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Abstract

It has become common sense to argue that the reforms of social policies after the 1988 Constitution were somehow instrumental in explaining social progress, and that Lula's policies mark a break with the 1988 Constitution. We suggest that both propositions are misleading. We argue that the financialization of government expenditures has led to worsening income distribution, and by limiting the ability of the state to increase social spending it has limited the ability of the state to reduce social inequalities. We argue that a recovery of Keynesian ideas about full employment and the euthanasia of the rentier are central for the development of a more just and civilized society in Brazil.

Keywords: Income Inequality, Social Policies, Keynesian Policies

JEL Classification: E250, H500, O540

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Introduction

It has become common place in the debates about economic and social policies in Brazil in the Washington Consensus era, that is, during the administrations of Fernando Henrique Cardoso and Luiz Inácio Lula da Silva, to emphasize that social indicators (poverty, life expectancy, literacy rates, infant mortality, fertility rates, etc) have shown marked improvement. However, the main complaint is that inequality levels have remained high, and that social policies are unable to eliminate inequality without being complemented by more efficient use of public money, in particular, better targeting to the poor. The superficial conclusion is that there is something right about social policies from the 1990s onwards, since after the 1988 Constitution there has been a certain amount of social progress (Schwartzman, 2000; Almeida, 2004; Barros and Carvalho, 2004).

Also, it has been argued by critics of Luiz Inácio Lula da Silva's (from now on simply Lula) social policies that his approach to social policies has marked a shift from the conventional emphasis on universal policies (Almeida, 2004). In this view, Lula's social policies have emphasized targeted programs in order to increase the efficiency of social spending, even though the debate on whether targeting has been efficient is still open.

This paper suggests that both propositions – that the reforms of social policies after the 1988 Constitution were somehow instrumental in explaining social progress, and that Lula's policies mark a break with the 1988 Constitution – are misleading. The rise in life expectancy, the fall in illiteracy rates, the fall in infant mortality and the reduction of fertility rates have a long history, and have coexisted with one of the highest levels of inequality in the world. Recent social policy reforms have a limited role in explaining the evolution of social indicators. Even if Lula's policies put more emphasis on targeting, a controversial proposition that we do not try to sort out, it seems that both Lula's social policies and those of his predecessor are secondary to the macroeconomic policies which promote the reproduction of financial wealth, in an environment of increasing inequality.

We believe that Cardoso's administration acceptance of the Washington Consensus agenda marks in Brazil the alignment of certain groups on the left of the political spectrum to anti-Keynesian policies. Further, there is no indication of a major

break between Lula's policies and those of his predecessor, although some minor differences subsist. In particular, the increase in the minimum wage accelerated in Lula's administration and the rate of expansion of the Bolsa-Família program has been exponential, which may explain the notion of a break with previous policies. However, the anti-Keynesian bias of economic policies during Lula's tenure, in our view, suggests that the ability of social policies in reducing the vast inequalities in Brazilian society remain limited at best.

The remainder of the paper is divided in three sections. The first section provides a bird's eye view of social policies in Brazil in the very long run. The following one shows the limitations of conventional wisdom arguments about recent social policies, and discusses the role of financialization in perpetuating the historic pattern of social exclusion. The last section indicates the drawbacks of the decision to abandon the Keynesian goal of full employment by left of center administrations.

A Long History of Social Exclusion

The roots of inequality in Brazil are to be found ultimately in the colonial heritage. The sugar and gold cycles of the XVI and XVII centuries – part of the Portuguese colonial venture, and essential for the colonization of the Northeastern and Southeastern regions respectively – and their need for high sums of capital, and African slaves as the primary source of labor were part of a social structure of production that implied high levels of inequality.

After independence, the elites that dominated Brazilian politics were linked to the export sectors, in particular to the rising coffee sector, and were fundamentally concerned with the maintenance of a structure of production based on the 'latifundio' – the large agrarian property – and slave labor, which was maintained by Brazil almost until the end of the Empire. The transition to wage labor and Republican governments took place hand in hand with the maintenance of an economy dominated by export interests, electoral fraud, and a system of patronage that did little to eliminate the great income inequalities accumulated in the previous centuries.

In fact, only the Great Depression and the process of industrialization led to serious challenges to the established social structures, and opened the possibilities of a

more equitable and democratic society. Yet, the Brazilian experience of National-Developmental policies, although quite successful in the promotion of industrialization, fell short in terms of generating strong social coalitions capable of reducing income inequality.

It should be noted that high levels of inequality – that sometimes are assumed to be detrimental to economic growth – were not necessarily an impediment for fast increases in income per capita. Even though the Brazilian economy lagged behind during the colonial period and the XIX century, during the major part of the XX century – up to the debt crisis of the early 1980s – it caught up with the developed world. In fact, during some periods (e.g. the Economic Miracle, 1968-1973), increasing income inequality might have been instrumental in producing higher rates of growth.

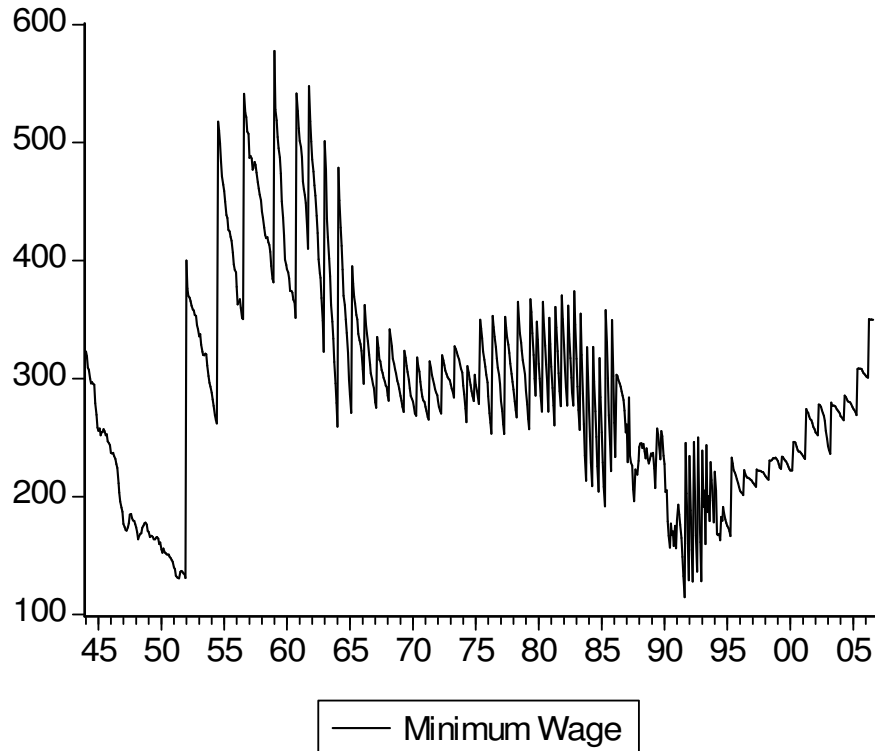
All in all, the institutions for social protection created during the import substitution industrialization (ISI) phase – roughly between 1930 and 1980 – were incapable of affecting positively the indicators on inequality and social exclusion. The Brazilian Welfare State, if we can speak of one in the periphery, was incomplete, fragile and circumscribed by one of the highest levels of social inequality for middle income countries in the world. Aureliano and Draibe (1989) classify the Brazilian welfare system as conservative or corporatist, one in which social protection was mainly concerned with the relations between capital and labor, and where the State socialized the costs of the reproduction of the labor force, as part of the subsidies to promote industrialization.

