

# Brazil

<b>Status Index</b> (Democracy: 7.90 / Market economy: 7.79)		<b>7.84</b>	<b>Management Index</b>		<b>6.88</b>
<b>HDI</b>	0.792		<b>Population</b>	108.1 mn	
<b>GDP per capita (\$, PPP)</b>	7.790		<b>Population growth<sup>1</sup></b>	1.8 %	
<b>Unemployment rate</b>	N/A		<b>Women in Parliament</b>	9.1 %	
<b>UN Education Index</b>	0.89		<b>Poverty<sup>2</sup></b>	8.2 %	
			<b>Gini Index</b>	59.3 (2001)	
Source: UNDP: Human Development Report 2005. Figures for 2003 unless otherwise indicated. <sup>1</sup> Annual growth between 1975 and 2003. <sup>2</sup> Population living below \$ 1 (1990-2003)					

## A. Executive summary

Brazil meets the minimum requirements for a democracy under the rule of law. During the first half of president Lula's term of office, standards of stateness and the rule of law have remained unchanged. The quality of political participation has improved slightly during recent years, due to the Lula government's efforts to open decision-making processes at all levels of the political system to civil society participation. The level of consolidation of democracy has not changed significantly. A larger step toward consolidation would require reforms in the electoral and party systems in particular. In this respect there were no successes to be noted. The level of satisfaction with democracy, democratic convictions and interpersonal trust within Brazilian society still reflect very low values, though one cannot infer from these a threat to democratic stability.

The country's level of development has not changed significantly in the last years. The HDI value and the Gini Index remained almost unchanged. Brazil continues to be one of the countries with less distributionary justice worldwide. Despite President Lula's strong commitment to fight poverty and inequality, the overall poverty level has not changed significantly in recent years. The institutional framework for market-based action has slightly improved. Like its predecessor, the Lula government is committed to modernize the country's economic system. Notwithstanding several accomplishments, there are challenges that need to be addressed. Overall economic development has slightly improved both quantitatively and qualitatively during the last years. Some macroeconomic data (growth, exports, imports, budget, debt) have enhanced, while others (inflation, investment, credits) have remained more or less unchanged. Unemployment declined somewhat in 2004, but remains high compared to 2001. The size of the informal sector could not be reduced significantly. The Lula government has undertaken several initiatives to further embed the Brazilian market economy in a social welfare policy framework. It remains to be seen whether these initiatives will result in fundamental improvements in the next years.

After two years in office, the public approval of president Lula's performance in government remains high. However, conflicting views inside the government and the Workers Party (PT) on some key issues, as well as the fragmentation of its political alliance in Congress, undermine the sustainability of the ruling coalition. As political parties have already begun to position themselves in preparation for the upcoming presidential campaign of 2006, President Lula and his government may face increasing difficulties in realizing major reforms during the second half of their term of office.

## **B. History and characteristics of transformation**

Democratic transformation in Brazil spanned a period of 16 years. The first steps toward liberalizing the authoritarian regime (1964–1985) were taken after General Geisel assumed power in March 1974 and were continued under President Figueiredo (1979–1985). Brazil experienced the most massive political mobilization in its history in connection with a campaign in early 1984 to institute direct election of a democratic president (“*diretas já*”). The armed forces, however, insisted on indirect election of the first civil government since 1964. Tancredo Neves was elected president by an electoral assembly in January 1985. Due to his personal integrity and popularity, he found acceptance even among those opposed to the government, but he died before he could take office. The office was assumed by the elected vice president, José Sarney (1985–1990). During the Constitutional Convention (1987–1988), the military prevented a far-reaching limitation of its institutional autonomy. The new constitution took effect in October 1988.

The transition to democracy came to a close on March 1990, when the first directly elected democratic president, Fernando Collor de Mello, assumed office. Implicated in a corruption scandal, the populist Collor was removed from office by Congress in September 1992. Vice President Itamar Franco served out the remainder of his term. The internationally renowned sociologist Fernando Henrique Cardoso won the presidential elections in October 1994. In 1998, after the constitution had been amended to allow his re-election, Cardoso became the first president in Brazilian history to be elected to a second term of office (1999–2002). Democracy as a form of state and government became more firmly established under Cardoso.

When the former union leader and Workers Party (PT) chairman Luis Inácio Lula da Silva, known as Lula, was elected president on October 27, 2002, it was the first time in Brazil's history that the presidency had been filled by a representative of those classes that, until then, had been largely excluded from positions of political or economic power. Thus Lula's inauguration in January 2003 not only

symbolized a socio-political change, it was also linked to the hopes of millions of Brazilians for the reforms needed to fight poverty and inequality more systematically than in the past.

Brazil's market economy transformation into a newly industrializing country began in the 1930s with a largely insulated home market. It was guided from the end of World War II by the concept of import substitution industrialization (ISI). This policy helped Brazil achieve high economic growth rates over several decades; at the same time it created a series of economic distortions. It did not succeed in producing sufficient competitive pressure to maximize domestic economic efficiency, nor did it succeed in organizing a fully functional banking system or in reducing the risk of balance-of-payments crises. Industrialization was not self-sustaining. Existing economic, social and regional disparities increased further.

The economic situation in the 1980s was characterized by growing unemployment, rapidly rising inflation rates, widely fluctuating gross domestic product growth rates, growing problems resulting from the large foreign debt and rising deficits in the national budget. After various heterodox economic plans had failed, comprehensive measures were taken, beginning in the 1990s and with more intensity from the mid-1990s on, to stabilize economic development. As finance minister (1993–1994) under President Franco and as president from 1995, Fernando Henrique Cardoso became the architect of a stability and reform policy that brought the country low inflation rates, better managed and more economically budgeted government, and more consistent macroeconomic conditions. However, it also brought growing government debt, extremely high nominal interest rates and only modest growth rates.

