontation with the second largest party in her coalition, the PMDB.

Coalition building and management are crucial elements of governing in a multi-party presidential system such as Brazil's. Under presidentialism, assembly support is not formally required for government formation or termination. Hence there are no constitutional provisions for a vote of confidence. However, governing in a complex party system requires stable legislative coalitions in Congress. The Brazilian president is constitutionally strong and typically the costs of building such coalitions are not high. Two instruments are crucial in the 'presidential toolbox'[10] of coalition management: the allocation of ministerial portfolios to coalition partners and 'pork and patronage'. Presidents have to deal with two variables when building legislative coalitions: their ideological heterogeneity and their size. Both are partly determined by the number of political parties in Congress, but they also reflect presidential choices. The recent increase in coalition size reflects growing party fragmentation, whose roots are to be found in the electoral rules and their interpretation by the Superior Electoral Tribunal. Ideological heterogeneity within the coalitions has also increased. The average ideological distance between the presidential party and coalition partners has widened considerably—it increased 400% from the mid 1990s to the mid 2000s, from an average of 0.4 under Cardoso to 1.6 under Lula (See Figure 2).[11]

Critically, the importance of the President's Party, the PT, has diminished both within the government coalition and in Congress. The PT lost 18 seats in the Brazilian Chamber of Deputies in the October 2014 elections and now holds only 14% of the total, down from 17% in 2010. Consequently the business of building coalitions becomes critical. Timothy Power, a Latin America scholar, has proposed a measure to capture the necessity of building coalitions: the index of coalitional necessity. In this metric the current Rousseff government manages the highest score (114) since the establishment of democracy in Brazil. By comparison this score was 58 and 78 under Cardoso's second term of office and Lula's two administrations respectively.[12] This state of affairs reflects the political vulnerability of the current government.

Figure 2 Legislative coalitions in Brazil



President Rousseff's second cabinet is slightly less heterogeneous than the previous one. The overall trend of increasing heterogeneity has political costs and efficiency costs. Political alliances with ideologically distant parties such as PRB—a right-wing party associated with evangelical Christian hardliners—or PP, whose boss was formerly a senior member of the military dictatorship, have alienated many PT members. More widely, these alliances have created political malaise and cynicism. Thus they have electoral costs both within the PT's core constituency and among swing voters.

Extensive bargaining among ideologically distant partners undermines the legitimacy of governments, which appear opportunistic. For citizens the virtues of consensus and inclusive institutional arrangements dissipate in the light of such horse-trading. Under Lula and Rousseff, Brazil appears to have crossed the threshold where the net benefits of power-sharing arrangements are negative. Oversized coalitions lose legitimacy when they are too heterogeneous and corruption is high. This was one of the triggers of the massive June 2013 riots against corruption, the high cost of living and poor service delivery, which took the country by surprise. An estimated one million people took to the streets in cities across Brazil in the country's biggest protests in two decades.[13] The government's response to the demonstrators' demands was timid and tighter security measures against demonstrations have diffused violent protests.

The costs of governability have therefore risen significantly, despite the fact that the Executive can count on a large (albeit unwieldy) majority in Congress. The relevant question is whether the president will become a hostage to Congress and lose the ability to implement her reform agenda. Rousseff's new cabinet reflects her (failed) strategy to reduce the government's dependency on Brazil's second largest party, the PMDB. By distributing ministerial portfolios to smaller parties in the cabinet (notably to PROS, PDS and PRB), the government has attempted to reconfigure the legislative coalition that underpinned the previous PT administrations, in which the PMDB played a pivotal role. The executive branch enjoys great dominance in the Brazilian political system, and thus far fragmentation has not led to significant deadlocks. However, because the PMDB now has the upper hand, the government is poised to face delays and obstructions in major areas such as tax and electoral reform. The government's political strategy backfired because the PMDB mobilised its backbenchers to defeat the government in the election for the key post of Speaker of the House, now controlled by a faction within the PMDB that defends independence from the executive branch. In the first week of congressional work the government was defeated in several votes including the key bill introducing mandatory budgets.

