Democracy and Macroeconomic Policymaking in Brazil: the fiscal agenda of Lula administration

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Abstract

The political choices that have led recent democracies to become embedded in the global economy have also led the governments of those countries to face paradoxical demands. On the one hand, the international integration model adopted in Brazil during the 1990s requires building the financial markets' confidence in governmental solvency and, therefore, fiscal constraints. On the other, democratization and the population's greater freedom to express demands for more and better public services and redistributive policies push incumbents in the opposite direction. The aim of this paper is the discussion of the impacts of this double process in fiscal agenda of the Lula administration. Differently from the conventional literature which stresses the political constraints over economic rationality, we argue that democracy makes macroeconomic policy in general (and fiscal policy in particular) not only more representative but also more effective. In other words, democracy is an enabling constraint. Comparative analysis to Cardoso government is done. If the first Lula administration represented the continuity of Cardoso neo-liberal macroeconomic policies, the second term presents some changes in the fiscal agenda. This allows us to ask whether there is a new governmental agenda, transforming the fiscal policy into an instrument to provide economic growth and income redistribution. Finally, the work also searches to overcome the conjuncture and apprehend the patterns of the macroeconomic policymaking in Brazil, which has been historically centered in technocratic executive branch of the government. This helps to explain the continuity of fiscal policy even in a government that considers itself popularly oriented.

Resumo

As escolhas políticas que levaram as novas democracias a se inserirem na economia globalizada têm trazido exigências paradoxais para seus governos. O modelo de integração internacional impõe a geração de confiança e credibilidade para os mercados financeiros com relação à solvência governamental, e, portanto, restrições fiscais. De outro lado, a democratização e a maior expressão das demandas populares por serviços públicos e políticas redistributivas empurram os governantes em outra direção. O objetivo deste texto é discutir os impactos na agenda fiscal deste processo duplo de transformações no caso brasileiro sob o governo Lula. Ao contrário da literatura econômica convencional que afirma que a lógica democrática traz constrangimentos à "racionalidade econômica", argumentamos que a democracia permite tornar as políticas públicas mais representativas e próximas às demandas sociais e mais eficazes. Uma comparação com o governo de Fernando Henrique Cardoso é feita. Se a política fiscal do primeiro governo Lula foi marcada pela continuidade com relação no governo de Fernando Henrique Cardoso de orientação neoliberal, o segundo mandato apresentou algumas mudanças. Pode-se indagar se está em constituição uma nova agenda fiscal no país, onde esta está deixando de ser apenas um instrumento de garantia de solvência para os credores e a adquirir um novo papel, de instrumento de crescimento econômico e de redistribuição de renda. Procurou-se ultrapassar as dimensões conjunturais da análise para apreender processos relacionados ao próprio modo de gestão das políticas macroeconômicas no país, historicamente centradas nas tecnocracias insuladas no poder executivo. Isso ajuda a explicar a continuidade da política fiscal mesmo num governo que se considera de orientação popular.

Palavras-chave: democracy, macroeconomic policymaking in Brazil, Lula administration

Introduction

The political choices that have led recent democracies to become embedded in the global economy have also led the governments of those countries to face paradoxical demands. On the one hand, the international integration model requires building the financial markets' confidence in governmental solvency and, therefore, fiscal constraints. On the other, democratization and the population's greater freedom to express demands for more and better public services push incumbents in the opposite direction.

The purpose of this article is to discuss the impacts on fiscal agenda of this dual process of transformations facing governments, bearing in mind the fact that Brazil is the world's fourth largest democracy and ninth largest economy. Choice of the fiscal subject deserves specific justification. The topic has usually been a privileged subject of study by orthodox economists and conservative politicians. Since the crises of the 1970s and '80s, analysts attacked Keynesian-oriented policies and the costs of the Welfare State with the argument that public deficit has historically been the outcome of irresponsible government spending, expressing a lack of moral commitment to coming generations[1].

Challenging those ideological assumptions, this analysis breaks from the conservative view and takes account of countless empirical studies that showed the failure of orthodox policies intended to achieve zero public deficits. Whether in the United States or in European countries, great difficulties were encountered for reducing public deficits under the economic recession and unemployment scenario that marked the 1980s. Studies show that most countries were only able to balance their fiscal accounts when new economic expansion cycles occurred. Probably this framework of economic and political hardship that led the mentors of the European Economic Community, in the Maastricht Treaty, to establish a nominal-deficit ceiling of 3 percent of GDP (SCHICH, 1993; BRADY & VOLDEN, 1998; BRIFFAULT, 1996; BENAVIE, 1998; EVANS, 1997).

This study also stands apart from conventional analyses in that it attempts to emphasize the fiscal issue from the political viewpoint; in particular, based on the possibilities that democracy has to offer. The literature in Economics and Public

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[1] Authors such as 1986 Nobel-Prize winner James Buchanan already stated that the main problem Western democracies faced in the late 20th Century was governmental tendency to generate deficits to meet the demands of voters and special interests (Buchanan, Rowley and Tollison, 1987).

Finance often assumes that the democratic rationale creates obstacles or constraints against “economic rationality” and fiscal adjustment initiatives. To the contrary, we argue that democracy not only allows improving the quality of social policies (making them more representative of and closer to social demands), but also makes their implementation more effective.

To support the argument, this paper reviews Brazil’s fiscal history in recent decades to recall that it was under the democratic regime that the public accounts, left in complete disarray by the military dictatorship, were finally restored to order. It was also in the context of administrations elected by popular vote that in 2000 the Fiscal Responsibility Law was passed (a law that, by the way, has been regularly respected by most of the sub-national governments), and that large primary surpluses have been accumulated by municipalities, states and the Union over almost ten years. The alteration of incumbent parties generated by regular elections, as well as the more decentralized political system that federalism and multipartism enable, have posed no obstacle to the development of a process of incremental transformation in the fiscal area, specially to assure the government’s solvency before its creditors. Regardless of a judgment of merit of the contents of those policies, we point out that democratic processes have not hampered significant changes in this area in Brazil. In other words, shared power has not constrained governability. To the contrary, the ability of different political forces to manifest themselves has fostered more effective and coherent public-policy outcomes. As some theoretical approaches offer, public policies made by means of negotiations with relevant political actors and implemented incrementally enjoy greater odds of success than those made arbitrarily in restricted arenas isolated from the remainder of the political system and from society’s demands.