Cardoso's successor Lula and his Workers Party (PT) had fought many of the reforms the Cardoso government put into effect during the 1990s. They had attacked Cardoso as a neo-liberal and insisted on an economic model with a stronger social component, one that answered more to the needs of people than to those of the banks and corporations. But as time went on during the Cardoso administration, even the PT had to admit that many of the Cardoso government's policies had produced results that were better than the opposition had expected. When, after three vain attempts in 1990, 1994 and 1998, Lula was finally elected to the presidency by a clear majority in 2002, it was not only because he had promised fundamental continuity with the course already chosen and had presented himself as substantially more moderate than before.

Lula promised to fulfill Brazil's obligations to international financial institutions and to maintain the stability policies of his predecessor. He demonstrated a strong sense for the insecurities and doubts that he, and especially his party, had aroused in Brazilian society and in the international world of finance. At the same time, he made the struggle against hunger and for more social justice central issues of his

campaign. The Lula government found itself confronted with great challenges, the high expectations within its own following being one of its greatest problems.

## **C. Assessment**

### **1. Democracy**

#### **1.1. Stateness**

The state's monopoly on the use of force is established nationwide in principle, but does not function completely. There are occasional reports of people involved in land rights disputes being murdered by hired killers, who operate in some regions with the connivance of the police and local authorities. In several large cities the state is unable to completely guarantee private and public security. While on the one hand private security services and fortified residential districts are expanding, the less affluent on the other hand feel abandoned by the state's security organs. All citizens have the same civil rights and the vast majority fundamentally acknowledges the state's constitution. The state is defined as a largely secular order. Religious dogmas have no noteworthy influence on politics or law. The state's basic infrastructure extends to the entire territory of the country, but its operation is to some extent deficient. The state apparatus operates efficiently and professionally in some regions, while others are still characterized by clientelism and patronage, and demonstrate considerable need for reform. Further problems are caused by widespread corruption and organized crime and violence. A climate of lawlessness in certain remote parts of the country and the slums of some large cities is aggravated by a weak judiciary and an often violent police apparatus.

#### **1.2. Political participation**

Free and fair elections take place without restraints. Elected rulers have the effective power to govern. The constitution guarantees unrestricted freedom of association and assembly. Freedom of speech and freedom of the press are guaranteed in principle. However, compared to other Latin American countries, the journalist profession in Brazil faces attacks, threats, pressures and obstruction of information, particularly in the rural areas. The media provide vigorous reporting on controversial issues and government performance, but media ownership is highly concentrated.

### **1.3. Rule of law**

There are no restraints on the basic functions involved in the separation of powers, with mutual checks and balances in place. The judiciary is institutionally well-differentiated and free from unconstitutional intervention by other institutions. However, it is extremely overburdened, and corruption scandals repeatedly occur. There are vast disparities in citizen access to legal counsel and the administration of justice, due to extreme inequalities in the distribution and availability of information and resources to all citizens. Judges have used their autonomy to impede court reform and often use their highly formalistic legal decisions to overturn government modernization efforts. As a rule, corrupt officeholders are prosecuted under established laws, but also slip through political, legal or procedural loopholes. Civil liberties are formally guaranteed, but are partially violated and not well-implemented in many rural areas as well as in city slums. Most violent crime is related to the illegal drug trade. Brazil's police are among the world's most violent and corrupt. In many states so-called "death squads" terrorize shanty-town dwellers and intimidate human rights activists. The prison system is anarchic, overcrowded, and largely unfit for human habitation.

### **1.4. Stability of democratic institutions**

Democratic institutions operate essentially according to their allotted functions, but specific structures of interaction between key institutions create problems of governance and negatively affect the implementation of reforms. The constitution of 1988 is characterized by a tendency toward over-regulation. Consequently, nearly all major reforms require a constitutional amendment and are therefore difficult to achieve. The electoral system produces a clear overrepresentation of the sparsely populated and often disadvantaged northern and northeastern federal states in the Chamber of Deputies and the Federal Senate. This allows traditional local and regional elites to more easily insulate themselves from modernization trends. All relevant political and social players accept the legitimacy and authority of democratic institutions.

### **1.5. Political and social integration**

The political party system is characterized by a high level of fragmentation, moderate polarization, most parties having a poor social support base (an exception being the Workers Party, PT) and high voter volatility. The reasons for this are partly historical, but they are also connected with the electoral system: The Chamber of Deputies has a system of proportional representation with open lists without a barring clause. The parties present regional lists of candidates, but voters may vote directly for individual candidates, as approximately 90% of voters in fact do. This system makes it more difficult for national party

leaderships to discipline elected representatives, and it fosters the traditional focus on personalities rather than institutions, particularly because political campaigns are planned and financed less by political parties than by the candidates themselves. At the national level most parties are organizationally weak. There is little party coordination or loyalty among congressional representatives. Changes in party affiliations within Congress occur with extreme frequency following elections, the switch being usually from opposition to governing parties and often across ideological boundaries. The costs of a party switch are minimal. The loose and weak structure of political parties makes it difficult to predict the outcome of congressional decision-making processes. Even numerical majorities of the governing parties cannot guarantee that the executive branch will be able to implement its reform plans.