In the congress elected in 2014, the coalition partners enjoy a nominally comfortable majority. The coalition holds 68.8% of seats in the Chamber of Deputies (353 out of 513). In the Senate the coalition's share of seats is even larger, at 71.6% (58 out of 81). Under Cardoso and Lula, there were significant gains from trade in executive-legislative elections; coalition partners had incentives to cooperate with governments. Cooperation does not arise from programmatic alignments but fundamentally from electoral incentives. Rousseff's confrontational style led to an array of defeats. The price of cooperation has risen because of the weaker strategic position of the president. An example was the approval of the budget law revision—lowering the required primary surpluses target—shortly after the elections.

ROUSSEFF'S POLICY SWITCH

In a previous era, policy convergence in macroeconomic management between the governments of the PT and the PSDB reflected Brazilian voters' appreciation of economic stability. The PT governments became a showcase of the 'responsible left' in Latin America and their approach was copied by other countries. Specifically the policy convergence reflects a prevailing consensus among voters.[14] But a widespread belief in fiscally sound social inclusion is also a key component of the new equilibrium.[15] Rousseff's departure from this consensus was caused by an external shock: the 2008 crisis opened the door to the old interventionist policies. Her policy switch is a recognition of the failure of the new strategy. Unlike Lula, Rousseff was a heterodox economist who had explicitly defended her government's economic policies. Her economic team has imposed (and will continue to impose) unnecessary social costs in order to restore lost credibility. The announced expenditure cuts and interest rate increases are harsher than expected because the government needs to signal its commitment to austerity after a long period of fiscal profligacy.

U-turn policy changes in Brazil and Latin America are generally more of a rule than an exception. Campello investigated 89 cases of policy switch between 1977 and 2007 and found that, in 77%, the major factor was the need to attract dollars during currency crises.[16] Interestingly, Brazil faces no currency crisis and so the policy switch requires an explanation. In the past, electoral promises have been broken—for example in 1998, when Cardoso committed to the Real Plan and subsequently devalued. Under Collor (1989) and Sarney (1985) there were similar events, but in all three cases voters punished the incumbents. In the election of 2002 that brought Lula to the presidency, the PT changed its manifesto during the electoral period and committed to fiscal responsibility and monetary austerity. There was no backlash against Lula in the 2006 presidential race because the economy rebounded and growth and social spending were restored. Importantly, Lula's policy switch occurred shortly before the elections in the wake of a confidence crisis resulting from polls that increasingly pointed to his victory.

The parallels between Lula's conversion to market reforms in 2002 and Rousseff's 'neoliberal turn' may obscure the great differences between the two. Lula faced a crisis of confidence brought about by his chances of winning. Cardoso's legacy was a 3% primary surplus, whereas Rousseff faces a primary deficit of 1%, which is a product of her government's earlier fiscal profligacy. This reduces the chances of an interventionist rebound in the wake of a short-term recovery. The need to recuperate government finances amid an international stagnant economy and the deceleration of the Chinese economy is a mirror image of what Lula faced.

Rousseff's conversion to austerity was announced after the elections by newly appointed ministers, not the president. Although economic performance had been deteriorating, the economy faced no hyperinflationary crisis; nor was it facing a balance of payments emergency by the time of the presidential race. The radical change in policy reflects the failure of the new interventionist policies, which almost cost her the election. The electoral costs of underperformance can be gauged by the 48.3% of the vote obtained by the opposition candidate, Aécio Neves of the PSDB, who campaigned on a platform of fiscal sustainability, market-oriented policies and social inclusion. The business elites and the traditional middle-income groups have become strongly inflation-averse and sensitive to fiscal issues.[17] They care about policy and not just outcomes. Meanwhile the much-heralded 'new middle class' that emerged with the commodity boom has expressed through the ballot box its frustration with the decline of upward mobility. These sectors are also more sensitive to corruption charges than the poor. Rousseff was elected with the vote of low-income groups who care mostly about outcomes: they benefited from social transfers and (now declining) employment generation. They will bear the costs of adjustment and this may be a source of discontent. There was a marked social and geographical cleavage in the vote, the most polarised since the return to democracy. This makes these constituencies crucial politically.