If the incremental processes require the governmental bureaucracy to display technical skill and managerial articulation (to bring about the administration’s agenda), they also require certain fundamental political conditions: the presence of institutional arrangements to force the Executive branch to take account of and negotiate policies and programs constantly with other political actors in the Legislative and in sub-national governments, and with organized society.

Contrary to views that regard power fragmentation as a constraint against governability and propose more centralized policymaking, the recent literature has been developing arguments in the opposite direction. In an important study of contemporary democracies, Lipjhart (1999) noted that a more fragmentary political system is not only more legitimate and representative in heterogeneous societies, but also equally effective in terms of macroeconomic management. Other authors, such as Stark & Brustz (1998) examine the institutional basis of the coherence of economic policies adopted in post-Socialist Eastern Europe to indicate that the ability to formulate and implement consistent and effective reform programs is augmented (rather than reduced) where the Executive branch is less concentrated, that is, more constrained to be accountable for its decisions before the various political forces in Parliament and in organized society. Being forced to discuss and negotiate their proposals with other actors, policymakers improve their understanding of the issues and expand their ability to obtain information, correcting miscalculations that, absent such a process, would only become evident at the time of implementation and would therefore be less amenable to adjustment. This also encourages policy-makers to think several steps ahead in the strategic games of reform policy, in addition to committing a greater number of political actors to and holding them accountable for the outcomes of the programs adopted.

In the same line of thought, it is worth noting that several attempts at monetary stabilization failed in Brazil and its neighboring countries in the 1980s and '90s, not just because of technical misconception, but because they were implemented in an authoritarian, technocratic manner (LOUREIRO, 1997; FIGUEIREDO E LIMONGI, 1999). On the other hand, the monetary stabilization (Real Plan) met with success because, compared to others, it was able to negotiate with the Legislative and organized society not only its implementation, but also the preparatory steps it required (SOLA & KUGELMAS, 2004). In sum, the argument we develop here is that democracy can operate as an opportunity for, rather than an obstacle to, government that is more appropriate accounts management, in other words, as *enabling*, not *disenabling constraints*.

Historically, we draw attention to the fact that the fiscal issue has been a part of the Brazilian public agenda for over two decades. In the 1980s-'90s, it encompassed institutional reforms intended to reorder public accounts and that were generally successful, such as the unification of budgets, the creation of the National Treasury Secretariat, the monetary stabilization, the restructuring of the public and private banking system. Since 1999, it focused on the policy of primary-surpluses generation that has served as an assurance of solvency for the financial market.

If the macroeconomic policy of the first Lula administration, under Finance Minister Palocci, was marked by continuity relative to what prevailed during the

Cardoso administration, the second Lula mandate showed some changes, such as the launch of programs targeted at acceleration of economic growth (PAC) and credit expansion, income-distribution policies, and even certain steps to make public indebtedness rules more flexible. In the presence of these policies one might well ask whether a new fiscal agenda is being built. Put another way, is fiscal policy ceasing to be just an instrument to assure solvency before creditors (financial credibility) and gaining the additional roles of generating resources to provide public services and acting as an instrument for economic growth policy?

Our analysis was driven by two alternative answers to this question, or hypotheses. The first assumes that the Brazilian fiscal agenda has been reoriented and that this reorientation is the result of changes in the international environment, leading to an overhaul of the orthodox liberal agenda. The second answer goes in the opposite direction, assuming that the Lula's fiscal policy has not changed fundamentally because it is upheld by a political coalition sustained by the interests of financial capital and rentiers, and that this coalition retains great economic and political power in Brazil.

The first hypotheses is based on the fact that the perverse effects of the application of the neo-liberal prescription (in the shape of crises that hit emerging economies in the late 1990s and have now extended to developed economies) have generated severe and growing criticism against the previously recommended policies, including not only dissidents like Stiglitz (2000), but even IMF officials, economists and journalists more closely aligned with the orthodox credo.[2] In Brazil, indications of an economic agenda change have appeared in the media, in business, in Academia, and in governmental discourse, since late 2007 (thus, before the explosion of the 2008 financial crisis). This evidence has emerged in the incorporation of the economic growth rhetoric (expanded investment, credit and domestic demand) along with social programs to reduce inequality, while maintaining the previous economic guidelines (commercial and financial openness, inflation targeting, a floating rate of exchange, and primary surpluses).

On the other hand, the hypothesis of continuing fiscal agenda by force of the financial coalition is based on political and economic reasons. Politically, this coalition has found support in the macroeconomic bureaucracy – the Central Bank, the Ministry of Finance, the National Treasury Secretariat, the Ministry of Planning –, in the

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[2] For a more in-depth analysis of changes in international agencies guidance, see Kugelmas (2006).

media's opinion-makers, and in important hubs of the epistemic community (made up of American universities, international agencies, consultancies, etc). On the economic front, the coalition is supported by the State's structural dependence on the financial industry and rentiers (to include pension funds for politically important segments of labor, including banking- and oil-industry workers) to continue rolling over the domestic public debt. It is a well-known fact that about one third of the Federal debt is made up of short-term bonds based on high interest rates and held prevalently by financial institutions.

Without disregarding the fact that the State can have autonomy (cf. Scokpol, 1985), even though in a relative way (cf. Poulantzas, 1977), there is a tension between the objectives of promoting democratic legitimacy and capital accumulation by the policymaking. As Przeworski (1990) argued, when capital is free to move from one country to another, as in current circumstances, the theory of structural dependence of the state on capital can be applied. As the freedom of capital movement is neither a natural nor an inevitable situation, we can affirm that the dependence of the Brazilian State on the foreign financial capital is the outcome of choices made by policymakers in the past - choices endorsed by the Lula administration. These political choices entail the paradoxical demands involving financial accumulation and political legitimacy, shaping a situation in which policies addressed to fight social inequality must be subordinated to the requirements of governmental solvency. Therefore, redistributive social policies can go forward just as far as they do not contradict the credibility required by financial markets.

