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Legacy or Complacency? Lula's Unfinished Business in Brazil

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When it comes to Latin America, "good news is no news." But Brazil has earned so many positive headlines recently that it might just rewrite this maxim. South America's most populous continental power has managed to string together a few decades of sound economic policies and pluralistic governance to become an example of how a multiethnic democracy and free market economy can help millions pull themselves out of poverty. President Luiz Inácio Lula da Silva, labor leader turned statesman, has made impressive strides during his tenure. At a time when some protagonists in the region are wasting time and energy pushing a polarizing, divisive agenda, Lula's term has been defined largely by steady pragmatism. He has demonstrated that antipoverty programs are good business and that economic growth is objectively better when the opportunity that comes with it is shared more equitably. But he risks squandering his remaining thirty months in office if he basks in the glow of his accolades and becomes complacent. He owes it to his people and to his own legacy to take on a host of lingering economic and political reforms to make Brazil more open and fair.

A nation of 190 million people concentrated around the edges of a country a bit larger than the lower forty-eight United States, Brazil possesses the essential ingredients for succeeding in today's globalized economy. Unlike most of the states of the New World, Brazil did not wage an armed struggle against a colonial power; it was merely declared independent from the Portuguese crown in 1822. Despite its vast ethnic diversity and pronounced income inequality, race has never been a cause for division or hostility. Brazil was governed by the military from 1964 to 1985, but throughout that period, an elected civilian legislature continued to function. Since José Sarney assumed the presidency in 1985, the country has been governed by a series of democratically elected leaders who, except for Lula, emerged from the political center. Today, the governing Workers' Party (*Partido dos Trabalhadores*) and the centrist opposition have a common bond of having struggled against decades of military rule.

Unlike most of Latin America, Brazil's relatively strong political institutions reflect the essential conservatism of its society. And, although bouts of indebtedness and hyperinflation in the 1980s and early 1990s stunted its long-term economic growth and prosperity, Brazil still ranks among the world's top ten economies.

Lula's rise to the presidency reflects pragmatism and savvy, and his current success is built upon the hard work of several predecessors. A founder of the Workers' Party, Lula adopted the rhetoric of the traditional Latin American left in his first three presidential campaigns. By his fourth try in 2002, he recognized the caution of the Brazilian electorate, tempered his speech, and was elected president by pledging to maintain the orthodox macroeconomic policies that had secured a welcome measure of economic stability.

Lula has governed with full respect for his country's democratic institutions and pluralistic

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politics, delivering a host of ambitious antipoverty programs but rejecting the hard line of his own party. Unlike some protagonists in the region, he has not wasted his time pushing a polarizing, divisive agenda. His instincts as a labor negotiator have served him well, particularly because he rejects the zero-sum formulas that trip up traditional populist leaders. He has, for example, balanced macroeconomic stability with social spending, managed to open Brazil's economy while tending to internal disparities, and forged an uncanny relationship with U.S. president George W. Bush while maintaining friendly relations with vehemently anti-American Venezuelan president Hugo Chávez.

Optimism runs high in Brazil. A veteran Brazilian diplomat not known for hyperbole told me earlier this year, "For the first time in my life, I am optimistic about my country's future." Arminio Fraga, former president of Brazil's central bank, recently praised the remarkable progress that Brazil has made in the last two decades but warned that "major gaps still exist, so there is no room for complacency, no room for hubris."[1]

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Toward a More Modern Economy

In April 2008, Standard & Poor's (S&P) Rating Services upgraded Brazil's debt rating to "investment grade," noting the country's much improved external debt situation, fiscal picture, and trade balance. Lula called the vote of confidence "a conquest by the Brazilian people they've been waiting for for many, many years."[2] Indeed, Brazil's economy is on track to grow 4–5 percent this year, after 5.4 percent growth in 2007. Inflation is running around 4.5 percent, and experts say this indicator bears watching. To weather the impact of the U.S. economic slowdown, Brazil has taken on the ballast of $200 billion in international reserves. It is now a net creditor nation, much less vulnerable to debt crises that bedeviled it in the not-too-distant past.