IMPEACHMENT POLITICS

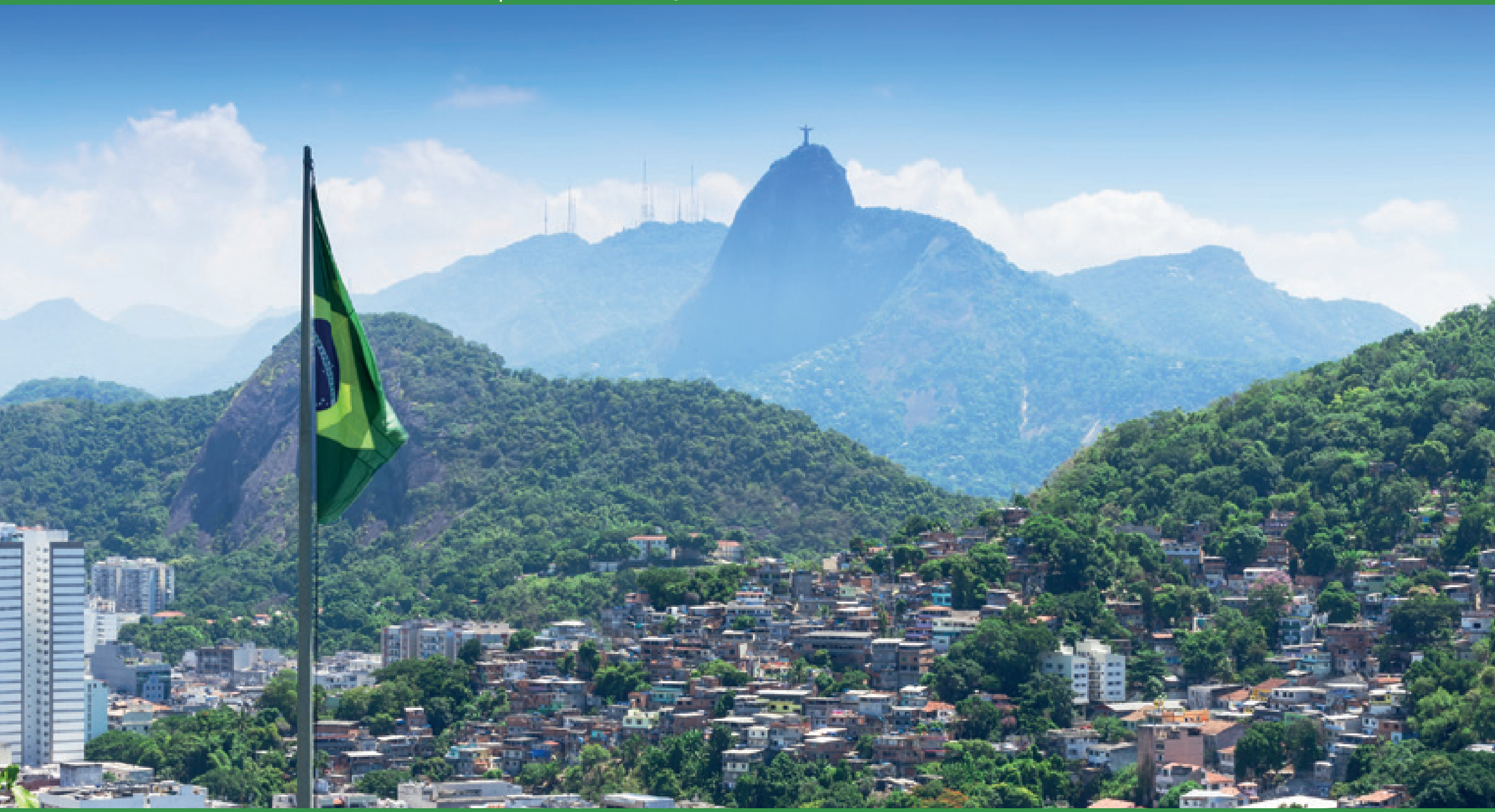
In early 2015, Rousseff's opponents called for impeachment. This prospect looms large following recent accusations of the use of illegal funds in the elections of 2010 and 2014. Indeed, current scholarship suggests that all the necessary ingredients are present. Hochstetler argues that presidents are impeached in Latin America where there is a combination of neoliberal policies, street demonstrations and a corruption scandal implicating the president.[18] Between 1978 and 2007, 30% of all democratically elected presidents worldwide were threatened with losing power before the end of their full terms; 12% did lose their posts.[19] In Latin America since 1978, roughly 40% of presidents have faced such challenges. Although the PSDB has not openly supported impeachment procedures, there are mounting allegations about slush funds. However, no evidence has emerged to implicate Rousseff personally. Thanks to PT's control of large trade unions and pressure groups, violent clashes, and riots cannot be ruled out should impeachment measures against Rousseff be initiated.