However, as the system incorporated increasing numbers of participants in public programs, the quality of services decreased markedly. For that reason, the upper and middle classes reduced their use of elementary and secondary public education, and relied on privatized health and pension systems to complement the public ones. The fall of the minimum wage (Figure 1) – to which several benefits were tied – is indicative of the deterioration of the precarious system of welfare from the 1950s onwards.¹ Also, in contrast with most of the international experiences, in particular the Western European

¹ It is important to note that after the 1994 stabilization plan the real minimum wage has increased steadily. Some authors suggest that, in part, the improvement in social indicators is related to the evolution of the minimum wage (e.g. Kakwani, Neri and Son, 2006). Yet, it is clear from Figure 1 that the minimum wage only recovered the level of the late 1970s, and is far below its 1950s peak.

one, the Brazilian system of social protection was concerned with social rights and citizenship only to a minimum extent. On the other hand, the fast rates of growth of income per capita, during the ISI period, suggested that there was hope for a reduction of the worst iniquities in the system.

Figure 1 Real Minimum Wage (1944-2006)



Source: IPEA Data

However, the debt crisis, the prolonged period of high-inflation, and the dismal economic performance of the 1980s, the so-called ‘lost decade,’ relegated discussions about development and inequality to secondary plane. Stabilization was the main concern for policy makers and in intellectual discussions. The 1988 Constitution – promulgated in the midst of the process of redemocratization – delineated a model for the universalization of social security, health and education rights to all citizens.² The Real Plan in 1994 and the resulting economic stability – which were not accompanied by

² For a discussion of the social policy reforms of the 1990s, that followed the 1988 Constitution, see Draibe (1999).

higher rates of growth – re-opened the discussions on strategies of development and their impact on social conditions. The consensus was that stability allowed the implementation of several of the objectives of the 1988 Constitution and that there had been a significant improvement in social indicators during the Cardoso government (Almeida, 2004).

Several authors claimed that the main problem with social policies in Brazil, during the Cardoso administration (1995-2002) was the lack of targeting, usually defended by the World Bank (e.g. Schwartzman, 2000; Barros and Carvalho, 2004). However, it is clear that – beyond the philosophical question on whether social policies should be universal or targeted – the amount of social spending was insufficient during the Cardoso administration, and problems were not restricted to inefficient spending. The fundamental problem was that, with the combination of high interest rates and primary surpluses, social spending was squeezed (Vernengo, 2007).³

It should be emphasized that since 1994, including the four years of the Workers' Party's administration, spending with the service of public debt, that is, the interest rate bill, has oscillated around 46 percent, with peaks of 55 percent in 2000 and 53 in 2005, of total government spending (see Figure 2). In other words, on average, almost half of the federal government expenditures go to banks, corporations and wealthy individuals that hold Treasury bonds. That is the main activity of the federal government.⁴ In contrast, in 2006 spending with social security, health and sanitation and education, all added up, corresponded to approximately 18.5 percent of the total spending of the Federal Government.

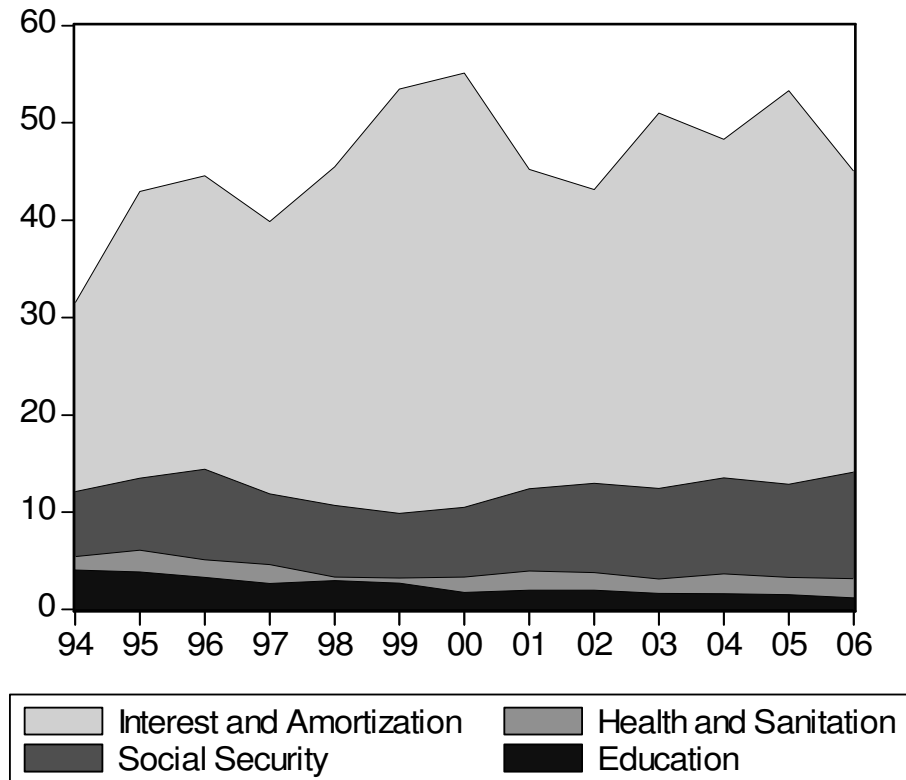
Conventional wisdom on social policies during the Cardoso administration is that poverty, and social indicators usually improved while income inequality improved slightly at the beginning but remained at high levels (e.g. Schwartzman, 2000; Almeida, 2004). Most of the discussion on inequality is centered on Gini coefficients, but if we look at the functional distribution of income, it is clear that inequality increased, with the

³ This type of macroeconomic policy mix was typical of the Washington Consensus policies and was imposed in agreement with International Monetary Fund (IMF) (Câmara and Vernengo, 2004-5).