Although Lula and his respected economic team are accorded great credit for this record, the foundation of this sound economy was poured by previous presidents and bolstered by a positive external economic environment. Much of Brazil's positive performance—particularly the $40 billion positive trade balance—is owing to record high commodity prices for its agriculture exports and burgeoning oil reserves. But a global economic slowdown threatens to wipe out some of the positive external conditions that Brazil took for granted. Now more than ever, Brazil must tackle long-standing roadblocks to unlock future economic growth. Some observe wryly that these positive results show what Brazil is capable of if its politicians merely refrain from doing stupid things. But if Lula is simply content to avoid policy blunders, his efforts will fall by the wayside.

Economic stabilization is not the same as economic modernization. The S&P rating says nothing about the state of Brazil's business environment and its ability to attract domestic and foreign investors. What is left of Brazil's economy after stripping out the windfall stemming from high commodity prices? This simple question should be enough to give Lula pause. Brazil's foreign direct investment is relatively anemic—only in 2007 did the country pull up its investment flows to 2000 levels—and largely concentrated in extracting natural resources. This is of little surprise (but much concern) to those familiar with the difficult domestic business environment that makes investing worthwhile only to those who can strike it rich in the commodities game. The country's tax code is legendary for its complexity and fiscal burden. The World Bank study *Doing Business 2008* found that it takes an average of 2,600 hours to prepare and pay corporate taxes (the worst of any country in the study) that eat up 69.2 percent of profit. That same report—which measures the ease of starting a business, hiring and firing employees, getting credit, registering property, and other indicators—gave Brazil an overall ranking of 122nd out of 178 countries, sandwiched between Honduras and Indonesia and better than only four countries in the Western Hemisphere.[3]

To be fair, Lula recognizes the need to nurture the country's growing economy, and he has made a series of promises in his second term to address some of the more difficult roadblocks to continued growth. In January 2007, he announced a $240 billion growth acceleration package, a public-private partnership to invest in sorely needed seaports, airports, and roads to complement the growth in agricultural and industrial production. Public funding can play a vital role in priming the pump for infrastructure projects, but unless Brazil fixes the incentives to invest in infrastructure (a system that *The Economist* termed "a legal and regulatory adventure"[4]), the country will continue to fight the same battles.

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Lula's government also promises to simplify the cascading state and federal taxes that discourage investment and foreign imports, but it has been slow to act on these promises. Far from working to untangle the labyrinthine tax codes, Lula has worked to retain some of those taxes destined for the chopping block, in an effort to keep pace with an ever-growing federal budget. Although the Congress ultimately voted against extending a temporary tax on financial transactions meant to fund public health programs, Lula dedicated considerable time and political capital to salvage this predatory tax that has become a catchall revenue source for contingency spending.

Lula clearly understands the challenges that face his country, and he is no stranger to the power of enterprise in lifting people out of poverty. Thus far, however, his second term appears to favor spending more money on development projects over reforming a system that strangles economic growth. Inefficient and burdensome regulations paired with high taxes to fund growing government activity threaten to undo the progress made under the first Lula administration. Julio Sergio Gomes de Almeida, former economic policy secretary under Lula, warned that "industry is doing well despite, not because of, government. . . . Now is the time to ensure tomorrow's growth, but I don't see any signs of economic reforms. . . . Brazil is already becoming complacent."[5]

Taking Apart Structural Poverty

Lula commented in an interview with *Newsweek* journalist Lally Weymouth upon his election that he did not have his first taste of bread until he was seven years old.[6] No one would doubt the personal commitment of such a man to fighting the savage poverty that would have swallowed up a lesser man. He set out to expand social programs aimed at eliminating hunger in his nation, paying families to participate in nutrition and education programs and expanding basic health care. Thanks to his Bolsa Família program, over 11 million families—one-fourth of Brazil's population—with incomes under $68 per month have benefited from small monthly cash payments to supplement their incomes, with the aim of increasing school attendance and caloric intake and reducing child labor. Despite a slow start that many attribute to the inexperience of his appointees, during the last six years, 20 million Brazilians have managed to pull themselves out of extreme poverty, in large part because of these social programs. Of course, one of the most important factors in improving the purchasing power of the very poor has been the precipitous drop in inflation resulting from sound economic principles applied for the past decade.