BUSINESS COALITIONS

Brazil has no economy-wide association to represent the interests of the financial, agriculture and industrial sectors, which remain fragmented. Access to BNDES or Petrobrás loans and contracts pit the interests of large and small contractors against each other. In addition, business is fragmented along territorial lines. The most important and vocal business association is a state-level entity, the Federation of Industries of the State of São Paulo (FIESP).

Under the PT, governments sought a rapprochement with business, in particular the manufacturing and construction industries. Lula created a Council for Economic and Social Development (CDE) to signal his commitment to integrating business and civil society. But, over time, the CDE saw its influence fade. Large firms have developed strong links with government and a number have become recipients of large federal loans and enjoy direct access to the presidency. Big business benefited handsomely from subsidised loans from BNDES that cost 0.5% of GDP. Industry has been sustained by extensive public spending. The car industry in particular has enjoyed exemptions from federal VAT-style taxes (IPI).

Corcovado, Cristo, favela near Copacabana, Rio de Janeiro



An informal alliance of large holding companies in construction, agribusiness and oil and gas exploration has underpinned the governments of the PT since 2006. This alliance is currently in disarray in the wake of the corruption scandal. The cartel operated by large contracting firms has been exposed. Although PSDB is more business-friendly than the PT, the governments of Lula and Dilma developed extensive links to individual firms, which have become important donors during elections.

Business as a whole has shown increasing impatience with Rousseff's policies. The country's decrepit infrastructure has been a main target of criticism, particularly among agribusiness. The industrial sector, in particular exporters of manufactured goods and the car industry, opposes the deindustrialisation process and the loss of competitiveness of exports that results from currency appreciation and heavy taxation. Brazil's tax burden, currently 37% of GDP, has recently surpassed the OECD average and is similar to Germany's. Recently businesses have expressed their frustration in tax revolts.[20] Agribusiness plays a dominant role in world markets and has benefitted from the commodity boom; it is less vulnerable to an appreciated exchange rate, but more vulnerable to the

Praça da Sé, São Paulo

transportation infrastructure problems. Specific sectors, however, have received large investments—notably oil and gas companies, which have important links to industries such as shipbuilding and building contractors.

Petrobrás represents 13% of Brazil's GDP. The scandal engulfing it therefore has far-reaching economic and political consequences. CEOs of large contractors and oil platform suppliers have been arrested and face charges of racketeering, cartel formation and of paying kickbacks to government officials. Three of the biggest contractors have already been downgraded by international rating agencies and many subcontractors have filed for bankruptcy. Restoring public works in the area of gas and oil will take years. Oil extraction in the pré sal, "which amounts to the US Apollo programme", as an international analyst put it, will be significantly delayed considering its impact on Petrobrás operations.[21]