The network of interest groups is relatively close-knit, but dominated by a few strong interests. Labor and capital associations dominate. Despite divergences among competing umbrella organizations, trade unions are strong political actors. Following democratization there was a gradual estrangement from traditional corporatist state models. Mobilization capabilities diminished during the 1990s and the level of trade union organization is presently on the decline. Entrepreneurs have a national umbrella organization, with the National Confederation of Industries in São Paulo State wielding the greatest influence.

Consent to democracy is low (2004: 41%), as is the degree of satisfaction with democracy (2004: 28%), but political protests do not tend to question the constitutional framework. This data must be interpreted in the light of the Brazilian experience under an authoritarian regime, which from the mid-1970s was less repressive than those in many other Latin American countries. Political parties, elections and legislatures had a certain significance even under autocratic rule, and the economic balance under the rule of the armed forces was not entirely negative.

Interpersonal trust is very low (2004: 4%). There is, nevertheless, a robust network of autonomous, self-organized groups and civic organizations. Among these is a growing number of non-governmental organizations. Traditional social movements are also active, most notably a movement of the landless founded in the mid-1980s that mounts high-profile protests against the neo-liberal economic policies and social injustice and organizes land occupation.

## **2. Market economy**

### **2.1. Level of socioeconomic development**

Social exclusion is quantitatively and qualitatively extensive and structurally ingrained. Although Brazil exhibits a medium level of development according to

key indicators, national mean values mask extreme disparities between a relatively developed southern and southeastern region, where, to some extent, conditions resemble those in industrialized countries, and a socioeconomically disadvantaged northern and northeastern region. The existing developmental imbalances between these regions have not lessened in recent years. Evidence shows that the high inequality levels one finds between regions are equivalent to the ones existing within one region, or even within large metropolitan centers in all regions. This points to the fact that social inequality is pervasive and not something simply derived from regional differences. With a Gini index value of 59.1, Brazil is globally one of the countries with the most inequitable distribution of income.

## **2.2. Organization of the market and competition**

Market competition has a strong institutional framework, but the informal sector generates about 40% of Brazil's GDP. Pricing is largely unrestricted. The use and transfer of profits is not regulated. The convertibility of the national currency, the Real, is guaranteed, and there has been a free-floating exchange rate since January 1999. Since the Competition Act went into effect in mid-1994, a coherent anti-monopoly and anti-cartel policy has evolved. Foreign trade has been liberalized during the last decade. The degree of openness is measured by the level of exports plus imports of goods and services increasing from 22% to 31% in the last five years as compared to the GDP. Nevertheless, there are still special exemptions and somewhat complicated registration formalities. Customs duties for imported goods change frequently. Imports from countries outside the Mercosur are constrained by high tariff and non-tariff barriers. The comprehensive re-organization of the financial sector was one of the most remarkable developments in the Brazilian economy of the 1990s. Today, the banking system and capital markets are well-differentiated, internationally competitive and aligned to international standards, with a functioning system of banking supervision. Capital markets are open to domestic and foreign capital. But although Brazil's financial sector is sophisticated and systemic risk is low, it lacks depth, and intermediation spreads are among the highest in the world. Brazil's public banks hold more than 40 percent of financial sector assets, but even with the large role of public banks, access to financial services is unevenly distributed, to the disadvantage of the poorest. Small entrepreneurs have little access to finance options. Financial services to small-scale entrepreneurs as well as microfinance and non-bank financial services should be expanded in order to encourage growth and employment.

## **2.3. Currency and price stability**

Inflation and foreign-exchange policies are synchronized with other goals of economic policy and are institutionalized in a largely independent central bank.

The Central Bank is broadly perceived as being de facto independent, even if it is de jure not granted total operational autonomy. There is a consistent policy for stability. Since the introduction of the *Plano Real* in 1994, there has been a drastic reduction in inflation rates. Macroeconomic stability and the control of inflation was one of the Cardoso government's priorities, and the Lula government follows the same course. The Fiscal Responsibility Act (*Lei de responsabilidade fiscal*, LRF), passed in May 2000 by the Cardoso government, subjects all levels of public administration to criteria of transparency and coordination and makes them responsible for their fiscal performance. It sets guidelines for primary surplus generation and debt limit maintenance, and it limits salary increases for civil servants. Governments have been issuing medium-term inflation targets since 1999 ("inflation targeting"), and the central bank takes responsibility for observing them. In 2003 and 2004, the central bank followed a very tight monetary policy. In order to reach inflation targets, it lifted base rates to a very high level (18.25%). After the Real's exchange rate was made fully convertible in January 1999, it repeatedly experienced massive devaluation pressure. Since 2003, however, the currency has strengthened significantly against the United States dollar. In 2004, the Central Bank intervened in order to keep the exchange rate at a competitive level.

#### **2.4. Private property**

Private property rights are well-defined and property acquisition is adequately regulated. Under President Cardoso, Brazil went through a radical transformation in forms of corporate ownership. For decades, state-owned corporations had dominated nearly all economic sectors, in which no private capital was available. Privatization was initiated by President Collor (1990–1992), but was not continued by his successor, President Franco (1992–1994). President Cardoso introduced and carried out a comprehensive process of privatization on the basis of several constitutional amendments. State monopolies in key sectors of the Brazilian economy (e.g. energy, telecommunications) were abolished, while other sectors were radically liberalized. Privatization is well-advanced in many areas, including the raw materials industries, transport and energy sectors and telecommunications. Regulation of liberalized economic sectors was arranged through framework legislation and in many cases assigned to newly established authorities that enjoy technical, financial and administrative autonomy. The Lula government has not carried on the privatization policy of its predecessor. It follows the idea that the state should play an active and managing role in achieving both economic growth and social justice. Accordingly, it stopped further sales of existing public enterprises. In 2004, the government launched a proposal of public-private partnerships, which is thought to attract private investment to supplement the public expenditures for infrastructure limited by tax and budgetary constraints.

