THE BRAZILIAN ECONOMY

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The BRAZILIAN ECONOMY

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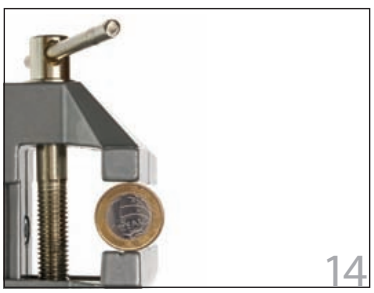
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Moderate leftist regimes that combine social inclusion, a protective nationalism regarding natural resources, and macroeconomic stability are moving to a common agenda in Latin America, says Patrícia Campos Mello, leaving radical leftist regimes in the dust. She analyzes the shared values of the consensus and whether it can be sustained if the economic circumstances change.

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Without the record-high 2011 tax revenue and with spending pressure mounting, the Rousseff administration will face hard choices in 2012. Experts consulted by Solange Monteiro identify problems like Brazil's habit of ramping up spending in election years and how social spending displaces such activities as investment.

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23 A conflict between social and economic goals

Reform of social security, which even the OECD considers too expensive, is desperately needed. Kalinka Iaquinto analyzes possible options for reform relating to the minimum retirement age, new rules for retirement by public employees, the end of the social security factor, and new pension eligibility rules.

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Social Security Minister Garibaldi Alves Filho talks with Kalinka Iaquinto about how the different pension regimes that make up social security can be reconciled, why the timing is right for changes, what types of changes there might be, lessons from what is happening in Europe today, and why economic credibility is important.

ECONOMY

Trade sets a record

In 2011 Brazil recorded US$256 billion in exports and a US$29.7 billion trade surplus, thanks to high commodity prices and Chinese demand. Exports to China, which represent 17% of total Brazilian exports, reached US$44.3 billion, more than 43% higher than in 2010. (January 3)

Foreign exchange inflows rose

Despite outflows in the fourth quarter, net inflows for 2011 totaled US$65.3 billion, up from US$24.4 billion in 2010. Central bank foreign exchange reserves rose by US$63.4 billion to US$352 billion. (January 5)

Consumer defaults up

Consumer defaults rose by 22.4% in the first 11 months of this year compared to the same period of 2010, according to Serasa Experian. (December 12)

Retail sales stalled in October

The Brazilian Institute of Geography and Statistics (IBGE) reported that in October retail volumes showed no growth from September. Brazilians reined in spending because inflation nearing six-year highs has eroded their purchasing power, and despite low interest rates households are hesitant to take on more debt. (December 13)

Unemployment falls; income holds steady

Unemployment in Brazil dropped to a 5.2% record low in November. Employment grew 1.9% year-on-year, up from 1.5% in October. However, the real average grew only 0.7% year-on-year. (December 22)

Industrial output sluggish

After three consecutive monthly drops, industrial output in Brazil rose 0.3% in November, but the recovery was not strong enough to signal a solid rebound for an economy that stalled in the third quarter. According to IBGE, November's industrial production fell 2.5% compared with a year earlier. (January 5)

SOCIETY

11.4 million Brazilians live in slums

The 2010 census found that 11.4 million Brazilians, 6% of Brazil's population and equal to the population of Greece, live without public services or urbanization in illegal areas, such as slums, stilt houses, caves, and villages. In the case of basic services, the major difference between slums and legally occupied city areas is the number of houses with adequate sewage systems. (December 21)

INTERNATIONAL

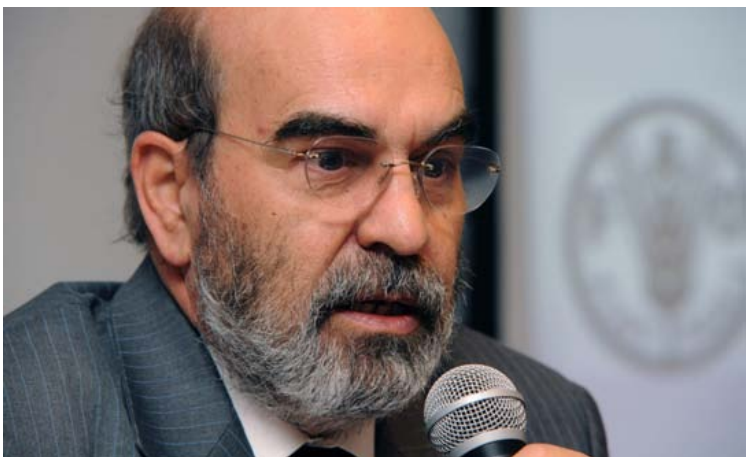


Photo: Elza Fiúza/ABr.