STRONG PRESIDENTIALISM, A WEAK PRESIDENT, DAUNTING CHALLENGES

Brazil is at a crossroads. Since the mid 1990s, governance has improved significantly. In fact, as we saw earlier, the country was once a role model for many developing countries. Brazil's multi-party coalition seemed to be working. Economic growth and a reduction in inequality prompted the rise of a large middle class. But the discovery of the pré sal in 2007, the international financial collapse and the demise of the commodity super cycle disrupted the political and economic equilibrium. The resulting crisis brought a return to old-style dirigisme, which led to a deteriorating fiscal situation, falling growth and inflationary pressures. President Rousseff faces strong opposition in Congress and a party system that is increasingly fragmented. Her own party has lost congressional influence and has to manage a devastating corruption scandal. Large-scale street demonstrations in 2013 reminded the outside world of the potential for ungovernability.

Although Rousseff has the support of a nominally large majority, she has become a hostage to the PMDB, a party from her own coalition that has secured the speakership of the House and the presidency of the Senate. With her popularity at an all-time low, a fragmented legislature and her own party's delegation in Congress shrinking, Rousseff is now the weakest president since democracy was restored.

Rousseff's policy switch has surprised the opposition and generated strong criticism from her own party. It has the potential to restore investors' confidence—yet the executive's ability to pass a reform agenda in areas such as taxation and social security is limited: change will be mostly confined to monetary and fiscal policy. In other words, the current administration does not have a solid reform agenda and will look like a caretaker government. The prospects of economic recovery before 2017 are slim. This means that the net costs of austerity measures are considerable. The chances of a second wave of demonstrations and a parliamentary backlash are high particularly if social mobilisation for an impeachment increases. Impeachment procedures are unlikely but cannot be ruled out.

While one could expect Rousseff's second term to be marked by a lack of policy implementation, this does not mean there will be no improvements in governance, since the system of checks and balances has its strengths. While Rousseff is not likely to be able to build coalitions to drive needed reforms, she can reverse policies in several key areas such as fiscal and monetary policy, (in which she has already proposed an important package to the legislature). Even these, however, run the risk of just partial reversal in 2015 should the popular backlash against fiscal retrenchment increase.

Brazilian prosecutors and the judiciary have played key roles in curbing presidential abuse of power and punishing corruption. The strengthening of the rule of law is an important accomplishment. Brazil's democracy will probably come out stronger and the country's economy will benefit in the long run.

Despite the daunting challenges facing Dilma Rousseff during her second term of office, Brazil is on the right track towards good governance. The vast scale of the corruption in Petrobrás has puzzled observers. Never before has grand corruption been uncovered and punished. Its short-term impact will be significant. Petrobrás' paralysis is expected to reduce the investment rate by 10% and GDP by almost 2%. Although the economy is in dire straits, the silver lining is that the rule of law is still relatively strong.

The key lesson to be drawn is that reasonably strong political competition and checks and balance institutions have prevented the kind of power abuse seen in other Latin American countries (except for Chile and Uruguay). Another important lesson is that the return to the ISI has failed. Outcomes have not matched expectations and voters increasingly see fiscal responsibility and economic inclusion as the way forward.