Encouraging school attendance and better health and nutrition, Bolsa Família is more than just a handout, but it is still no substitute for long-term investments in human capital. Brazil's income inequality is infamous, but less well-known is a pervasive inequality in access to and quality of education—and this only further exacerbates the unequal distribution of wealth. While access has improved, less than half of young people in rural Brazil complete primary school,[7] and less than half of the total population completes secondary school. Inequality is further exacerbated by free tuition to public universities that benefits well-off students far more than poor and middle-class students, who are less likely to complete high school and be in a position to take advantage of free postsecondary education. Quality of education is also of serious concern: even the best students struggle on international educational exams, with 50 percent of students in Brazil failing to receive even passing grades in reading and comprehension and only one-fourth of students passing in mathematics.[8]

These are no simple solutions to Brazil's inequality woes, but the country's fiscal program all but rules out the possibility of serious reform. Excluding debt service, the federal government spends its money largely on three things: pensions, transfers to state and local governments, and its own bureaucracy. Brazil's pension system is not only unwieldy compared with other countries (developed or otherwise), but it also benefits wealthier citizens disproportionally.[9] Lula took a brave step in increasing the minimum retirement age for public employees, but the pension system is in desperate need of more sweeping reforms. The system of fiscal transfers to state and local governments, originally meant to help lessen the gap between wealthy and poor states, has not encouraged a more equal distribution of social services as intended; instead, it has funded a growing network of bureaucrats and administrators, who are paid more relative to private-sector workers in those states that receive a lot of their revenue from the central government.[10] And finally, Lula's own bureaucracy has grown incredibly during his tenure: his government has created thousands of jobs to fill thirty-seven ministries, sixteen of which have been created since 2002.[11]

Lula has demonstrated that antipoverty programs are good business and that countries do not have to choose between social spending and sound economic policy. But a growing bureaucracy—especially one predicated on the notion that the country's problems can be solved by government spending alone—threatens the country's fiscal stability as well as its ability to invest in the welfare of its poorest citizens and tackle rampant inequality. Lula cannot be blamed for the current state of affairs—these were largely systems that he inherited—but it is fair to expect him to make the case for reducing the tax burden on the private sector and to deliver more fiscal accountability in the public sector.

Taking on Entrenched Political Interests through the Rule of Law

Perhaps no measure is more important to building Lula's legacy as a transformative leader than bringing about a host of reforms that instill transparency and accountability in Brazilian politics. Just as the black market dominates the economies of many developing countries, corruption undermines good governance and political accountability in weak states. A good number of Brazilian politicians—including Lula's first chief of staff and members of the governing Workers' Party—have been accused of corruption in recent years. Some Brazilians complain of a culture of impunity that undermines faith in their politicians; for example, while several scandals have forced senior officials to resign their posts in recent years, few, if any, have faced criminal prosecution.

In addition to low-level forms of corruption, the lack of accountability and weak political parties slow Brazil's evolution to a more prosperous and just nation. Even the most prominent political parties are underdeveloped, with little or no grassroots organizations and, consequently, little or no accountability among elected representatives. As a result, it is difficult to impose a coherent, predictable decision-making process—particularly among federal and state legislators—and to convert public opinion into sound public policy. Consequently, voters have grown cynical about their elected leaders, which in turn undermines a sense of accountability that is essential to any modern political order.

Lula has done very little to date to address these essential weaknesses. But a Brazilian federal electoral tribunal (in a ruling later upheld by the Supreme Court) outlawed party-switching, which had become a notorious practice as members traded their party affiliation for political favors and pork. Party-jumping was weakening the political parties, and the court action was intended to improve accountability. But more needs to be done. Brazil's ambassador to the United States, Antonio Patriota, recently observed that Lula has built up the kind of political capital that is essential for taking on the thorny issue of political reform.[12] And while Lula has weathered a series of political scandals in his administration, his legacy depends on bringing about systemic change that imposes the rule of law and holds individuals accountable for abusing the public trust.

Other Unfinished Business

These reforms are part of a broader agenda of upholding the rule of law for all citizens. Stronger, more accountable democratic institutions will make it easier for the poorest Brazilians to claim their fair share of economic opportunity and for all citizens to hold their government accountable. There is no more important antipoverty program than fighting the corruption and state-sponsored privilege that breeds inequality and estrangement among those living on the margins of society. Social programs can do much to mitigate the damages of poverty, but systemic political reforms to build a modern and accountable state that is capable of applying the rules of the game without fear or favor are essential to solving poverty.