These are the driving hypotheses behind the upcoming analysis. In the next section, we provide a brief description of the path of the fiscal agenda in Brazil in the past three decades, noting its main points of inflection brought about by foreign crises and domestic political arrangements. We then compare the economic agendas of the Workers' Party (PT) before their Federal Government experience and after, emphasizing the Palocci period (Minister of Finance) which maintained the liberal prescription and even attempted to go deeper into it, with the proposed zero nominal deficit. In part three we examine the economic agenda of the second Lula administration, discussing whether the flexibilization found therein reflects a new fiscal agenda or not. Our closing discussion attempts to organize the arguments that lead us to a negative answer to the proposed question, that is, to a confirmation of the second hypothesis. We also attempt to go beyond the conjuncture to apprehend broader economic and political processes associated with an historical pattern of macroeconomic policymaking in Brazil.

I - The path of the Brazilian fiscal agenda

I.1 From the military regime's mismanagement to the reestablishment of public accounts order

During the military dictatorship, the power of the National Congress to legislate on public financing was transferred to a governmental bureaucracy body, the National Monetary Council (CMN). This had full power to manage the national debt without subjecting its operations to the General Budget of the Union (OGU). Because the OGU had fallen into discredit given its inability to impose limits and constraints to fiscal policy, parallel budgets emerged that were subject only to the Executive power, as exemplified by the monetary budget. In fact, all through the 1970s, a large number of different budgets guided the Brazilian public sector's finances. In addition to the OGU, there were the so-called "monetary" budget, the debt account and the State-owned company budget.[3]

The monetary budget operated as a tool to control the monetary and non-monetary liabilities used for foreign exchange policy, to authorize subsidies and credit lines for different industries, and other programs. Note that each budget was approved by a different public authority and at different times, leading to full disarticulation across the government's economic policies. The monetary budget was a sort of drain on the Treasury's funds, through actions such as farming and exports credit, or the Policy of Guaranteed Minimum Prices (OCDE-BRASIL, 2001).

In addition, in the 1970s the government embraced a strategy of using monetary authorities as economic development banks. It was a way to enable the "growth through debt" policy. Large volumes of funds were raised without increasing the tax burden, that is, without destabilizing the incumbent military regime. The result was inevitably monetary expansion or increased debt (OECD-BRASIL, 2001).

In fact, from the monetary perspective, there was not only the Central Bank, but also *Banco do Brasil* (BB), who struggled for and gained power from the former. When

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[3] Until the late 1970s, the revenues and expenses of State-owned companies had not been consolidated in a single budget. Only with the creation of the State-owned Companies Secretariat (SEST) in 1979 did the government acquire more accurate knowledge of the total number of State entities and began drawing a general State Companies Budget for the next year.

Central Bank was established, in 1964, BB, which until then played the role of monetary authority, wielded enormous strength within the country's power structure. This power enabled it to withhold a significant share of the economic policy attributions, generating an unusual situation where two competing monetary authorities existed, and, consequently, effective control over monetary policy was absent.[4]

As if that were not enough, there was also the debt account, which, since the early 1970s, operated autonomously and assured interest and principal payments (debt service) through the issuance of new bonds. The process became known as the "domestic debt roll-over". Debt grew because of several factors, including its own service and the financing of non-budget spending, and it was never known how much was due to each factor (OCDE- BRASIL, 2001).

This was the fiscal status until the major crisis that hit capitalist economies in the 1970s and '80s, triggered by several factors, including the oil-prices shock. It had repercussions for peripheral countries, such as Brazil, in the shape of a severe foreign-debt crisis. Notoriously, the crisis exhausted the model of economic development based on growing foreign debt (BRESSER-PEREIRA, MARAVALL & PRZEWORSKI, 1993). The public finance situation in Brazil worsened, leading to another serious fiscal problem: the Union guaranteeing any loans taken by States, municipalities and State-owned companies, which BB honored through the Monetary Budget. Injections of funds into State banks also started to come from the BB movement account. Although pressure from international agencies led to attempts at reorganizing public finances under the military regime, these attempts were unsuccessful[5] (OECD-BRASIL, 2001).

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[4] Dec. 12, 1964 marked the sanctioning of Act NO. 4.595. It created the CMN to formulate economic policy and the Central Bank to execute and oversee these policies. However, BB remained as depositary of the elective reserves of commercial banks and a provider of check-clearing services. BB became also the operator of the so-called "movement account", established to process a leveling of reserves with Central Bank. It was a BB liability before BACEN, conceived to fill Central Bank's initially lacking administrative and technical infrastructure. Despite having been created as an interim tool intended to operate only during the institutional transition period, the movement account was perpetuated because it facilitated the extension of non-budget loans and financings. In other words, the movement account allowed BB to make unlimited withdrawals from the Treasury, preventing any manner of fiscal control. In addition, in the absence of a Treasury Secretariat, the government could not effectively know the state of its accounts.

[5] Because of rising international interest rates in the early 1980s, the process of funding the Brazilian economy with foreign funds became unsustainable: interest expense reached US$ 13 billion in 1982, equivalent to 82 percent of exports, while the current account deficit reached over 5 percent of GDP. Mexico's moratorium that same year caused a severe shock for the Brazilian economy when international reserves dropped, foreign capital inflows dried up and direct investment declined. Then, it began a long process of foreign debt renegotiation that was only completed in 1994. In 1983, the Brazilian government established, jointly with the IMF, a stabilization program that successfully evened out the balance of payments, but failed to bring inflation under control (OECD - BRASIL, 2001).

This chaotic framework – where any effective control over monetary policy and public indebtedness was impossible – was the legacy the dictatorship and its technocratic management of the economy left behind. Though macro-structural economic factors and the international situation did have an impact on the creation of the framework, we cannot but emphasize that the disorganization of Brazil's public accounts was greatly magnified by the government's authoritarianism, as there was no democratic control over the technocracy decisions.

Steps to reorder the governmental finances, such as the unification of budgets, the creation of public accounts control bodies like the National Treasury Secretariat (STN) and stricter rules for public debt only came to be after democratization, in the second half of the 1980s and during the 1990s (GOUVEA, 1994). The consolidation of these steps, as well as centralization of the monetary authority with the Central Bank, only occurred after the implementation of the Real Plan, from 1994 onwards, and with the adoption of economic reforms, whose goal was not only monetary stabilization, but also a greater insertion of the country into the international economy. In fact, to understand the path of Brazil's fiscal agenda, it must be framed within the path of the neo-liberal agenda itself.