⁴ Schumpeter (1918, p. 3) suggested that “public finances are one of the best starting points for an investigation of society.” Fiscal spending shows, without the veil of ideology, what the real priorities of a government are. If the fundamental beneficiaries of government spending are rentiers, living from high remuneration of financial assets, it is hard to defend the notion that such administration prioritizes the poor and dispossessed.

participation of wages in total income falling from 40.1 percent in 1994, the year of the Real Plan, to 36.1 percent in the last year of Cardoso's administration (Vernengo, 2007).⁵ Far from reducing the high levels of inequality, the Cardoso administration was associated with a considerable compression of wages and the worsening of income distribution.

Figure 2 Government Spending (% of Total)



Source: SIAFI - STN

It must be noted that in addition to general efforts to enlarge access to public education and health, according to the inclusive criteria of the 1988 Constitution, Cardoso's administration created a series of programs that complemented the welfare system and that were targeted to the poorest sectors of society. For example, the Bolsa-Escola, Bolsa-Alimentação, Auxílio-Gás and other cash transfer programs were created, and the

⁵ They also continued to fall in the first year of Lula's administration – the only one for which there is data – with the participation of wages in total income reaching only 35.6 percent.

program Erradicação do Trabalho Infantil (PETI) to eliminate child labor was forcefully implemented.⁶ According to Almeida (2004), in spite of the creation of these complementary social protection programs, the overall emphasis of governmental intervention during the Cardoso period remained associated to universal policies, in particular, access to education and health.

Some authors suggest that the effects of those transfer programs, although positive are small at best (e.g. Bourguignon, Ferreira, and Leite, 2003). Others suggest that the significant improvement in social indicators is, to a large extent, the result of more efficient targeted cash transfer programs, in addition to higher minimum wages (e.g. Kakwani, Neri and Son, 2006). The argument is ultimately about the size of the positive impact of targeted cash transfer programs rather than about the general usefulness of such programs. Critics of cash transfer programs – like Almeida (2004) – suggest Lula’s administration emphasized the relevance of cash transfer programs, in particular the Bolsa-Família – after his election, and that this was a substantial break with the previous emphasis in universal social programs. The following section discusses whether there has been a significant rupture in social policies during the Worker’s Party (Partido dos Trabalhadores, PT) administration, and the reasons for the improved social indicators in both Cardoso and Lula’s administrations.

Lula’s Social Policies

The Worker’s Party acceptance of the macroeconomic strategies adopted during the Cardoso administration should be seen as part of the general move of left of center parties to repudiate the Keynesian policies that served as the pillars for the development of the limited Brazilian welfare state (Câmara and Vernengo, 2006). However, it would be incorrect to assume that the role of the State has been reduced. The most important change is in the way the State intervenes rather than a considerable reduction of its impact on social and economic outcomes.

Lula’s government was initiated with great expectations and the belief that his administration would have a foundational character in promoting significant reductions in

⁶ In 1960 22.15 percent of the children between 10 and 14 worked, while the same figure in 1990 was 17.8 percent. In the first year of Cardoso’s administration the number was already 16.15 and was reduced to 14.43 by the year 2000 (World Bank, 2002).

the secular problem of social exclusion. However, very few proposals for social policies were discussed before the election and fundamental emphasis was accorded to the necessity of generating higher rates of employment. After the election, however, the question of stability became central, and fiscal restraint was seen as an essential part of the anti-inflationary program. In fact, as part of the strategy to obtain long term fiscal sustainability a reform of the pension system was implemented. The main social program – which was seen by many as the emblematic program of the incoming government – was the so-called Fome Zero (or Zero Hunger). By the end of 2003 Fome Zero was demoted from its position of flagship of social programs, and partially integrated into the Bolsa-Família, which had incorporated several of the Cardoso's social programs.⁷

The origins of Bolsa-Família are deeply rooted in the Workers' Party views on social policy, favoring cash transfers over other developmental programs. Eduardo Matarazzo Suplicy, a Workers' Party Senator from São Paulo advocated a reverse income tax policy program, which he first presented to the Senate in 1991.⁸ Later those ideas led to the Bolsa-Escola implemented in Brasília by Cristovam Buarque and the Programa de Garantia de Renda Familiar in Campinas, both during Workers' Party's administrations.

The main rationale for the integration of the several conditional cash transfer programs (Bolsa-Escola, Bolsa-Alimentação, Zero Hunger and Auxílio Gás) into Bolsa-Família was to provide a more capable administration, and to target the poor more efficiently. Almeida (2004) argues that the emphasis on Bolsa-Família led to a marked break with the Cardoso's administration position on social policies, and a new emphasis on targeted instead of universal programs. This view is to some extent supported by the fast paced increase in the extent of coverage of Bolsa-Família. In January 2005 covered 6 million families and accounted for around 1 percent of government spending, while by the end of 2006 it is expected to cover 11 million families and correspond to 2.5 percent of total expenditures. However, the distinction between Cardoso and Lula's administration social policies is minor at best. In fact, both are similar to several cash

⁷ Rocha (2005) suggests that the impact of Fome Zero and Bolsa-Família on social indicators might be bigger than the effects of the Cardoso's programs – Bolsa-Escola, Bolsa-Alimentação and Auxílio-Gás.

⁸ Silveira (1975) provided the original proposal for a negative income tax.

transfer programs in Latin America.⁹ The question of whether targeting of universal programs are central is unable to shed light on the essential modification of social policies in both periods.