## 2.5. Welfare regime

Social welfare networks to compensate for old age, illness, unemployment and disability are partially well-developed, but do not cover all risks for all strata of the population. Over the last decade, Brazil carried out significant reforms to expand the coverage, quality and efficiency of its health system and strengthen its safety net. Infant mortality fell by more than a third, maternal health has improved, mortality from infectious diseases has decreased substantially. Nevertheless, the risk of poverty and hunger continues to be high for significant portions of the population. President Lula was elected on a platform that emphasized rapid and far-reaching improvements in people's welfare. The effects of the government's high priority social initiatives, including efforts to eradicate hunger (*Fome Zero*), create youth employment (*Primeiro Emprego*), and unify social transfer programs for greater effectiveness in reducing poverty (*Bolsa Familia*), have so far come short of expectations. The government has realized an ambitious social security reform, with far-reaching fiscal and equity effects, bringing generous public employee benefits more in line with the private sector while introducing a complementary, fully funded pensions pillar for civil servants. In spite of favorable economic development trends in the last years, the government's room for manoeuvre in the social domain remains narrow.

Brazilian society is markedly heterogeneous. Although compensation schemes for those disadvantaged by extreme social disparities do exist, they are insufficient. Women formally possess equal rights, but face a reality marked by inequality in both the domestic sphere and professional life. In education, the gaps between men and women have narrowed greatly, and women on average possess higher educational qualifications as a result of their more disciplined study behavior. The visibility of women in public life, the media and politics is increasing, not least of all thanks to the activities of numerous women's organizations.

## 2.6. Economic performance

Long-term growth of per-capita GDP is moderate, with the annual growth rate between 1990 and 2002 being 1.3%. In 2002, GDP per capita was 7,770 US\$ (PPP). Basic macroeconomic data have been very positive during the last two years. In 2004 industrial output grew by 8.3%. This was the fastest rate in 18 years. The output of capital goods was increased by 20%, the biggest increase in 12 years. The official inflation rate in 2004 was 7.5% and the target for 2005 is 5.1%. The six largest metropolitan regions in the country (São Paulo, Rio de Janeiro, Porto Alegre, Belo Horizonte, Salvador and Recife) registered the lowest unemployment rate in December 2004 since the compilation of data from October 2001. The number of unemployed in these cities fell to 9.6%, a drop of 1.3% in comparison to December 2003. The average annual unemployment rate in 2004

was at 11.5%, just 0.8% lower than the 12.3% average in 2003. The fiscal deficit in proportion to the GDP fell to 2.7% in 2004. The main reason for the fall was an increase in tax collection. In 2003, the fiscal deficit had been 5.1% of GDP. Debt as a proportion of GDP fell from 57% at the end of 2003 to 51%. Trade figures showed both imports and exports hitting record levels during 2003 and 2004, leaving Brazil with a favorable trade balance for the first time in many years. Despite the emergence of positive macroeconomic data, GDP growth continues to fall short of the Brazilian economy's growth potential.

## **2.7. Sustainability**

Ecologically sustainable development is an issue in some sectors of the economy, but tends to be subordinated to economic growth targets. The threat to the rainforests and other serious environmental problems have not been eliminated. Despite the fact that Brazilian legislation has taken a positive direction in many areas (e.g. water management, forest protection, biodiversity), the threat to key ecosystems is undiminished. President Lula's election manifesto included many environmental aspects, e.g. the principle of "transversality," implementing an integrated environmental policy within the overall government policy. It also promised scope for the participation of civil society in controlling public policy, and for involving different levels of government in consolidating the sustainable development agenda. Following these guidelines, the environmental ministry sought to strengthen the articulation and coordination of all ecological policies undertaken by both federal and state agencies. While the administration defended its record on environmental issues, environmentalists very soon started to complain about the apparent abandonment of various campaign promises, including tough policies aimed at restraining genetically modified food, nuclear power and Amazon deforestation. Despite the government's efforts to appease both the developmentalists and the environmentalists, progress remains modest and implementation capacity is weak, compared with the magnitude of the challenges ahead.

The quality of government and private educational and training facilities is improving. Between 1999 and 2001 public expenditure on education accounted for 4% of GDP. Educational expansion was a notable success during the Cardoso years, but the quality of public schools continues to remain a serious concern. The Lula government has not yet seriously implemented measures in the sector, its concepts and priorities on education being somewhat unrefined. The government's first minister of education gave priority to the fight against illiteracy, which, however, remained largely unsuccessful, leading to his resignation after just one year in office. His successor declared the opening of the universities as his first priority. Awareness of the importance of investment in research and development (R&D) has increased remarkably during the last decade. R&D expenditures accounted for 1.1% of GDP between 1996 and 2002.

Nevertheless, limited own funding remains a severe obstacle for investments in R&D for two-thirds of private firms. Only 11% of researchers work at private firms.