I.2 The importation of the neo-liberal agenda under Collor and the reforms of Cardoso administration

The trade openness began with the Collor administration in 1990, which triggers a process of gradual departure from the imports substitution model that had prevailed in Brazil during the national-developmentalist period (started with Vargas in the 1950s and consolidated during the military governments). Economists and politicians, committed to the essential principles of neo-liberalism, especially during the Cardoso administration, gradually dismantled that model.

Along with the trade and financial openness that broke away from State protectionism, the suspension of State monopolies of oil, energy, telecommunications etc., the privatization of numerous public companies and banks, the disassembly of the State's planning apparatus and the monetary stabilization process under the implementation of Real Plan, we must point out other equally significant dimensions, such as: the computerization of public accounts and their resulting orderliness and transparency, the renegotiation of the sub-national governments' debts under Act No. 9.496/1997, the implementation of restructuring programs for public and private banks

(PROER and PROES), and the creation of relatively sounder banking protection and oversight systems (SOLA & KUGELMAS, 2002; LOUREIRO & ABRUCIO, 2004; MOISÉS, 2005).

This reformist experience brought about a new political culture for the country, under which monetary stabilization became a public good. Notoriously, coexistence with the high inflation rates that characterized a significant portion of Brazilian history in the second half of the 20th Century created perverse impacts for public finance and society (SOLA & KUGELMAS, 2002), with losses for lower-income individuals devoid of bank accounts and without wage adjustment in line with inflation. For governments, chronic hyperinflation meant that the budget was a "work of fiction", as was often mentioned then; it led to an inability to plan revenues and spending and to a complete absence of any kind of control or transparency as concerns public accounts.

In addition, but no less importantly, it is essential to emphasize that the failure of several previous inflation-control programs attempted in the period, which always led to increased inflation and a deeper mistrust in the government's abilities, ended up having an (unexpected) positive impact on the country's fragile democratic culture: they raised the perception that a new monetary stabilization experiment could only succeed (as it did in fact with the Real Plan, in 1994), if negotiated in advance with political actors in Congress and with sub-national governments, and if it overcame the technical and political mistakes of the previous bureaucratic pattern, based as it was on shock measures conceived in restricted arenas that were insulated from the relevant political forces (LOUREIRO & ABRUCIO, 2004).

However, if the Cardoso macroeconomic policy successfully stabilized prices[6], the fiscal situation was not sustained because of the constant accumulation of public and foreign debt. Although the Real Plan put fiscal adjustment as its focus, blaming unbalanced public accounts as the fundamental cause of high inflation, there was no fiscal adjustment prior to or simultaneously with stabilization. The true anchor of the monetary stabilization was a foreign supply shock through the policy of over-appreciating the Real against the US Dollar and continued trade and financial openness, which began with the Collor administration and deepened with the Mercosur agreements of 1994. The result was an incentive for imports and a disincentive for

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[6] The monthly rate of inflation felt from an average of 43%, during the six months between January and June, to an average of 2.9% in the six months after the currency change, occurred in July of 1994. And declined continuously during four years, to a monthly average of 0.14% in 1998, ending a long period of high inflation rates started in the 1970s.

exports, reversing the previously existing trade surplus. The consequent increase in the services balance deficit quickly led to a situation where the current transactions deficit skyrocketed from 1.8 billion US Dollars in 1994 to 33 billion 1998, or over 4 percent of GDP.

The public debt, in turn, rose from 30 percent of GDP in 1994 for around 50 percent in early 1999, soon after the currency devaluation. This debt accrued despite the public sector has consolidated primary surplus having been highly positive in 1994 and approximately in balance between 1995 and 1998, while the proceeds from the privatization of Federal and State public companies allowed reducing total debt by 4.8 percent of GDP in the same period.

In fact, interest rate hikes were the instruments used to adjust the balance of payments when it deteriorated because of the above-named reasons. Within a framework of successive financial crises – Mexico in early 1994, Southeast Asia in 1997 and Russia and Brazil itself in 1998 –, the domestic interest rate was used to attract the short-term capitals needed to level the balance of payments and sustain the over-appreciated exchange rate. This element was crucial to assure prices stability, the main trump of the Cardoso administration in light of his possible reelection in 1998. The privatizations were another important factor for the attraction of foreign capitals, helping even out the balance of payments, since most of the winning bids came from foreign companies (PINHEIRO, 1999; IBRE, 1999).[7]

Therefore, the growth of the net public debt-to-GDP ratio to around 50 percent at the time of the agreement with the IMF and the adoption of a new fiscal policy, in 1999, based on the generation of growing primary surpluses, may be largely credited to the fiscal cost of the economic policies combination adopted at the Real Plan implementation period. The exchange rate anchor policy subordinated the monetary policy, which, in turn, generated high costs that fiscal policy would have to bear in the next period.

In other words, the pace of public (as a perverse effect of the policy of interest rate hikes to face financial instability) and foreign debt (because of intensified trade openness, overvalued exchange rate and consequent current account deficits)

[7] IBRE (1999) pointed out the role of privatizations: "between 1995 and 1998, these [foreign, privatization-related] flows added up to US$ 42 billion, or 38 percent of the current account deficit in the same period."

accumulation characterized this as being a period of unbalanced stabilization (OLIVEIRA & TUROLLA, 2005).

Faced with this vulnerability, which was dramatically revealed with the foreign crisis of 1998, leading to the devaluation of the Real in January 1999 and laying bare the limitations of the preceding economic policy, the second Cardoso term had to come up with significant changes to dampen the impact of openness and foreign shocks. They are based on the three pillars: 1) adoption of an inflation targeting regime; b) a floating exchange rate; c) a fiscal adjustment intended to produce primary surpluses and thereby assuring creditor trust in the government's solvency before the increased interest expense brought about by financial instability (OLIVEIRA & TUROLLA, 2005).