It is true that central to both Cardoso and Lula's social policies is the idea that cash transfer – that is, direct monetary transfers to poor families – are essential to reduce poverty and inequality. Also, the fact that most cash transfers have been conditional, depending on the commitment by poor families to send their children to school or to health centers, for example, indicates that the reduction of poverty and inequality are seen to be connected to human capital, a Chicago doctrine that became popular in development circles in particular at the World Bank.¹⁰ However, the fundamental change in social policies has been caused by the process of financialization.

In fact, after the Real Plan in 1994 real interest rates have been high in real terms, and that has implied that the number one expense of the central government has been the service of the debt. Public debt holders are ultimately banks, corporations, and a tiny minority of the population. The process of financialization that started with the debt crisis in the 1980s achieved its high point after stabilization. Financial transfers in the form of interest payments on domestic public debt became the central 'social program' of Cardoso and Lula's administrations, consuming close to 50 percent of all spending. Not surprisingly the fall in wage participation in total income was matched by an increase of the operational surplus from 38.4 percent in 1994 to 42.9 percent in 2003 (Vernengo, 2007).

In other words, if the pattern of social policies that led to the corporate welfare system developed during the ISI period was fundamentally associated to the socialization of labor costs for the industrial sector, then in the post-liberalization and stabilization period social policies have become secondary to the process of financial accumulation

⁹ Bolsa-Familia provides around 25 dollars to more than 10 million families, the Oportunidades program in Mexico gives between 100 and 170 dollars to 5 million families, and the Plan Jefes y Jefas de Hogar, in Argentina, provides around 50 dollars to 1.8 million people, to name the more prominent cash transfer programs in Latin America. Of these, the Plan Jefes, introduced in the midst of the worst crisis in Argentinean history, is the only one that tries to integrate the recipients into the labor market, and, at least conceptually, subscribes to the notion that social policies should be centered on the generation of decent employment. Bolsa-Familia is, in terms of coverage, the largest cash transfer program in the world.

¹⁰ For the pioneers of development education and health were as much, if not more, a result as a cause of economic progress. For a critique of human, and the even more encompassing view of social, capital see Fine (2001).

(Pochmann, 2004). The question, then, is how social indicators did – life expectancy, illiteracy rates, infant mortality, and fertility rates are displayed below, but alternative indicators like United Nations Development Programme (UNDP) Human Development Index (HDI) would show similar improvement – actually improve during the Washington Consensus era (Table 1).

Table 1 Social Indicators (1940-2004)

	Life Expectancy	Illiteracy Rate	Infant Mortality	Fertility Rate
1940	43	56	158	6.1
1950	46	50	138	6.2
1960	52	40	118	6.3
1970	54	30	117	5.5
1980	60	25	88	4.4
1990	65	19	50	2.7
1996	67	17	41	2.1
1998	68	14	36	NA
2004	71	12	27	1.9

Sources: IBGE, and Schwartzman (2000)

The conventional view, which suggests that social programs alleviated the worst effects of economic downturns and were central in the progress of social indicators, seems misplaced considering that those indicators have improved since, at least, the 1940s. Output growth is not a likely explanation of social improvement either, because the record during the 1980s and 1990s has been dismal.

The most likely explanation is that the progress in social indicators was a result of the process of industrialization, and the consequent migration from rural to urban areas. Urban areas provide greater access to electricity, treated water, medical care and public schools. In other words, urbanization, the extension of social benefits to rural workers, and the relative fall of the cost of food rather than a reduction of inequality are the most

likely driving forces of social progress in Brazil (Vernengo, 2007).¹¹ The urbanization process that resulted from industrialization transformed the country from one in which 70 percent of the population lived in rural areas in 1940, into one, in which more than 80 percent of the population live in urban areas in 2000. The underlying process was one of fast rural modernization, with an intense process of capitalist expansion in agriculture without land reform. The migration from rural areas was fast paced and in the short span of three decades nearly 40 million people migrated to cities, 24 percent of the whole population in the 1950s, 36 percent in the 1960s and 40 percent in the 1970s (Cardoso de Mello and Novaes, 1998).

We believe that the process of industrialization during the 1930-1980 period was the force behind social progress, and that it was the success of that process that allowed the continuous improvement in social indicators long after the process of import substitution industrialization lost dynamism. The process of industrialization was so successful that urban areas remained an important outlet for rural workers that were not absorbed in the modernized agribusiness sector. Therefore, alternative macroeconomic policies, which put a lesser burden on social spending, might in fact accelerate social progress. For that reason it is hard to believe that social indicators would not have improved even more, and more importantly, that inequality would not have been reduced, if a larger share of government spending was diverted from interest payments to social programs.

Pochmann and Amorim (2004, p. 73) note that the map of social exclusion has a clear regional pattern, with incredibly high concentration of the worst social indicators in the North and Northeast regions, which they attribute to 'old causes,' linked to the pattern of land tenure, the reduced bargaining power of the labor force and represented by reduced access to education, food, health and the formal labor market. On the other hand, they find that in the South and Southeast regions, in the 1990s, a new form of social exclusion has emerged, one that exists despite greater access to education, food and health, and even some experience with formal labor markets. The new social exclusion is basically associated to higher levels of unemployment and labor market informality.

¹¹ These factors are also behind the fall in poverty rates (Vernengo, 2007).

Further, it should be emphasized, as noted by Lessa *et al.* (1997), that the extension of the social safety net implicit in the 1988 Constitution never made it completely into the budgets implemented by several administrations. In fact, in 2002 the Cardoso administration spending on social programs (excluding social security payments) corresponded to 73.9 percent of its expenses on debt servicing (Pochmann, 2003, p. 5). Total social spending, excluding social security, as a share of GDP in 1998 was 12.2 percent which corresponds to around half of what was spent in OECD countries in the same year (*ibid.*, p. 6).¹² The same limitations broadly apply to Lula's social policies.¹³

The idea that social spending was high and not properly targeted to the poor is clearly out of place. Additionally, whether Lula has tried to target social policies to the poorest sectors of society seems irrelevant as an explanation of recent social progress. It seems, on the contrary, that the financialization of government expenditures has led to worsening income distribution, and by limiting the ability of the state to increase social spending it has limited the ability of the state to reduce social inequalities. The main cause of the expansion of social exclusion is the inability to create decent (i.e. well paid) employment. In the past, income inequality went hand in hand with high rates of growth and the expansion of consumption to relatively large shares of the population. During the Cardoso's administration a new pattern of income concentration has emerged and has been maintained in Lula's administration, one that is inimical to growth, and relies exclusively on financial transfers towards the wealthy.