FAO Director José Graziano da Silva

FAO priority: End hunger in Africa

The existence of more than 925 million people suffering from chronic malnutrition does not seem to scare José Graziano da Silva, the Brazilian who is the new director of the UN Food and Agriculture Organization. "As our resources are limited, we will focus on Africa, especially the countries of North Africa. We cannot lose time," Graziano said. (January 1)

U.S. ends surcharge on Brazilian ethanol imports

Pressured by the economic crisis, the U.S. Congress ended a 31-year commercial duty of US$0.54 per gallon on Brazilian ethanol; it expired on December 31. For Brazilian producers, this is the first step toward a global market for ethanol as a commodity. (December 24)

LAW

National Council of Justice powers curtailed



Photo: José Cruz/ABr.

Inspector General of Justice Eliana Calmon

Federal Supreme Court Justice Marco Aurelio Mello suspended the powers of the National Council of Justice (CNJ) to investigate judges, determining that the agency can only act after investigation by local judiciary internal affairs units. The full Supreme Court will review the injunction early in February. Until then, CNJ investigations will be paralyzed. Eliana Calmon, Inspector General of Justice, refuted charges that the CNJ is breaching the confidentiality of judges and Justice employees. (December 19)

DEFENSE & SECURITY

EMBRAER sells aircraft to Indian government

The maiden flight of the first of three EMB 145 Airborne Early Warning and Control aircraft ordered by the Indian government was successful. Brazilian aircraft maker Embraer has a strong presence in the Indian market and counts both the national government and private businesses as customers. (December 6)

Borders: 115 tons of drugs seized in six months

The Strategic Plan for Borders seized 115 tons of marijuana and cocaine between June and December 2011 — 14 times more than in the same period last year. The action plan for 27% of Brazil's borders involves 710 municipalities in 11 states, and 10 neighboring countries. Brazil's vice-president Michel Temer called the results extraordinary. The operations will continue in 2012. (December 15)

Photo: Embraer.



EMB 145 Airborne Early Warning and Control aircraft

ECONOMIC POLICY



Photo: José Cruz/ABr.

Central Bank Governor Alexandre Tombini

Important policy shift signaled

President Rousseff said Brazil would target growth of 5% in 2012 and underlined that the authorities would work to maintain a strong fiscal position that allowed for cutting interest rates to stimulate growth while bringing inflation down. The authorities expect a large external shock, which would allow benchmark interest rates to fall from the current 11 percent into the single digits. (December 19)

Congress approves 2012 budget

After intense negotiations and even exchanges of insults, Congress approved the budget proposal for 2012. As requested by the administration, the budget does not include adjustments for public employee salaries or social security pensions. The situation of retirees was the primary sticking point. It was promised that President Rousseff would discuss a permanent policy of pension readjustment. (December 23)

Inflation target barely met in 2011

The Brazilian Central Bank said today that according to official inflation figures for 2011, current monetary policies were "consistent with declining inflationary pressures." Central Bank Governor Alexandre Tombini said that there are indications of a consumer inflation downward trend in that wholesale price inflation has been declining. The annual official inflation rate of 6.5% hit the upper limit of Brazil's target band under the government's inflation-targeting program. (January 6)