### **3. Management**

#### **3.1. Level of difficulty**

The structural constraints on governance in Brazil range from moderate to high. The country exhibits an average level of development and educational standards. It is an ethnically heterogeneous and highly secular society. The overall poverty rate refers to 28 – 29% of the population. Since 1997, poverty levels have remained relatively stable but the poverty profile has changed significantly. High unemployment and a permanent reduction of labor income in the industrial sector has resulted in the increase of urban poverty. Conversely, rural areas have been less affected by slowing growth and the macroeconomic volatility. Nevertheless, Brazil's poverty continues to be largely rural, and extreme poverty is concentrated in the largely semi-arid Northeast region of the country. The health of Brazilians has improved significantly. Infant mortality has fallen by more than a third. The number of new HIV/AIDS cases has remained constant. Mortality rates from AIDS have also declined significantly since 1998, partly a result of free universal access to anti-retroviral therapy (since 1996), and partly due to the government's strong HIV/AIDS prevention program. The country has strong civic traditions. The vibrant and increasingly influential civil society consists of NGOs, community-based organizations, social movements, and professional associations. There are no irreconcilable ethnic, religious or social clashes, but there are extreme social and regional disparities. Brazil is characterized by the largely peaceful manner in which a multiplicity of ethnic groups lives together, and the country cultivates its image as a society free from racism. Even if this does not always conform to realities on the ground, the country's cultural and ethnic diversity and its peaceful integration into a national society is an enormous social accomplishment. It keeps the country and its political system out of a type of conflict that often consumes substantial energies in other Latin American countries.

**Profile of the Political System**

Regime type:	<i>Democracy</i>	Constraints to executive authority:	5
System of government:	<i>Presidential</i>	Latest parliamentary election:	06.10.2002
		Effective number of parties:	8.7
1. Head of State:	<i>Luiz Inácio Lula da Silva</i>	Cabinet duration:	01/03-present
Head of Government:	<i>Luiz Inácio Lula da Silva</i>	Parties in government:	7
Type of government:	<i>divided government</i>		
		Number of ministries:	23
		Number of ministers:	25
<p>Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional constraints posed by a federal or decentralized state, a second parliamentary chamber, referenda, constitutional and judicial review and the rigidity of the constitution. Electoral disproportionality (Gallagher index) reflects the extent to which electoral rules are majoritarian (high values) or proportional: <math>\sqrt{\frac{1}{2} \sum (v_i - p_i)^2}</math>; <math>v_i</math> is the share of votes gained by party <math>i</math>; <math>p_i</math> is the share of parliamentary mandates controlled by party <math>i</math>. For presidential/ semi-presidential systems, the geometric mean of presidential election and parliamentary election disproportionality is calculated. Effective number of parties reflects the political weight of parties (Laakso/Taagepera index) = <math>1 / (\sum p_i^2)</math>; <math>p_i</math> is the share of parliamentary mandates controlled by party <math>i</math>. Number of ministries/ ministers denotes the situation on 1 January 2005.</p>			

**3.2. Steering capability**

The government of President Lula da Silva is committed to constitutional democracy and a socially responsible market economy. Its policies give these goals priority over short-term expediency. Strategic priorities of the government are fighting poverty and improving educational levels. In spite of the very different personal background of former trade union leader Luis Ignacio Lula da Silva, the policies of his government have continued many of those implemented by the Cardoso government. President Lula was elected in October 2002 on a platform that emphasized increased social equity and faster growth. On the one hand, the new government committed itself to tight fiscal policy, inflation targeting, and the honoring of debt contracts. On the other hand, it promised far-reaching improvements in people's welfare, evidenced by several high priority social initiatives, including efforts to eradicate hunger, create youth employment, and unify social transfer programs for greater effectiveness in reducing poverty. In February 2005, after more than two years in office, the Lula government had an approval rating of 42.6%. President Lula himself had an approval rating of 66%, implying that thanks to his successful economic policies, he has managed to remain very popular.

The government is committed to democracy and a market economy, but has so far only shown limited success in implementing its announced reforms. A number of achievements and reforms were offset by many promises and projects which have not yet been translated into concrete government policies. The government has made important progress in some key reform areas. An ambitious pension reform, with far-reaching fiscal and equity effects (bringing generous public employee benefits more in line with the private sector while introducing a complementary

fully funded pensions pillar for civil servants), was realized in 2003. The reform will disburden the state budget by about €18 billion during the next 20 years. The government has also been successful in getting its tax reforms through Congress during its first year. Other projects, such as the long overdue reform of the judiciary or the agrarian reform, have only made modest advances. Shortly after taking office, President Lula made the unprecedented gesture of personally receiving a delegation of the landless movement MST. His administration hired a number of their key activists. However, despite of the government's genuine commitment to agrarian reform, in 2004 it settled only about 81,000 landless families. This figure corresponds to 71% of the government's initial target of 115,000 families. This was the second consecutive year the government was unable to accomplish its own target. The government's loan program Pronaf has failed to reach farmers, not least because the process of sanctioning loans is highly bureaucratic. Especially during the government's second year in office, the expectations that the agenda of economic and social reforms would advance, have remained unfulfilled. The government also seems to have lost interest in the reform of the political system itself.

The government's problems in effectively implementing its reform policy are in part due to conflicting interests and policy goals inside the ruling coalition, and in part a consequence of formidable institutional barriers to reform, as well as due to a fragmented system of political parties. The federal government's organizational capabilities also stretch to their limits in the provisions of Brazilian federalism, which grant considerable autonomy to individual states and municipalities. In view of the enormous regional disparities, it is hardly possible to make general statements about the individual states and their reform policies.