Brazil Interrupted

The Worker's Party emerged from the so-called new unionism of the 1970s, which was rooted in the successful process of import substitution industrialization. In that sense, the emergence of the Worker's Party in 1980 gave voice to middle income and lower middle income groups that demanded higher salaries, adequate housing, education, health, social

¹² Brazil ranks as a high social spending country within Latin America, together with Argentina, Chile, Mexico, and Uruguay. In 1998, social expenditure was about 22 percent of the GDP, more than a half corresponding to social security, while the education share was 3.9 percent, health 3.4 percent, housing 1.2 percent and training programs around 1 percent.

¹³ Bresser-Pereira (2005) suggests that there has been a considerable effort since redemocratization in expanding social spending. The data presented by Pochmann (2003) suggests that the effort falls short of the Herculean task of reducing Brazilian social exclusion.

security, in other words, better social protection. That is, the classical agenda of social inclusion of the Western European left was central to the political project of the Worker's Party. However, an important feature of the new unionism was its autonomy from the State and its critical stance on the State relationship with unions and the corporatist labor regulation implemented during the so-called Vargas era. Fiori (2006) suggests that the Workers' Party's – as much as Cardoso's Partido da Social Democracia Brasileira (PSDB) – dislike of National Developmental policies of the Vargas Era opened the opportunity for the acceptance of the neoliberal policies of the Washington Consensus agenda.

In this sense, a contradiction between the Workers' Party social policy objectives and the party's economic strategies become apparent. In particular, the emphasis on anti-inflationary policies at the beginning of Lula's administration, and the relegation of employment creation to a secondary role, indicated that according to the Workers' Party logic full employment was not central for its strategy of social inclusion. More importantly the secondary role given to employment generation by the Workers' Party may be seen as the consolidation in Brazil of a general movement of the left in the direction of anti-Keynesian policies, including the Western European left that usually was the main intellectual reference of Latin American left of center parties (Câmara and Vernengo, 2006).

In this respect, it is interesting to note James K. Galbraith (2003) re-evaluation of the American system. Usually the American or Anglo-Saxon model is seen as more market oriented than its Western European counter part, which in part explains why it has often been neglected by the Latin American left. However, Galbraith notes the United States has relied heavily on government intervention in housing, health care, pensions, and education, and that, not only have these programs been largely successful and popular, they also provide a Keynesian stimulus to spending that help account for the strength of the U.S. economy. In other words, a greater commitment to full employment, reflected for example in the behavior of the Federal Reserve Board when compared to the European Central Bank, seems to be a characteristic of the American model that should appeal to the left in Brazil, and Latin America in general.

Figure 3 Unemployment Rate

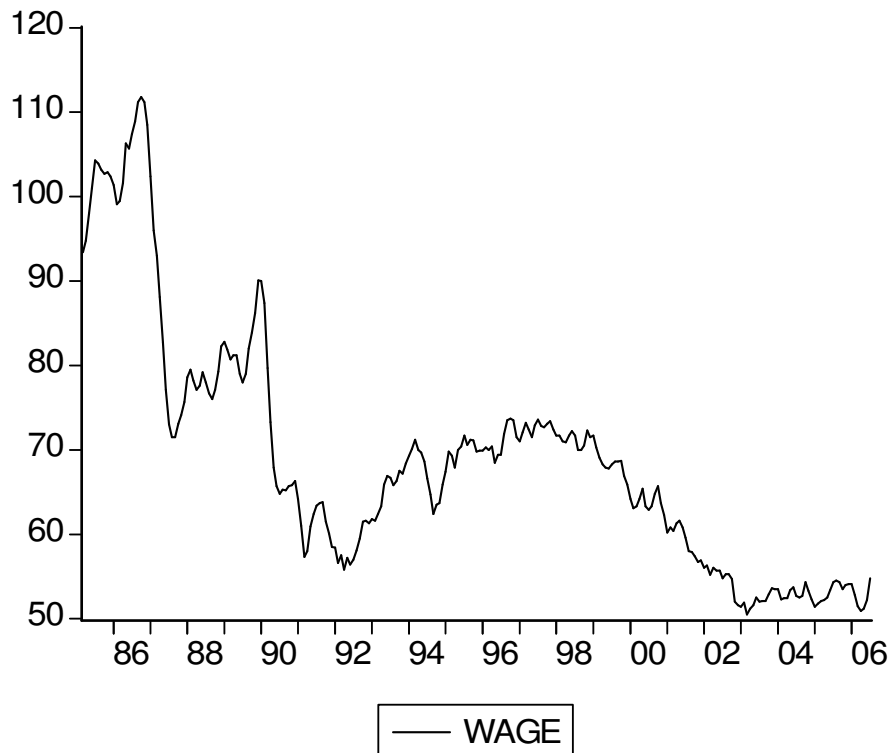


Source: DIEESE

The Workers' Party, as much as the social democrats, has relegated Keynesian ideas as old-fashioned, and has embraced the notion that fiscal austerity is essential for economic progress. For that reason, and in contrast to Keynesian policies, interest rates have been maintained at record levels, and primary fiscal surpluses have been the norm. Primary surpluses have been even hiked with respect to Cardoso's administration, and proposals of zero nominal deficits have become popular, implying that even higher primary surpluses are seen as acceptable and desirable. Also, exchange rates have been considerably appreciated in real terms. This macroeconomic policy mix has, not surprisingly, led to the maintenance of relative high levels of unemployment. Figure 3 shows that the average rate of unemployment in the Workers' Party administration remains high at roughly double the average of the 1980s level.¹⁴

¹⁴ Figure 3 shows the unemployment rate for the São Paulo metropolitan area, the main industrial region of the country. Numbers for the five largest metropolitan areas would display similar results.