II - Continuity and flexibilization of Lula economic agenda

This section deals with the PT economic thinking immediately before the 2002 victory in the polls. We attempt to reconstitute the positions expressed or implied by the party and its candidate and officials in the period leading to the elections, in an attempt to show how far the fiscal policy adopted since 2003 means a break from or a continuation of the policies Cardoso embraced.

II.1 PT proposals before the 2002 presidential race

The main program-related documents that the PT released before the 2002 campaign were relatively vague on the fiscal policy regime to be adopted in the event of a victory. Even so, they let through that the criticism leveled against the Cardoso fiscal policy shift from a complete rejection of the "fiscal crimp" to a growing concern with the "viability" of measures to be implemented under a possible Lula administration. In particular, concerns are raised over the balance of political and social forces at the domestic and international levels, over the "constraints created by globalization" and over the need for a "transition" to preserve the future administration's credibility to implement responsible, non-adventurous policies.

The preparation of Lula's economic program for the 2002 vote began explicitly with the release, in June 2001, of a document titled *Another Brazil is Possible*, signed by 14 members of the party, most of whom were economists.[8] Although it was never approved as an official PT document, the outline of the document was reused in the text

[8] Available at the "O Estado de São Paulo" website. Monday, June 18th, 2001.

Concept and Guidelines of the PT Program of Government for Brazil, approved in December 2001 at a National Meeting of the PT. Despite harsh criticism of the Cardoso administration, the document also makes a point of criticizing the "left": "we will have to break away from the Utopian and naive initiatives that have so often enthused and frustrated the historic proposals of the Brazilian left". The crux of the criticism against the economic policy is the increased foreign vulnerability of the Brazilian economy, in particular the loss of macroeconomic policymaking autonomy.

On the fiscal dimension, the high short-term public indebtedness and the interest expense were regarded as fundamental constraints against a reorientation of the fiscal policy toward "*redistribution and the promotion of growth*". Emphasizing the prospect of development model change, the text defends a "transition" to a different model over an undetermined period. It makes generic mention of a need to increase public spending on housing, sanitation and infrastructure, and of the need for State-owned companies to invest, particularly in the energy industry, in addition to proposing a tax on the extraordinary gains of privatized companies to fund infrastructure investments. The document also criticizes "*rentiers and speculation*" and suggests guidelines for a "*comprehensive tax reform*". Despite denying the possibility of simply resuming the national-developmentalist project, it proposes taking up some of its elements, associating the State's role in the economy (now as an inducer and coordinator) with the pursuit of full employment and the universalization of social policies. It further emphasizes the role of Federal public banks in a new financing pattern, targeted credit, and the use of mandatory savings funds.

The economic policy proposals Lula offered during the 2002 campaign can be found in three main documents: the Government Program Guidelines approved in the 2001 PT national Meeting, which, as mentioned, derives from *Another Brazil is Possible*; the Letter to the Brazilian People, released in June 2002; and the candidate's Program of Government, introduced in July of that same year.

These three documents have been subject to in-depth analysis, though the resulting studies lead to different, and sometimes opposing, conclusions. Paulani (2004), Carvalho (2004), Maldonado Filho (2003) and Borges Neto (2003), argue that the Lula administration has broken from or even betrayed the proposals made during the campaign, while Machado (2007) argues for a gradual evolution of those proposals and, therefore, a relationship of continuity between the campaign proposals and the policy effectively implemented.

Although *Concept and Guidelines of the PT Government Program* criticizes long-term primary surplus targets and the interest burden that makes public debt more expensive, it also retains defense of the State's solvency as an objective, and remains silent on specific primary-surplus policies. Between the approval of this document and the release of the program of government, Lula released the text known as *Letter to the Brazilian People*. As the crisis deepened because of the election process, the main novelty found in the *Letter* was an explicit commitment to a primary surplus goal capable of maintaining a stable net debt-to-GDP ratio, a formulation later incorporated in the program of government with slight formal changes

Analysis of the referenced documents, given the (perhaps intentional) non-explicit style that marks them, certainly allows understanding that there was either continuity or departure of the Lula's fiscal policy relative to what the campaign proposed. A greater departure can be seen if the analysis is extended to the whole of economic policy *vis-à-vis* partisan proposals and those of candidate Lula himself before rising to power. Nevertheless, this position shift by PT and its candidate could already be seen from the path of moderation PT and Lula followed in the 13 years that separate the elections of 1989 and 2002.

The fact that Lula's economic policy shares an agenda with the second Cardoso term appears to be a possible, or even likely, result of the PT's programmatic path. What surprises, however, is that the fiscal policy in the first Lula administration may have even been a more radical version of that under the second Cardoso administration.

II. 2. The "Palocci age" and the proposed radicalization of fiscal policy

In the beginning of the Lula administration, the Ministry of Finance released a document titled *Economic Policy and Structural Reforms,* in April 2003, which clearly introduced the chosen economic agenda of the moment. That agenda included the concept that resumed growth for the Brazilian economy required, above all, fiscal balance, the implementation of structural and microeconomic reforms (such as Social Security reform[9] and operational autonomy for the Central Bank) and focalization of social policies.

As concerns fiscal policy and according to the Ministry of Finance, it was essential to restore balance to public accounts, as a reduction of the public sector's

[9] According to a 2003 Ministry of Finance document, the worsening of the public accounts was a result of increased social security expenses.

financing needs would cause interest rates to drop, rising domestic savings rates and enabling the government to resume investment in infrastructure. Therefore, the Lula's economic policy first addressed the fiscal issue, taking steps to generate greater and continued primary surpluses (4.25% of GDP), that were considered necessary to assure a reduction of the debt-to-GDP ratio over the years, in addition to stretching the term profile of the debt. Fiscal adjustment was assigned greater weight under the assumption that it conditions the main macroeconomic variables, such as the inflation, interest and foreign exchange rates.

Note that the chosen agenda also intended to create the conditions for the fiscal policy to mitigate, rather than magnify, the economic cycles. As a complement to this, in late 2004, the Ministry of Finance releases an additional document titled *Microeconomic Reforms and Long-Term* that expresses the understanding that the macro policy should be supplemented by microeconomic reforms. Only after the implementation of these measures (macroeconomic policy and institutional reforms) could the much-vaunted "spectacle of growth" begins. To achieve this end, legislative and administrative steps were advanced with an aim to developing the credit market and improving the tax structure and the business environment, in addition to labor-law and regulatory reforms.