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4. Ames, Barry, *The Deadlock of Democracy in Brazil,* Ann Arbor, University of Michigan Press, 2002.
5. Torres, Ernani T. Filho, Macahyba Filho, Luiz and Rodrigo Zeidan, *Restructuring Brazil's National Financial System*, IRIBA Working Paper, University of Manchester, 2014.
6. See Musacchio, Aldo, and Lazzarini, Sergio G., *Reinventing State Capitalism: Leviathan in Business*, *Brazil and Beyond*. Cambridge, MA: Harvard University Press, 2014.
7. Source: Brazilian Central Bank, *Nota a Imprensa*, 2015. Available at http://www.bcb.gov.br/?ECOIMPEXT
8. Gallagher, Michael, 2014. Election indices dataset at http://www.tcd.ie/Political_Science/staff/michael_gallagher/ElSystems/index.php, accessed Feb 17 2014.
9. The coalescence rate declined to 44.2 under Rousseff 's first term down from 62.1 under Cardoso.
10. Raile, Eric D., Pereira, C and Power, T (2011) "The executive toolbox: building legislative support in multiparty regimes", *Political Research Quarterly*, 2011, 64 (2): 323-334.
11. The ideological distance is calculated with data from Zucco and Benjamim (2010), which uses W-nominate for their calculations. In this methodology the voting record of all representatives are clustered allowing the identification of their commonalities.
12. Index of Coalitional Necessity is obtained by multiplying the effective number of parties by the inverse of the percentage of seats held by the president's own party, then dividing by ten for ease of interpretation. See Chaisty, Cheeseman, and Power, "Rethinking the 'Presidentialism Debate': Coalitional Politics in Cross-Regional Perspective", *Democratization*, 21, 1, 2014.
13. In central Rio over 300 thousand protestors marched, whereas in Brasilia over a 100 thousand demonstrated in the *Esplanada dos Ministérios*; many protestors climbed onto roof of the National Congress building. The cost of bus fares triggered the mass demonstrations. More importantly, cost overruns and inflated budgets in the construction of FIFA led to widespread criticisms about the government's priorities and about government performance. Reacting against the "Fifa-Standard Soccer Stadiums", demonstrators carried signs in the streets asking for "Fifa-Standard Hospitals" or "Fifa-Standard Schools." See Prada and Marcello (2013) and BBC (2013), See Prada, Paulo and Maria Carolina Marcello "One million march across Brazil in biggest protests yet", Reuters report, June 20, 2013. Available online: http://www.reuters.com/article/2013/06/21/us-brazil-protests-dUSBRE95J15020130621 and BBC "Brazil protests spread in São Paulo Brasilia and Rio," 2013, http://www.bbc.com/news/world-latin-america-22946736, 2013.
14. Some analysts have argued that policy moderation resulted from pressures from PT's mayors and governors, which had to build alliances to win elections and to govern.
15. See Alston, Lee, André Melo, Marcus, Mueller, Bernardo and Pereira, Carlos, *Beliefs, Leadership and Critical Transitions: Brazil 1964-2014*, Princeton University Press, 2015.
16. Campello, Daniela, *The Politics of Market Discipline in Latin America: Globalization and Democracy*, Cambridge University Press, 2015.
17. This seems to be a regional phenomenon but it is particularly acute in a Brazil that experienced hyperinflation, as suggested in Stephen B. Kaplan, *Globalization and Austerity Politics in Latin America*. New York: Cambridge University Press, 2013.
18. Hochstetler, Kathryn, "Rethinking presidentialism: challenges and presidential falls in South America," *Comparative Politics*, 38 (July) 2006.
19. Hochstetler, Kathryn and Samuels, David, "Crisis and rapid reequilibration: the consequences of presidential challenges and failure in Latin America", *Comparative Politics*, 2011 (January).
20. André Melo, Marcus, Barrientos, Armando and Coelho, Andre, *Taxation, Redistribution and the Social Contract*, Brooks World Poverty Institute Working Paper WP 11, University of Manchester, 2014.
21. Three Petrobrás senior directors have been arrested and two have entered into leniency agreements with public prosecutors.

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Marcus Andre Melo is a Professor of Political Science at the Federal University of Pernambuco and a former Fulbright Scholar at MIT. Previously, he was a Coca-Cola Company Visiting Professor at Yale University and a Fellow of the John Simon Guggenheim Foundation. He was also a resident Fellow at the Rockefeller Foundation and has consulted for several multilateral institutions. Professor Melo has co-authored *Making Brazil Work: Checking the President in a Multiparty System*, New York, Palgrave, 2013 and *Beliefs, Leadership and Critical Transitions*, Brazil 1960-2012, Princeton University Press, forthcoming in 2015. His work has appeared in *The Journal of Democracy*, *Legislative Studies Quarterly, Comparative Political Studies*, among other scholarly journals. He also contributes regularly op-eds to Brazil's leading business daily *Valor Econômico*. He holds a PhD from the University of Sussex.