Figure 4 Average Real Wages



Source: DIEESE

Further, higher levels of unemployment have been accompanied by a significant reduction of the average real wage (Figure 4).¹⁵ The benefits of stabilization that allowed average wages to increase moderately in the mid-1990s have been eroded by now, and wages remain broadly at half their 1980s level. Note that a rising minimum wage was, in part, instrumental to improve social indicators since several benefits are tied to the value of the minimum wage, though only a minority of the labor force actually receives a minimum wage, which is incredibly low.¹⁶ Hence, the average real wage provides a better picture of the labor market conditions. Also, the fall in the average real wage is

¹⁵ Figure 4 also uses the data for the metropolitan area of São Paulo, with 1985 being equal to 100.

¹⁶ It must be noted that the rate of increase of the minimum wage accelerated in Lula's administration with respect to Cardoso's administration.

compatible with the squeeze of the share of wages in total income that fell around 10 percent since the early 1990s.

Employment and real wage data makes it difficult to defend any claims that the Workers' Party is committed to reducing social exclusion as a central element of its agenda. Social spending cannot compensate for the lack of decent jobs and adequate compensation. Decent work should be at the heart of a national strategy for economic and social progress. As noted by Bresser-Pereira (2005) social spending alone cannot reduce the increasing income inequality, and the absorption of surplus labor should be central to any strategy of social inclusion. Further, Celso Furtado (1992) suggested that the only possibility of reinvigorating the construction of the Brazilian economic system – interrupted since the early 1980s – would be to re-invigorate the domestic market and reverse the process of patrimonial concentration that, for him, was central to understand the social malformations in Brazilian society.

Interestingly enough, social spending is not disconnected from employment generation policies. In fact, lower rates of interest, which would stimulate consumption and employment generation, would also allow for reduced fiscal effort for debt servicing and the expansion of social spending. The main conundrum in Brazilian economic policies, then, is the high interest rate level, which impacts both employment generation and squeezes social spending. The following section discusses the causes of high real rates of interest in Brazil after stabilization in 1994.

Tropical Casino Capitalism

Our discussion suggests that central to understanding the limitations of Brazilian social policies, as well as its economic performance, is the persistence of high real rates of interest since the Real Plan. In fact, Brazil has had the highest real rate of interest in the world for most of the period. Figure 5A shows that the high rate of interest is a Brazilian phenomenon, with almost no parallel in recent times among Latin American countries. For the whole period nominal interest rates remained higher than the average for the Latin American economies. While nominal rates have fallen in the whole region, including Brazil, the fall was not sufficient to lead to a marked fall in the real rate of interest, because inflation also fell significantly.

Figure 5A Nominal Interest Rates (19 Latin American countries)

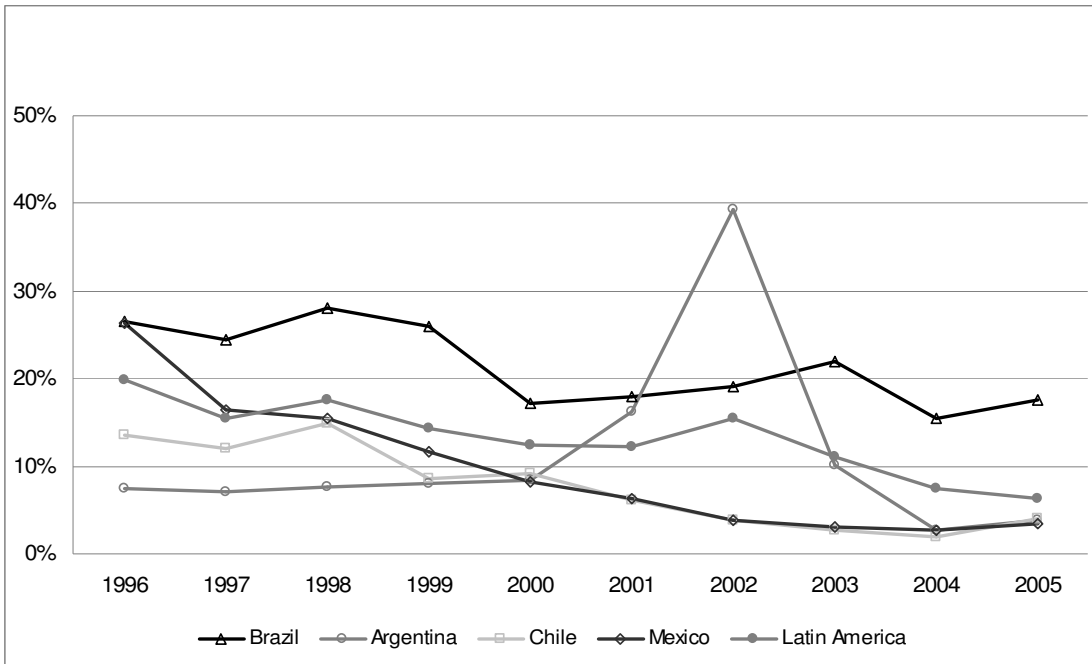


Figure 5B Inflation Rates (19 Latin American countries)