The political leadership responds to mistakes and failed policies with changes. Learning processes occur. The leadership sometimes demonstrates its capacity for complex learning and acts flexibly, but at other times its policies remain stuck in long-established routines. Even before taking office, former union leader Lula had demonstrated his sensitivity to political and economic realities and showed a great deal of pragmatism. His government's policies, even though faced with a "revolution of expectations" with regard to reducing poverty and inequality from a considerable proportion of Brazilian society, have proved to be based on the "art of the possible". This was not least due to learning processes on the part of leading members of the executive with regard to the functioning of the international economic system. Nevertheless, the government has been criticized for not pursuing consistent and reasonable policies. One good example of a meaningful reform that neither the Cardoso nor the Lula administration have been able to enforce is the reform of the political system. Many experts and parliamentarians consider such a reform as necessary, in order to equalize the representation of the regions inside the parliament, to reduce the number of parties, to increase the efficiency of parliament, and to discourage widespread party switching. Above all, the smaller parties inside the government coalition

profit from the current situation, which is why the executive would jeopardize the cohesion of its own alliance in pushing ahead with such political reforms.

### **3.3. Resource efficiency**

The Lula government uses most available resources efficiently. It has to be taken into account that the government was confronted with a frightening fiscal and economic crisis when assuming office on January 1, 2003. The debt burden had risen to 63% of GDP, Brazil's risk coefficient for the international financial markets had skyrocketed to 2400 points, inflation was predicted to exceed 40% in 2003. Brazil was not far from default in 2002. The new government implemented measures that contributed to gradually restoring confidence, which had faltered during and in the aftermath of the presidential election in 2002. These measures have succeeded in stimulating growth, reducing credit risk, stabilizing foreign exchange markets and limiting inflation.

Improvements in the economy owed much to the new government's reliable and consistent macroeconomic policies and to the individual qualifications of its main protagonists, but they were as much due to the strengthening of institutions during the Cardoso years, which helped maintain macroeconomic discipline. Of particular importance was the inflation targeting framework and the Fiscal Responsibility legislation. However, it should also be taken into account that the positive signs the world economy has recently shown, have significantly contributed to Brazil's successes. Export performance as one of the major factors behind this success is a clear indication of this. It is still too early to assume that Brazil has passed the test of external vulnerability.

But even if high public debt remains an important source of vulnerability, much progress has been made in strengthening the institutional framework for public debt management. The current government has successfully reduced the public sector net debt ratio to GDP and the foreign debt-to-export ratio to the lowest values in a long time. On the fiscal side, the government has managed to meet its annual budget targets, even in adverse conditions. Brazil's tax burden, close to 40% of GDP, is rather high compared to international standards and close to the OECD average.

It is difficult to make general statements about the quality of administration in the country's 5,560 municipalities, given the sometimes momentous differences. Sections of the municipalities have introduced a participatory budgeting procedure that allows civic organizations substantial opportunities for input in budgetary preparation and control. Other municipalities seem to prefer less process-oriented and more result-oriented measures of administrative modernization. However, client relationship patterns between administration and citizens have prevailed in a considerable proportion of the municipalities.

With regard to human resources, the Lula government has followed a course common to presidential regimes preceding him. Following a change of government, thousands of jobs within the public administration were given to new incumbents. Many appointments were favors granted to coalition partners or union leaders, and very often the new incumbents were not adequately qualified and prepared for their position. This has undermined an effective management of the public administration and caused some setbacks to government action. On the other hand, the government has managed to limit the greediness of its own party and its coalition partners with regard to using public expenditures for personal purposes.

In October 2002, representatives of 19 political parties were elected to the Lower House of Congress. Although the party of President Lula received only 17.7% of mandates, it was able to construct a broad parliamentary alliance of seven political parties within a few weeks, which has lasted until this writing. The most significant step was the de facto integration of the conservative PMDB into the governing coalition. The successful forging of a broad but very heterogeneous ruling alliance as well as President Lula's close cooperation with governors from all political parties ensured that important reforms could be passed in 2003. But the price for these successes was high. The allies had to be compensated with posts inside the government and the public administration. As an opposition party, the PT had repeatedly criticized the traditional spoils system of Brazilian politics, but it ironically acted in the same manner. With the goal of attaining a congressional majority, it established a give-and-take, clientelist policy of exchange of favors that started to backfire during its second year in office, turning the executive somewhat into dependents of old political bosses in the Lower House and in the Senate.

President Lula suffered a significant parliamentary defeat on February 15, 2005 when his candidate for the presidency of the Chamber of Deputies was defeated by another candidate. The setback calls into question Lula's relationship with Congress as the president faces a key year, during which he has promised to finally deliver on his plans for extensive reform. The president's coalition strategy has led to growing dissatisfaction within the Workers Party. Intra-governmental frictions increased considerably during Lula's second year in office. While the government's policies are strongly focused on preserving macroeconomic stability, elements in the Workers Party and former allies in civil society demand more distributive justice and a major push in the struggle against poverty and social disparities.

Over the last few years, Brazil has developed some internal control regimes to fight against corruption and other forms of misuse of public resources and abuse of public authority. The Lula government seeks to provide all integrity mechanisms, most of which are functioning. One change introduced by the new

government is a more transparent and inclusive approach to government decision-making, building on successful local experiences, from participatory budgeting to involvement of community associations and local councils in budget and policy decisions. Through better access to information, the approach can also help in fighting corruption. In 2002, the supreme electoral court passed a judgement requiring candidates who participate in the national elections to present their campaign expenditure statements in electronic form. Although parties have had to render accounts since 1993, the new regulation provides a broad picture of party financing for the first time. In May 2003, President Lula established the “Council for Public Transparency and the Fight against Corruption” within the Police Inspector General’s office. Its structure and functions were regulated in December 2003. As it is an advisory body with no executive or enforcement power, it cannot impose reform programs on other ministries.