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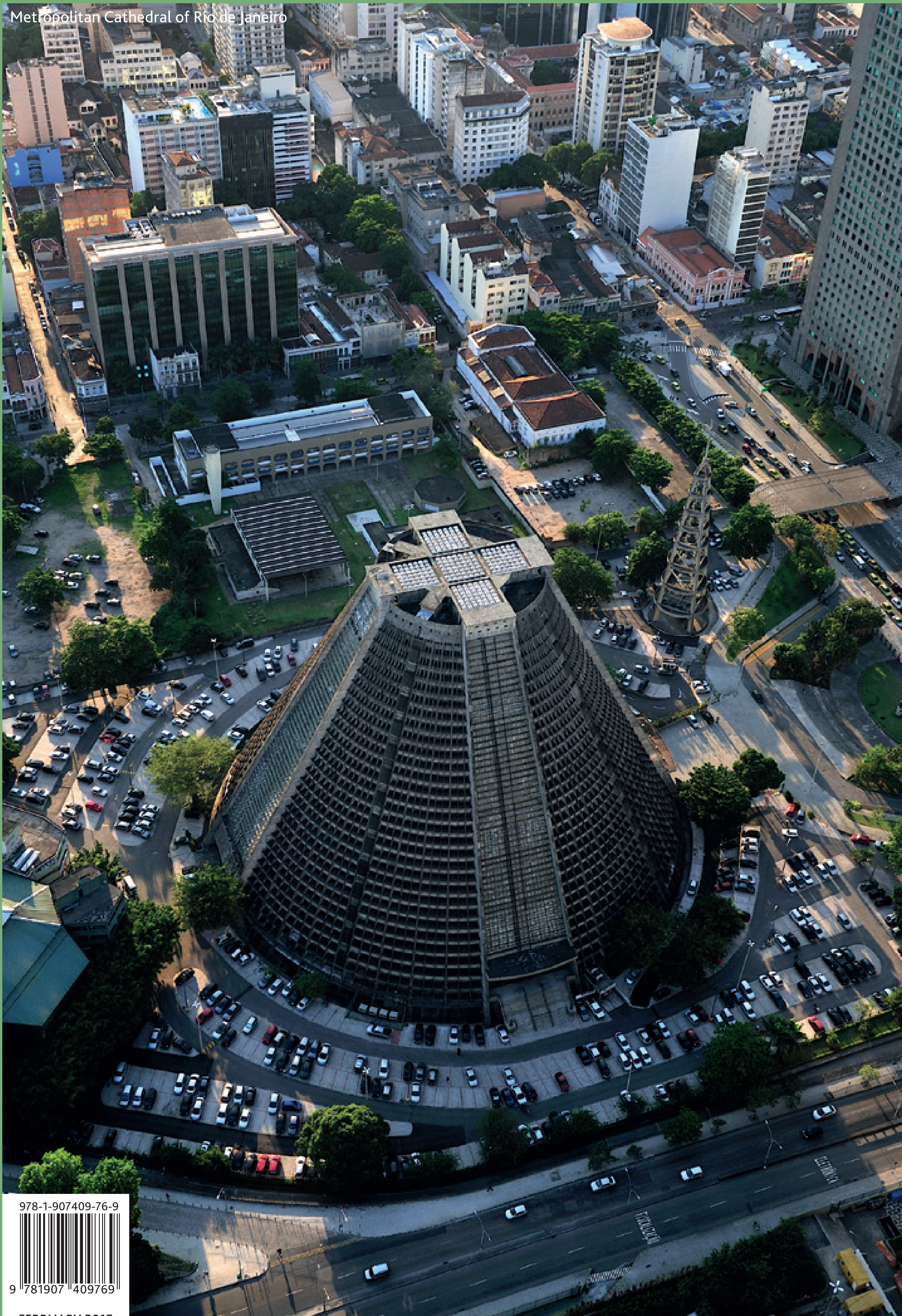

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FEBRUARY 2015