This set of measures allowed reducing both the pace of inflation, which had reached 12.5 percent in 2002, and interest rates, which were at 27 percent in early 2003 (that is, 16 percent in real terms net of inflation). Despite all that, a proposal developed within the government to achieve zero nominal deficits within a short period of time (about five years) as a means to reduce the pace of the debt-to-GDP ratio, which was estimated at 50 percent in May 2005. Discussions ensued about the low quality of the fiscal adjustment promoted that far as, according to the advocates of the notion, the fiscal issue in Brazil had been addressed through an increased tax burden and the compression of public investment. Adoption of a zero nominal deficit could be the shortest path to simultaneously achieve economic growth without inflationary pressures, achieve investment grade, and reduce the tax burden.

However, implementing the proposal would require steps that were considered "arduous" in the short and medium term. Many of those would have to take place in the form of constitutional amendments as a means to restrain the government (or signal credible commitment) and prevent stop-and-go fiscal policy. The zero nominal deficit program proposed the following steps: increase the primary surplus target to 5 percent of GDP; reduce mandatory Union spending (on health and education) to free up revenues from the current 20 percent to 35 percent of the budget; a real-terms freeze of public apparatus spending, especially in connection with public sector wages and hiring ("management shock"); an a new round of social security reforms to reduce the social security deficit, by uncoupling benefits from minimum wage and increasing the minimum retirement age.

The beginning of the public discussion of the proposal coincided with the political crisis of 2005, which eventually led to the replacement of the Chef-Minister of the Presidential Staff Office. In an interview with the press, the newly named minister called the plan "rudimentary", said that any such debate was "completely irregular", and stated that there was no "authorization from the government" for such a debate to occur.[10] As a result, the zero nominal deficit proposal gradually vanished from public debate as a new wind blew in the economic area, reinforced by the replacement (albeit due to contingent reasons) of the Minister of Finance[11]. In October 2006, within the context of the second-round reelection of President Lula, the then-Minister of Institutional Relations went as far as saying that the "Palocci age" was over.

II.3 Fiscal policy in the second Lula administration

The debates leading to the reelection of Lula covered the difficulty the model in place since 1999 had to promote economic growth. According to figures available at the time, GDP had grown a mere 0.5 percent in 2003, 4.9 percent in 2004 and 2.3 percent in 2005, which generated harsh criticism from the opposition. Results in 2004, although distorted by the depressed basis for comparison with the preceding year, had reinforced the credibility of Palocci's policy, but GDP figures for 2005 seemed to cast doubt on the policy's ability to produce sustainable growth.

As noted, the main priority of fiscal policy under the first Lula administration was to assure credibility before the financial markets by means of high primary surpluses to keep the debt-to-GDP ratio under control – in fact, at better levels than agreed with the IMF. In that period, public investments were the great losers, due both to the fiscal freeze and the high interest rates. In fact, the second round of voting was marked by criticism of the meager economic growth in late 2006. As a result, the

[10] See the O Estado de São Paulo newspaper (Nov/8/2005).

[11] It is well known that Palocci left the Ministry of Finance in March 2006 because of a political crisis arising from allegations that he had violated the banking secrecy of a housekeeper that had made accusations against him.

President Lula commissions the Chief of Staff and the Ministry of Finance to prepare a set of measure to “thaw” the economy and reach a target of 5 percent GDP growth in 2007 and for the duration of the second term.[12]

However, the change in economic policy did not take place abruptly, as it faced opposition even within the economic staff itself, from those that defended maintaining the previous stance and even a deeper fiscal adjustment. This is proven by the fact that in November 2006 the Macroeconomic Studies Division of IPEA (an agency then connected with the Ministry of Planning) released the document titled *an Agenda for Economic Growth and Reduced Poverty* (LEVY & VILLELA, 2006) that reaffirmed the agenda of the “Palocci age”. The text argued that only through “arduous” fiscal steps could the country achieve GDP growth near 5 percent – and that only in 2017. That is, orthodox discourse advanced that the only choice available was for the country to stay the course of sacrifice for over ten years to achieve modest growth (relative to population and workforce growth).

Still, the changes in the economic team and the new Chief of Staff, who also begins to influence economic policy, were decisive – along with the economy’s meager results – for a reorientation of the guidelines that prevailed under Palocci. In addition to the political weight of the new Chef-Minister of the Presidential Staff Office, the new Minister of Finance begins replacing the ministry’s high-level staff. A change of command also occurred at BNDES, intensifying the institution’s support to industrial policy. With this, the bank departed significantly from its direction during the Cardoso administration, when its main purpose was to subsidize privatizations.[13] At IPEA, too, a more orthodox orientation gave way to another that emphasized development with social inclusion.

In sum, the second Lula administration started to show signs of a flexibilization of the orthodox equation: the concept of extreme adjustment as a necessary precondition for growth is reversed: growth is understood as a condition for fiscal balance, and that for two reasons. First, greater growth, through increased public revenues, would allow

[12] Politically, it is certainly plausible to argue that the 2006 elections were signal for the government that most Brazilians want grow with stable prices and accompanied by public policies to improve income distribution.

[13] It is worth noting that the BNDES has deviated from the hegemonic orthodox economic policy since the first term. Controversy over the role of the BNDES and the Long-Term Interest Rate (TJLP) caused a clash between the chair of the Central Bank and the BNDES who advocated reducing the TJLP. There is now, after Palocci’s exit, a perceptible change in the volume of applications granted and the level of the TJLP. Approved projects rose from 54 billion reais in 2005 to 74 billion in 2006, while the TJLP dropped from 9 percent in March 2006 to 6.85 percent since July 2007.

maintaining the fiscal agenda of primary surpluses needed to gradually reduce the debt-to-GDP ratio and maintain credibility before the financial market. Second, growth also allows generating funds for public investments without the need to reduce current expenses (payroll, social programs such as *Bolsa Família*, and Social Security), thereby doing away with the need for a social security reform that implies reduced social benefits. Therefore, from the political perspective, added economic growth appears to be the key to meeting the demands of every one of the Lula administration's constituencies without causing economic loss to any of them and therefore without incurring in excessive political costs.