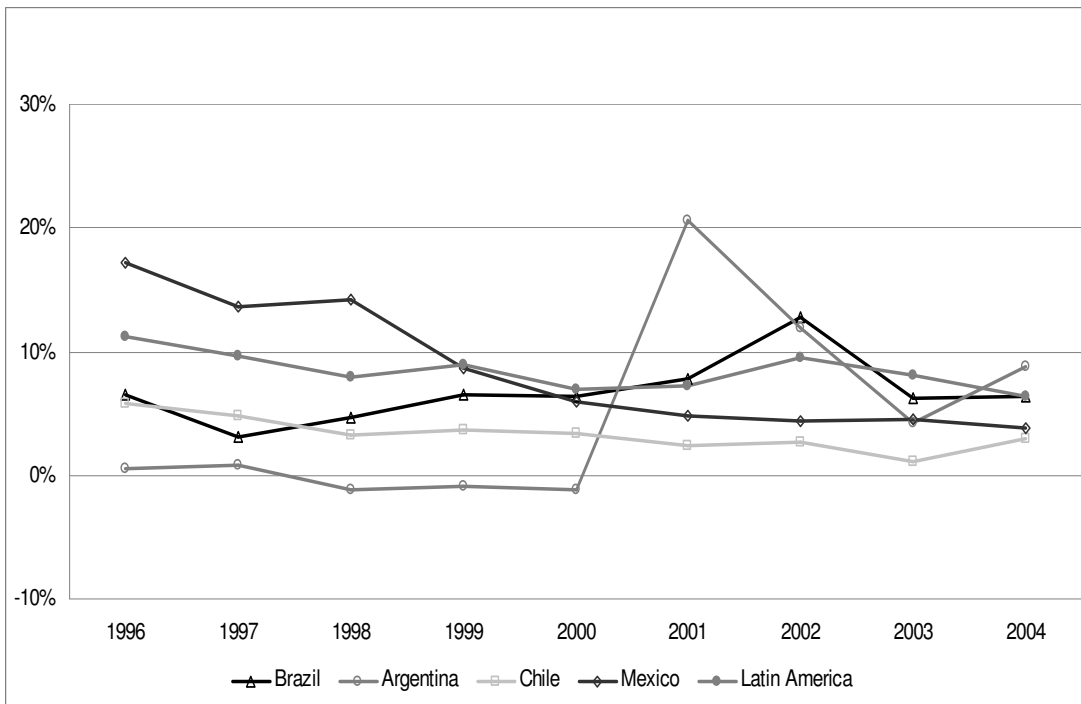
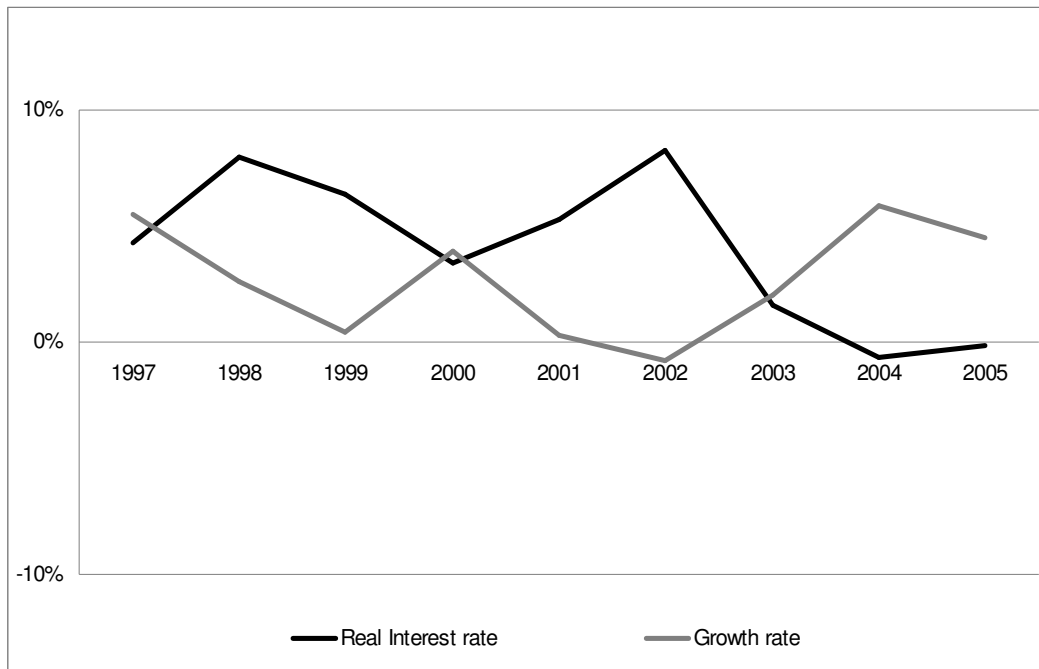


Figure 5B Real Interest Rate and Growth (19 Latin American countries)



Source: International Financial Statistics, IMF

Figure 5B shows that Brazil has had one of the lowest rates of inflation over the whole period. Also, Figure 5C shows that there is a clear negative correlation between high rates of interest and economic growth, which explains the relative poor performance of the Brazilian economy during Lula's administration when compared to other Latin American economies. The persistency of the high rates of interest throughout the whole period, even with compared with Latin American economies that share similar problems, indicates that the Brazilian situation results from a conscious policy decision. Furthermore, there is no evident break in policy management in Lula's administration. Over the whole period nominal interest rates fell only as inflation fell, and the real rate of interest has been around 10 percent, which is, as noted, among the highest in the world.

According to conventional wisdom interest rates are high in Brazil because of the lack of credibility that results from absence of fiscal responsibility. This is not verified empirically in the Brazilian case. Before discussing the effects of deficits on interest rates, the proper definition of the deficit must be clarified. If one argues that deficits lead to higher interest rates, one must not use the nominal definition of the deficit, which includes all revenues and all expenses, including interest payments. The reason for not

using the nominal deficit is that if the interest rate rises the nominal deficit also increases, because it includes the interest payments on accumulated debt. Thus, the proper measure is the primary deficit, which excludes interest payments, and is the non-financial difference between spending and revenue.

In general, those who believe that lack of credibility is at the root of high rates of interest in Brazil argue that primary deficits have reduced the credibility of monetary policy in Brazil after 1999. However, the Brazilian government has had primary surpluses since 1999. In fact, since 1985 only in four years there were primary deficits, and none above 1 percent of GDP. All in all Brazilian governments have been remarkably fiscally responsible.

A variation of the lack of credibility explanation is exposed by Arida, Bacha and Lara-Resende (2005). The authors note that there is no long-term credit market in Brazil, but there is “a large long-term credit market open to Brazilian debtors where the jurisdiction is foreign” (2005, p. 268). The authors conclude that jurisdictional uncertainty associated with the settlement of contracts explains the lack of long-term credit markets in Brazil and the extraordinarily high rates of interest since 1994. There are two problems with the jurisdictional uncertainty hypothesis. First, it would be better as a theory of high long-term rates, since there is no reason why a policy variable determined by the Central Bank should respond to jurisdictional uncertainty. Yet, the base rate determined by the Central Bank has been on average close to 15 percent since 1995. Jurisdictional uncertainty cannot explain high short-term rates. Second, and more importantly, jurisdictional uncertainty is not a new phenomenon in Brazil, and yet real rates on interest were not high before the Real Plan. In fact real rates were negative before 1994.