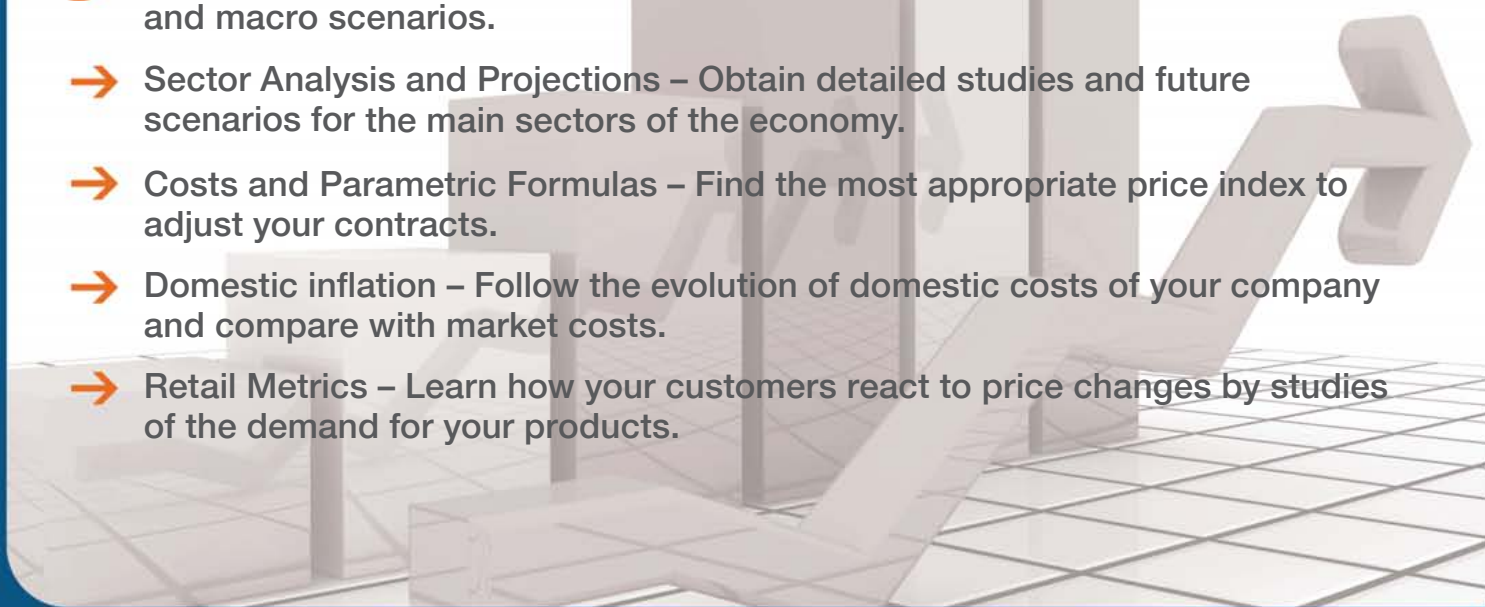
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Are we mortgaging our future?

The 1988 Constitution quite rightly calls on Brazil to take care of the poor. The question is whether we're doing it the right way.

From 2001 to 2011 the Brazilian government managed to keep direct operating and fixed capital expenses stable, but transfers for the social safety net surged. During that time transfers to households took up 70% of government primary spending. That left only 29% for education and health and barely 0.3% for investment. In fact, Brazil spends twice as much on pensions as the OECD average.

As the current pension system is designed, it offers incentives for Brazilians to leave the labor force—just when Brazilian companies are desperate for more and better skilled employees. By squeezing out education and health, the system also makes it harder to educate people, young or old, for the jobs that are begging for candidates.

There may also be international repercussions: Vagner Laerte Ardeo says that "If the market believes that our fiscal stance is not sustainable because of social security commitments, Brazil can fall out of favor." The social safety net is enmeshing every aspect of Brazilian life and trade.

Like everyone else, we're delighted that so many more Brazilians have joined the middle class. However, members of the the new middle class are prevented from increasing their productivity and wealth because public health and education are poor, infrastructure is in ruins, and the government overregulates the economy. So the new middle class is paying for transfers for the social safety net and public employee salaries and getting little in return. Properly supported, a dynamic new middle class would be the key to generate wealth and tax revenues so that Brazil could balance its budget.

Professor Francisco Lopreato thinks it's possible that Brazil can invest more without changing the current model of transfers to the poor, but there are a lot of ifs in his prescription: "If we can reach international interest rate levels," we can lower public debt. If we fully exploit deep sea oil, it could produce tax revenues equal to 3.5% of GDP. In other words, if all goes well . . . maybe years down the road, social transfers will no longer dominate the budget.

The budget outlook for this year is already worrisome. Brazil is expecting lower GDP growth and less in tax revenues — and in addition there has long been a tendency to spend more in election years.

Meanwhile, the budget outlook for this year is already worrisome. Brazil is expecting lower GDP growth and less tax revenues, and besides what has to be spent on infrastructure to meet our international commitments, José Álvaro Moisés points out another problem: "The tendency to spend more in election years is part of the Brazilian political culture," he says, "but from the standpoint of fiscal policy, it's a structural problem."

There have been proposals that might relieve some of the fiscal pressure, like the Supplementary Pension Fund for Federal Public Employees. But the Brazilian economy cannot function well as long as the administration and the legislature are only willing to consider short-term solutions when the problems require that they think long-term, beyond the next election and the next pension payment — and that they also think about the implications of their short-term decisions for coming generations of Brazilians.

Maybe, in fact, what Brazil really needs now is a fiscal equivalent to the Real Plan. However, it's difficult to figure out what the Rousseff administration's long-term strategy really is. Perhaps we'll finally learn in 2012.

Finding the key to the Brazil-U.S. relationship

Despite grand rhetoric, engagement between the U.S. and Brazil has been elusive. Part of the problem stems from differences in perception: The U.S. still approaches Latin America with a mentality left over from the cold war. Brazil seeks recognition from Washington as an emerging power.