This is the context in which to frame the launch of the Growth Acceleration Program (PAC), announced in January 2007. Focused mainly on public investment in infrastructure and other priority areas and on stimulating public credit, the program also sets forth tax cuts, changes to the tax system and long-term fiscal steps.[14]

One might argue that, through PAC, the government's discourse casts fiscal policy in a new role besides the one that revolves around reducing the debt-to-GDP ratio. The program attempts to reorient the role of fiscal policy as an instrument of a growth strategy in addition to its previous purpose of merely assuring the public sector's solvency. Because hitting the fiscal target was always associated, on the one hand, with cuts in public investment and, on the other, with an increased tax burden, the fiscal policy of the "Palocci age" played a contractions role insofar as it undermined the national infrastructure and channeled public spending to debt service payments.[15] It can thus be inferred that the PAC reflects a change in the government's view (or at least in its discourse) of the role of fiscal policy.[16]

If the PAC has endured criticism from orthodox economists, for some of their unorthodox or developmentalist peers it symbolizes a change in the Lula

[14] In addition to expansion of subsidized public credit for firms through BNDES, as we will discuss ahead, expansion also occurred at *Caixa Econômica Federal* (CEF).

[15] One of the program's main points is an expansion of public investment at .5 percent of GDP annually. The PAC also allows the government to deduct from the 4.25 percent primary surplus target Pilot Investment Projects (PPI) spending up to .5 percent of GDP

[16]This understanding finds support in the following quote by the Chief of Staff (in an interview to journalist Luis Nassif, on March 5, 2008):"What we were able to do in this second Lula administration was change the dynamics of economic discourse. The previous dynamics was 'let's build stability.' That was important and the Real Plan was created to do just that. Nevertheless, stability does not automatically lead to the dynamics of investment and growth. So we had to change the dynamics: let's maintain stability and deal with growth Available at http://www.projetobr.com.br/web/blog/6

administration's economic orientation.[17] According to João Sicsú, head of the Macroeconomic Studies Division of IPEA in the second Lula administration, the PAC removes the concept of the "invisible hand of the market" and replaces it with the "visible hand of the State."

Another sign of change in fiscal policy focus can be seen in how the government addressed the topic of social security reform. In the beginning of his second term, President Lula established a forum to discuss the topic, including representatives from labor, business and the government. Nevertheless, the forum finally and consensually concluded that Retirement Funding should continue to be an integral part of the concept of social security, funded with contributions from workers and employers and with its redistributive elements financed with social security budgetary funds, as set forth in the Federal Constitution. This goes against the fiscally inclined reformist proposals. Even in the absence of consensus as to minimum retirement age and minimum contribution period to gain access to benefits, the members of the forum were able to agree on retaining the connection between social security benefits and minimum wage – an item whose modification orthodox economists consider fundamental.[18]

The hypothesis of a fiscal agenda shift could be reinforced by the good economic results of 2007, with 5.4 percent GDP growth. Per-capita GDP rose by 4 percent from 2006, a level celebrated by the Minister of Finance for being at a par with the results achieved in the 1950s, '60s and '70, but now with inflation under control and growing production capacity. Investment too, measured as gross fixed-capital formation (GFCF), rose by 13.4 percent, the largest annual rate since the series began, in 1996. In addition to increasing investment, according to the government, 2007 showed increased industrial production, employment gains (with greater formal employment), and credit expansion (especially from BNDES), which assured "rather robust demand growth."[19]

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[17] For its critics, the PAC does not address current spending, which, for them, is the main obstacle against Brazilian economic growth.

[18] It is worth mentioning that the appointment of new and unorthodox economic administration actors has allowed the emergence of criticism against the hegemony of the creditors' view in macroeconomic policy orientation. One example is the publication and seminar, in November 2007, under João Sicsú, the new IPEA director, with the title *Public Revenue and Spending*, which raise questions about social security deficit information. In addition, more recent IPEA's publications begin to show new analytical views of government spending and to question the rhetoric of its excessive growth, especially as concerns current spending and social policies.

[19] According to IPEA, the 6.5 percent increase in household consumption was due to higher employment levels (with growing numbers of formally employed workers), increased income, expanded credit, and public policies such as minimum wage raises and the "Bolsa Família" program.

However, even though the second Lula administration started to show signs of departure from the radical fiscal adjustment path that characterized the "Palocci age," new trends emerged even in early 2008. The threat of a rebounding inflation made room for the monetary policy council (COPOM) to begin a new cycle of interest rate hikes. The international financial crisis (beginning with mortgage problems in the US) also caused the government to respond by raising the primary surplus target by and additional .5 percent of GDP in 2008 and 2009 (although the raise is formally intended to establish a sovereign fund).

These elements allow arguing that a fiscal agenda flexibilization took place in the Lula administration, but that this flexibilization did not amount to a comprehensive shift.

Finally, it is worth mentioning the impact of the international financial crisis on macroeconomic management in Brazil. Firstly, in October 2008 Brazil's macroeconomic policy experienced a situation opposite to most developed countries. After two years of economic growth in excess of the entire period following the 1994 launch of the Real Plan, inflation pressures emerged and led to a new cycle of interest-rate hikes, with fiscal constraints and foreign exchange appreciation, in an international scenario of high gains in the main agricultural and mineral commodities produced domestically. The Central Bank of Brazil had already raised the short-term interest rate by 2.5 percentage points between April and September 2008, from 11.25 percent to 13.75 percent a year; in June, the Federal Government had announced an increase to the primary surplus of .5 percent of GDP, and the exchange rate against the US Dollar reached its highest levels (1.56 Reais to the US Dollar) since the devaluation of 1999. The main concerns among the government's economic policymakers seemed to be an overheated economy and the threat of inflation, causing even diehard Keynesians to recommend more austere fiscal and monetary policies to contain price increases.[20]

With the arrival of the financial crisis, however, the liberalizing trend that had prevailed for over twenty years began to wind down, and even some of the main advocates of the previous strategy seemed to convert to an agenda of resumed regulation of the financial industry and of the international flow of capitals. Even so, the Lula administration's response to the crisis maintains the ambivalent profile of the