Lula should study the World Bank's *Doing Business 2008* and resolve to improve his country's performance in each category. These criteria are the recipe for the economic empowerment of all people and for jump-starting sustainable, broad-based growth. A public commitment to this goal will spur policymakers, regulators, and legislators to action.

It is laudable that Lula has committed substantial resources to modernizing Brazil's infrastructure so that its economy can grow toward its full potential. Public financing can prime the pump for such massive projects. But creating the conditions for attracting vast sums of private capital—from within Brazil and from abroad—makes good economic sense, too. To be sure, Brazil already has improved its reputation as a relatively safe and sound destination for foreign capital. But Brazil's government can go a long way toward reassuring willing investors by modernizing its antiquated complex tax code, ensuring transparency in public transactions, adopting transparent and predictable regulatory regimes, adopting first-rate protections for intellectual property, and liberalizing the labor and capital markets. Moreover, some international investors are discovering that a number of business-friendly governors have taken advantage of their considerable power to adopt measures that make their regions more attractive to investment.

There is work to be done on the global stage as well. Lula could do much to spur the world economy—including his own export-dependent agricultural sector—through pursuit of global trading agreements. Brazil and its president have unique credibility to thwart the protectionist agenda of India and to rally the developing world to press Europe and Japan to accept the elimination of agricultural subsidies that President Bush has already promised.

Finally, the Brazil-U.S. CEO Forum proposed a series of practical recommendations intended to open up commerce and investment between these two economic giants. Among the recommendations was the finalization of a bilateral tax treaty to eliminate dual taxation and, in so doing, facilitate trade and capital flows between the two nations. The forum also endorsed an open exchange of information on investment opportunities to facilitate the work of venture capital funds. This dialogue, launched by Lula and Bush in March 2007, has been healthy and promising, but it is essential that both governments heed the advice of CEOs who are eager to see their economies grow together in every sense of that expression.

Genuine Leadership

Although Lula's government has sought an expansive role for Brazil on the world stage—including a permanent seat on the United Nations Security Council—Lula is quick to reject the notion that his nation pretends to "lead" Latin America. "We are not trying to find a leader in Latin America," Lula said in a September 2007 interview. "We don't need a leader. I am not worried about being the leader of anything. What I want is to govern my country well."[13] Although the Brazilian head of state is not eager to be seen competing with Hugo Chávez for preeminence in Latin America, the fact is that comparisons between the two are inevitable.

Finally, in a region beset by the false prophets of populism, Brazilians are out to prove that capitalism tamed by the rule of law is the only effective cure for the worst strains of deep and persistent inequality. In doing so, they will teach their neighbors the important lesson, as only they can, that it is not necessary to surrender political freedom for economic opportunity.

Notes

1. Dan Shirai, "No Room for Hubris," *LatinFinance*, May 2008.

2. Associated Press, "Brazil Celebrates S&P's Raise of Debt Rating to Investment Grade," April 30, 2008.

3. World Bank, *Doing Business 2008* (Washington, DC: World Bank, September 2007), available at http://publications.worldbank.org/ecommerce/catalog/product?item_id=6957899 (accessed July 25, 2008).

4. *The Economist*, "Heavy Going," April 14, 2007.

5. Raymond Colitt, "Sleeping Giant Brazil Wakes, but Could Stumble," Reuters, May 12, 2008.

6. Lally Weymouth, "'I Have Changed,'" *Newsweek*, November 11, 2002.

7. Jeffrey M. Puryear and Tamara Ortega Goodspeed, "Coveting Human Capital: Is Latin American Education Competitive?" in *Can Latin America Compete? Confronting the Challenges of Globalization*, ed. Jerry Haar and John Price (New York: Palgrave Macmillan, 2008).

8. Inter-American Development Bank, *Education, Science, and Technology in Latin America and the Caribbean: A Statistical Compendium of Indicators* (Washington, DC: Inter-American Development Bank, 2006).

9. *The Economist*, "Heavy Going."

10. Ibid.

11. Mac Margolis, "The Free-Spending Lula," *Newsweek*, January 7, 2008.

12. Antonio Patriota, "Lula's Legacy: Challenges and Opportunities for Brazil" (keynote address, American Enterprise Institute, Washington, DC, April 17, 2008), available through www.aei.org/event1708/.

13. Simon Romero and Alexei Barrionuevo, "Quietly, Brazil Eclipses an Ally," *New York Times*, July 7, 2008.

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