The Fiscal Responsibility Act, passed in May 2000 by the Cardoso government, subjects all levels of public administration to scrutiny based on how they fulfill the criteria of transparency and discipline. The act makes them responsible for their fiscal performance. Certainly, the law puts a check on corrupt behavior. The federal government and the state governments have not been involved directly in the corruption scandals of the last years. Nonetheless, criminal prosecution of corruption is still ineffective, largely because the justice system is in need of radical reform. There is a lack of external control, and changes in the penal code and procedural law would also be necessary to give investigators a means to effectively stem “impunity.”

### **3.4. Consensus-building**

All major political actors agree on the need to strengthen democracy, though they disagree on which paths best lead to this goal. Sections of the ruling Workers' Party (PT) and its civil society allies advocate a more direct model of democracy. There are also conflicting positions on the relevance of the market economy. While government officials follow the market oriented course of the Cardoso government, a considerable section of the PT is critical of the Lula government for pursuing the very same policies, to oppose and fight which the party was in fact at one point launched. While the government itself claims to have moved away from the “neo-liberalism of the Cardoso years,” its internal adversaries complain about a “continuity of the neo-liberal adjustment.” In this process, the PT leadership has not always acted prudently toward its critics. Some noted party activists have been expelled because as Congress members they did not vote for the government’s social security reform. Others have left the party. As long as macroeconomic success continues, it is not likely that the government’s internal adversaries will play a major role. However, the consensus on building a market-based economy is still a fragile one. There are no clearly anti-democratic veto powers in Brazil. Indeed there are powerful landlords in some rural areas who

effectively own the local judiciary and police and respond violently to attempts at agrarian reform. The government has been able to prevent an escalation of conflicts within Brazilian society, which is characterized by extreme social disparities and regional differences. Its success in bridging growing social inequities has, however, been rudimentary. The government has endeavored to promote solidarity, but with little success.

The participation of civil society, including the role of various councils and committees at regional, state and municipal levels, can be important for the creation of social capital and more effective public policies. The Lula Government conducted consultations throughout the country, involving more than two thousand civil society organizations representing labor, women's groups, environmentalists, consumer fora, indigenous peoples, Afro-Brazilians, the landless movement, religious communities and the physically challenged. It also created and convened popular national councils and fora, embracing different aspects of its policies. President Lula opted to directly dialogue and negotiate with the MST, with the National Conference of Bishops, and with the Brazilian Association of NGOs. However, such democratic inclusion in public policy does not produce sudden reversals of economic stagnation, unemployment, hunger, poverty, land concentration and social injustice. On the contrary, it can also lead to growing frustration toward the political system if no results of the inclusionary policies become visible along the way.

Brazil's military regime, which governed from 1964 to 1985, left behind fewer victims than did the dictatorships in neighboring countries. Some 300 people were murdered, compared with 3,000 in Chile and at least 10,000 in Argentina, much smaller countries. But also in Brazil, thousands were tortured, jailed or exiled. Survivors make up President Lula's government. The president himself was imprisoned during the military regime for leading strikes. Brazil eased away from military rule without a final settling of accounts. Before returning to the barracks, the military declared a reciprocal amnesty, absolving both the regime and its opponents of their crimes. The armed forces never apologized, nor did the government investigate their crimes and imprison generals. The armed forces have gradually accepted democratic rules, but a process of national reconciliation has not taken place. Brazil's previous president, Fernando Henrique Cardoso, decreed a doubling of the secrecy period for classified documents. However, increasingly, victims are pressing for the access to secret archives. The Lula government has so far reacted with ambivalence to such demands. Yet it seems to be aware that there can be no final reconciliation without truth.

### **3.5. International cooperation**

The political forces have applied international assistance directly to the requirements of their transformation and have demonstrated their adaptability. In

many areas, the Lula government's reform policies are consistent with the programs of such international organizations as the IMF, the World Bank, UNDP and the Inter-American Development Bank, often implemented in close cooperation with these organizations. Conversely, organizations like the World Bank appreciate the close collaboration with the Lula administration and concede that it is guided by a vision for a more equitable, sustainable, and competitive Brazil.

The government is considered credible and reliable by the international community. While Brazil's risk coefficient for the international financial markets skyrocketed to 2400 points before President Lula took office, it came down to 400 basis points at the end of 2004, the lowest rate since 1997 (but still higher than the average for emerging market economies). International organizations as well as consulting agencies praise the government's budget discipline and its reform policies on the way to a market-based economy.

The Lula government is making active and successful efforts to establish and deepen as many cooperative international relationships as possible. Relations with neighboring states are constructive. During president Lula's first two years in office, Brazil has been able to strengthen its role as a regional power in South America through a more active foreign policy. Under U.N. command and supervision, the government committed military forces to Haiti to assist the efforts to stem violence. Brazil resumed a leading role in the Friends of Venezuela initiative, created to search for a peaceful solution of the country's internal conflicts. Along with the new Argentine president Kirchner, Lula tried to reactivate the Mercosur integration process. He also managed to impede a hasty creation of the Free Trade Area of the Americas (FTAA) and was a leading actor in the negotiations between the European Union and the Mercosur to establish an Interregional Association Agreement. Some observers affirm that the deadlock in the negotiations for the creation of the FTAA and in the negotiations between Mercosur and European Union resulted from a lack of pragmatism on the part of Brazil, while others admit that the country very effectively defends its national interests. The Lula administration played a leading role in creating the South American Community of Nations in December 2004. Along with countries like India and South Africa, Brazil managed to establish itself as a key player of international trade negotiations during the WTO meeting held at Cancún in September 2003.