[20] Luiz Gonzaga Belluzzo. *Economista defende desaceleração no crédito e política fiscal contra inflação*. Disponível em <http://www.agenciabrasil.gov.br/noticias/2008/06/05/materia.2008-06-05.0898733525/view5> em 05/06/2008 - 19h29.

preceding macroeconomic policy. On the one hand, the main measures announced seem intended to face the issue of the domestic and international credit retraction that came in the wake of the crisis: release of a massive amount of funds banks previously had to deposit with the Central Bank (required reserves), increased funds for BNDES, authorization for the Federal Government-controlled *Banco do Brasil* and *Caixa Economica Federal* to acquire financial or non-financial companies. On the other hand, the Central Bank continues to uphold the same interest-rate policy, keeping the prime rate at 13.75 percent a year, despite the notorious drop in inflationary pressure and a contractionist fiscal policy, as illustrated by the primary surplus accumulated between January and October 2008, which exceeds 95.6 billion Reais, or 55.8 percent more than in the same period in 2007[21].

Although the financial crisis offers, on the international front, a window of opportunity to reform the previous macroeconomic policy model, pointing in the direction of measures to control and regulate financial flows and of expansionist monetary and fiscal policies, the same appears not to take place at the domestic level.

Concluding Remarks

Contrary to conventional literature, we argue that democracy and successful management of macroeconomic policy are compatible as practices. Note that democratic practices in Brazil did not hamper the effectiveness of the monetary stability policies that characterize the macroeconomic agenda of the 1990s. The electoral impacts of the Real Plan reveal that controlling inflation, far from being a 'bitter pill' imposed on the population or a challenge against democratic governability, amounted to an important trump for its advocate, Fernando Henrique Cardoso, who was elected president without runoff in 1994 in the wake of the monetary stability and also reelected on the basis of economic performance in 1998.

In addition, if electoral democracy was not an obstacle to the implementation of the macroeconomic agenda of the 1990s, in the 2000s it has remained a crucial factor for the inclusion of growth and income distribution into the Brazilian public agenda, even if subordinated to the macroeconomic agenda that has been prevalent since the Cardoso administration. The election of Lula in 2002, his reelection in 2006, and his second administration in particular, marked as it is by the PAC and intensified income

[21] Only in January 2009, the Central Bank dropped the interest rates to 12.75%.

programs, clearly illustrate the process. Together with the three pillars of inflation targeting, floating exchange rate and a primary surplus, the objectives of growth, which has been distant in recent decades, and, above all, of income distribution, which has been historically procrastinated, start incorporating into the government's discourse.

In other words, if the macroeconomic policies Brazil adopted over the course of the past three decades are related with broader changes in the international economy and to how we become embedded in this process, political democratization has likewise had impacts on the definition of many of its components, leading governments, on charting their paths, to take account not only of the market's constraints (monetary stability and fiscal adjustment to assure solvency and creditors confidence), but also the society's more comprehensive demands, which are crucial to their political legitimacy (economic growth, job growth, income distribution etc.).

However, if electoral processes are essential to democratic order, they are not sufficient to assure deepening democracy. As noted by various contemporary theoreticians of democracy, not only the mechanisms of government formation, but also the policymaking, with more or less inclusive or participative institutional arrangements, is equally crucial to the consolidation of democratic principles (HABERMAS, 1996; YOUNG, 2000; HELD, 2006; URBINATI, 2006). Along these lines, we further hold that the continuity of liberalizing, pro-market macroeconomic policy on the part of a more left-leaning administration such as PT's is explained by the constraints imposed by economic globalization and the country's insertion into the process, and has much to do with macroeconomic policymaking, that is, with the decision-making arenas that concentrated power in the Executive Branch instead of sharing it with other political actors in the Legislature or even in organized society.

Looking at the Brazilian experience, we note with support from ample literature that economic policies have been chiefly formulated within the Executive bureaucracy and apart from the political party system and even Congress itself. Therefore, not only the developmentalist policies implemented by the Vargas and JK administrations in the 1950s, but also the attempts to control the inflationary process in the late 1980s and '90s, under a democratic regime, were formulated in restricted arenas made up of the Executive's technicians and bureaucrats and in full isolation from political parties and Congress (or, as it is now said, "armored against political pressure") (D'ARAÚJO, 197582: MARTINS, 1985; LOUREIRO,1997).

Indeed, we can stated that macroeconomic policies in Brazil have been drawn in restricted policymaking arenas that are relatively insulated from outside pressures and dependent on the personal support of the President of the Republic, or a strong minister These arenas are made up not only of highly-placed civil servants, but also of prestigious academic or financial market economists who become temporarily involved with the government as ranking officials or advisers – with broad powers to draw and implement economic measures or programs. Although these traits emerged in the context of authoritarian regimes, they are equally present under democracy, which assigns great institutional power to the executive through provisional measures and control over budget execution (MAINWARING, 1997; FIGUEIREDO & LIMONGI, 1999).

Even the Real Plan, which successfully achieved monetary stability and differed from its predecessors for the bargaining had with Congress to put into place preparatory steps that involved constitutional amendments (SOLA & KUGELMAS, 2002), failed to establish a new pattern of policymaking. The same law that launched the Real Plan (the Provisional Measure no. 542, dated June 30, 1994) established the CMN's composition was limited to the Ministers of Finance and of Planning, and the Chairman of the Central Bank, excluding other Ministers of State, the Chairmen of Federal Public banks, representatives from private-sector banks, employers associations and worker unions.

Furthermore, the great autonomy the Central Bank has enjoyed in Brazil (*de facto*, not *de jure*) clearly illustrates this insulation. For over 14 years, the Central Bank has been embracing a policy of exceedingly high interest rates (often the highest on the world) in spite of pressures from important political groups such as the São Paulo State Manufacturers Federation and business in general, from non-orthodox economists, who repeatedly speak in Academia and the press. This autonomy reached its highest in the midst the 2008 international financial crisis , when the Central Bank, contrary to most of its international peers and unconstrained by internal political forces that opposed it, kept nominal rates at 13.75 percent a year until January 2009. In sum, the recent Brazilian experience illustrates insofar as a limited group of policymakers with little political constraints may impose decisions contrary to the majority of political forces and thus jeopardize democratic consolidation.

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