The alternative explanation may be termed the external financial fragility hypothesis. In this view, the main change that occurred in the Brazilian economy in the early 1990s was the liberalization of the capital account of the balance of payments. In this context, if the administration wanted to avoid the inflationary pressures caused by depreciation, as it did after 1994, the main policy instrument was to increase the rate of interest to avoid capital flight and stimulate capital inflows. High interest rates to control capital flows became central once the capital account was open. Thus, the fragility of the

balance of payments situation in which inflows and outflows can lead to severe crises, which was created by external liberalization, is the main cause of permanently high rates of interest.¹⁷

High interest rates also play an important role in changing income distribution. Although Brazil has maintained primary surpluses above 3 percent of GDP since 1999, nominal deficits have been around 5 percent. The difference corresponds to 8 percent of GDP and is made of interest payments to the owners of government bonds, including banks, pension funds, corporations and wealthy individuals. The share of wages in GDP has been compressed from 45.4 in 1991 to 35.6 percent in 2003 while the operational surplus, which includes profits, rents and interest payments, increased from 32.5 to 42.9 percent in the same period. Capital controls – that were widely used in the past, and have been used by several developing countries recently – would allow for lower rates of interest.

Capital controls reduce the pressure to use the interest rate as an instrument to avoid capital flight, and to manage the exchange rate. Lower rates of interest would translate directly into a reduced debt servicing burden for the federal administration, and would allow for the expansion of social spending. Contrary, to most authors that suggest that reduced interest rates should be used to promote a fiscal adjustment, we believe that nominal and primary fiscal deficits are necessary when the levels of unemployment are high. As we argued elsewhere,¹⁸ one of the perverse legacies of the Washington Consensus agenda was that counter-cyclical fiscal policies were eliminated, and permanent fiscal adjustment became the norm.

In addition to increase the fiscal space for social spending, lower interest rates would lead an environment in which income distribution might improve. Reduced income inequality, and expansion of credit would allow for the effective development of a more inclusive mass consumption society. The revitalization of domestic demand is central to promote a more equalitarian society.

In other words, to reverse the long cycle of social exclusion higher levels of social spending and more importantly higher levels of decent work should be created. The

¹⁷ For an explanation along those lines see Bresser-Pereira and Nakano (2002).

¹⁸ See Câmara and Vernengo (2004-5).

latter would only be possible in an environment that resembles what Keynes referred to as the euthanasia of the rentier, that is, capital controls and relatively low rates of interest. This would require also dismantling the financial process of capital reproduction and income concentration that has emerged after the 1980s lost decade and consolidated after the Real Plan under both the social democrats and the Workers' Party.

Concluding Remarks

The Brazilian society has a long history of social inequities that are ultimately connected to its colonial past, and the form in which the economy was integrated into mercantile capitalism. The long period of development that started with the Great Depression was unable to eliminate some of the major inequalities, and despite the improvement in social indicators, the Brazilian society remained essentially unequal. There was an incredible hope that redemocratization, that started in 1985, would lead to a considerable reduction of social and economic inequalities.

Conventional wisdom suggests that the reforms of social policies after the 1988 Constitution were somehow instrumental in explaining social progress. Yet, the rise in life expectancy, the fall in illiteracy rates, the fall in infant mortality and the reduction of fertility rates have a long history of improvement, and have coexisted with one of the highest levels of inequality in the world. Hence, recent social policy reforms have a limited role in explaining the evolution of social indicators. The election of Lula led many to believe that Brazil was mature enough to start paying its incredible social debt.

However, some authors put forward the notion that Lula's social policies mark a break with the 1988 Constitution emphasis on broad universal social policies. In our view, even if Lula's policies put more emphasis on targeting – something that is far from clear – it seems that the crucial element in both Lula's social policies and those of his predecessor is that social spending has been squeezed by the financial needs of the State, and that employment generation has been insufficient to eliminate the enormous inequalities of Brazilian society. The problem with Lula's social policies, in our view, is that they do not break with the secular pattern of income inequalities, and, in fact, stimulate increasing social injustice.

It is true that cash transfer programs like Bolsa-Família have been expanded exponentially and that the minimum wage increased have accelerated somewhat, and that may, in part, explain the relatively easy re-election of Lula for a second term starting in 2007. Yet, high rates of interest, which imply high remuneration for the wealthy, have become the hallmark of the post-liberalization period, and Lula's macroeconomic policies have been a continuation of those of Cardoso. Social policies have been confined to a secondary role, and are absolutely incapable of eliminating the vast inequities of Brazilian society. If the long history of social exclusion was associated for a long time to the type of integration with international markets – one that implied that land tenure would be unevenly distributed and one that would use forced labor – the new inequality is also directly connected with the form of integration to international markets. Inequality now results from an open financial account and the highest real rates of interest in the world. A perfect match for one of the highest levels of inequality in the world!¹⁹

More significantly the social policies of Lula's administration are, as much as those of his predecessor, envisioned as handouts for the needy, and are disconnected from the creation of decent employment and redistribution of income. The hallmark of left of center governments, historically, had been the integration of universal social policies tied with full employment policies, and the search of a more equalitarian income distribution. To the extent that the Workers' Party broke off with its preoccupations with full employment and income distribution it has become more attuned with the movement of several left of center parties – like the New Labour rejection of the socialist elements of its platform in the United Kingdom or the New Democrats rejection of some of the policies associated with the New Deal in the United States – which accepted Thatcher's *motto* according to which 'there is no alternative.'

The key for more efficient social policies is, then, a more closed financial environment that would produce the Keynesian 'euthanasia of the rentier.' To guarantee the euthanasia of the rentier, Keynes pointed out that the central bank should be able to

¹⁹ If the book by Gilberto Freyre (1933) *Masters and Slaves (Casa Grande & Senzala)* was the classic description of the inequalities of the colonial plantation society, even if it understated racial conflict, a fitting title for the portrayal of the current inequalities should be *Financial Masters and Slaves (Conta de Juros Grande & Senzala)*.

set the rate of interest independently from any international pressures. Hence, capital controls are the necessary complement to Keynes' fiscal policy proposals for full employment generation, and unless Lula and his Workers' Party²⁰ reverses the anti-Keynesian bias of their policies there is little chance for a more equitable and civilized society in Brazil. Only then, Brazilian society might reduce "the disparity between what we are and what we hoped to be," which as Furtado (1999, p. 26) suggested "has in no other period of our history been so large."

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²⁰ At the time we are writing Lula has just obtained his re-election in 2006, which would guarantee another four years of Worker's Party administration.

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