#### **4. Trends in development**

##### **4.1. Democratic development**

Brazil meets the minimum requirements for a democracy under the rule of law. Standards of stateness and the rule of law have been constant over the review

period. The quality of political participation has improved slightly, due to the Lula government's efforts to open decision-making processes at all levels of the political system and increasing civil society participation.

The level of consolidation of democracy has not changed significantly. Regression from the level of consolidation already achieved was successfully avoided. A larger step toward consolidation would require reforms in the electoral and party systems in particular. In this respect, there were no successes to be noted. The level of satisfaction with democracy, democratic convictions and interpersonal trust within Brazilian society still reflect very low values, though one cannot infer from these a threat to democratic stability.

#### **4.2. Market economy development**

The country's level of development has not changed significantly in the past five years (2000-2004). The HDI value remained almost unchanged from 2000 (0.771) to 2002 (0.775). The same goes for the Gini-Index, which from 60.7 in 1998, modified to 59.1 in 2002, meaning that Brazil continues to be one of the countries with less distributionary justice worldwide. In spite of president Lula's strong commitment to fight poverty and inequality, the overall poverty level has not changed significantly during the period of review.

The institutional framework for market-based action has slightly improved during the last years. Both the Cardoso and the Lula government have been committed to modernize the country's economic system. Brazil is less vulnerable today to external shocks than a few years ago. Notwithstanding several accomplishments, there are some challenges that need to be addressed.

Overall economic development has slightly improved both quantitatively and qualitatively during the last years. Some macroeconomic data (growth, exports, imports, budget, debt) have enhanced, while others (inflation, investment, credits) have remained more or less unchanged. Unemployment declined a little bit in 2004, but compared to 2001 it remains high. The size of the informal sector has not been significantly reduced. The Lula government has undertaken several initiatives for a better social embedding of the Brazilian market economy. It remains to be seen whether these initiatives will result in fundamental improvements in the next review period.

**Table: Development of macroeconomic fundamentals (2000-2004)**

	2000	2001	2002	2003	2004
Growth of GDP in %	4.4	1.3	1.9	0.2	5.2
Export growth in %	14.4	9.0	9.1	21.1	32.0
Import growth in %	9.0	2.3	-13.4	2.2	30.0
Inflation in % (CPI)	4.4	7.1	9.9	8.2	7.5
Investment in % of GDP	18.2	17.4	17.1	17.8	19.6
Tax Revenue in % of GDP	33.3	35.5	35.5	34.9	n.s.
Unemployment in %	7.1	6.2	11.7	12.3	11.5
Budget deficit in % of GDP	4.5	3.6	4.7	5.2	2.7
Current account balance in billion \$	-24.2	-23.2	-7.7	4.0	6.5

Source: Banco Central do Brasil

#### D. Strategic perspective

When taking over the presidential office in January 2003, President Lula said that if at the end of his tenure “each Brazilian can eat three times a day, I will have fulfilled the mission of my life.” Many observers expected a PT government to spend heavily on social issues and initiate a new cycle of growth through increased public investment. To the surprise of many, and to the disappointment of many of Lula’s supporters, the government remained committed to fiscal prudence and honoring Brazil’s debts. Giving priority to economic stability, however, has meant that the government did not keep its campaign promise of eradicating poverty in Brazil. Lula himself has admitted on several occasions that his social programs were not as successful as expected.

Nevertheless, after two years in office, the public approval of President Lula’s performance in government remains high. His personal approval rating was 65% at the end of 2004, while that of his government was at around 45%. The 2004 municipal elections were an important test ahead of the next general elections to be held in October 2006. They brought mixed results for the governing PT. The PT won in 441 towns, nine of them state capitals, and was able to enhance the party’s national position. But the party lost ground in traditional PT strongholds, like Porto Alegre, Belém and São Paulo.

Conflicting views inside the Lula government and the PT on some key issues, as well as the fragmentation of its political alliance in Congress, have made 2004 less productive in terms of structural reforms. The lower chamber of Congress has been at a standstill lasting several months, thus delaying the passage of crucial legislation. The problem was caused less by the opposition than the government’s allies and its own party. Lula’s problems with Congress were manifested in the February 14, 2005 election for the presidency of the Chamber of Deputies. The ruling coalition refused to rally behind the government’s preferred candidate and

instead elected a populist candidate from the small Partido Progressista. To make matters worse, the PT is no longer represented in the chamber's directive body. The government's diminishing power in negotiating with Congress was also demonstrated by the fact that at the end of March 2005, the government was forced to withdraw a controversial tax decree from the Chamber of Deputies in order to avoid an opposition victory.

The schism in the PT is one of the largest problems currently facing Lula. He must bring all factions of the party back into line or risk undermining his government's sustainability. The president must force through at least a part of his legislative agenda for 2005, which includes reforms to trade unions and education; otherwise his re-election in 2006 would be seriously endangered.

The realization of far-reaching reforms could be facilitated if some rules of the Brazilian political game were changed. Such reforms could also increase the general efficiency of Brazilian governments and political institutions. Above all, the country would need a reform of the electoral and party legislation in order to diminish the effective number of parties in parliament, to put a stop to permanent party switching and to strengthen the remaining parties. In this way, the political process would become more steady, calculable and professional. However, such reforms are highly improbable before the next general elections in 2006. As political parties have already begun to position themselves in preparation for the upcoming presidential campaign of 2006, President Lula and his government may face increasing difficulties in realizing major reforms during the second half of their term of office.