João Augusto de Castro Neves, *Washington D.C.*

Brazil is the key to Latin America," U.S. Senator Richard Lugar said last December. The observation of the Republican chair of the Foreign Relations Committee echoed that of another American leader four decades earlier. For President Richard Nixon, Brazil was the "key to the future" of U.S policy toward all of Latin America. Considering the ebb and flow of the relationship in the past few decades, marked by what some would call benign indifference, the analogy is somewhat puzzling.

Briefly during the cold war the U.S. government devised the idea of elevating bilateral relationships with several regional powers so as to share some of the burden of its global Communist containment policy. It is reasonable to believe, therefore, that the key-country reference was to Brazil's importance on Latin America's strategic chessboard. Recent historical accounts, however, suggest that, despite the ambitious rhetoric, engagement between the two countries at the time was rather elusive.[1]

Since the end of the cold war, Brazil-U.S. relations have been difficult to characterize with a simple label. Notwithstanding many shared characteristics and values between the two biggest democratic economies in the Western hemisphere, the bilateral agenda has been somewhat unambitious compared to other countries in the region or other rising powers. The fact that the similarities and possibilities for cooperation do not translate into substantive policies signifies, to some officials on both sides, a paradoxical discord.

Part of the problem stems from different perceptions. Brasília seems to have a hard time drawing attention from the American foreign policy establishment. Washington still approaches Latin America with a mentality reminiscent of the cold war. Brazil often perceives U.S. policy initiatives in the region as responses to other issues

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that alarm Washington — concerns about Communism and, more recently, about populist nationalism, terrorism, and the growing pull of China's economic presence often drive the U.S. Latin American agenda.

This perception, however, tends to distort political and economic nuances within the region. Many Washington policy initiatives that some countries see as promising opportunities are met with skepticism or even resistance by Brazil. Examples are free trade negotiations and, to a certain degree, military cooperation. Furthermore, it is difficult to imagine Brazil having any influence over U.S. relations with Mexico, Central America, Colombia, or even Chile. It seems that the idea of Latin America still widespread in Washington policy circles is outdated. Since the late 1990s, for example, Brasília has pulled in its regional strategic boundaries to encompass only South America.

There are also obstacles on Brazil's side to deepening U.S.-Brazil relations. There is a fine line between a more assertive foreign policy and an anti-Americanism that easily creeps into the diplomatic rhetoric. In fact, one of the drivers behind Brazil's regional initiatives was the fear of American economic and military influence on Brazil's close neighbors. In part, that also seems to be the case with the country's more recent strategy to forge coalitions of emerging powers, such as the BRICS, to exert more global influence.

Brazil often perceives U.S. policy initiatives in the region as responses to other issues that alarm Washington.

Nevertheless, there is certainly room for progress when it comes to trade negotiations and cooperation in areas like technology and energy. But unlike other major economies in the region, Brazil does not seek a free trade deal or aid. When it comes to the U.S., Brazil's interests resemble those of other major rising powers, such as India. President Obama seemed to comprehend this when he said in visiting Brazil last March that it was time to treat engagement with Brazil "as seriously as we do with nations like China and India." Naturally that should set a positive tone for President Rousseff's visit to Washington this coming March. The currency between Washington and Brasília, therefore, is recognition. That is the real key that may open the door to a deeper relationship in the future.

[1] See *Kissinger and Brazil*, by Matias Spektor (2010).

The Brasília consensus

Moderate leftist regimes are consolidating in Latin America. This "Brasília consensus" is superseding radical leftist regimes. The big challenge is how countries can sustain the consensus despite international financial crisis and an expected weakening in commodity prices.



Photo: Lula Marques.

Patrícia Campos Mello

As he took office July 28, Peruvian President Ollanta Humala promised to govern "Peru for all," echoing the words of his mentor, Luiz Inácio Lula da Silva, who spoke of "Brazil, a country for all." Humala announced the expansion of an income transfer program, Juntos, similar to Brazil's Family Grant. He also decreed an increase of 12.5% in the minimum wage and stressed that his priority is growth with social inclusion. The speech was co-written by Louis Favre of Brazil's Labor Party (PT), who organized Humala's election campaign.

Hugo Chavez, a former inspiration for leftist Humala, was not mentioned, even indirectly.

The victory of Humala in Peru's presidential election — and his first six months of government with many moderate initiatives and a centrist Cabinet — advances the "Brasília Consensus." Moderate leftist regimes that combine social inclusion, a protective nationalism regarding natural resources, and macroeconomic stability are consolidating in Latin America.

The greatest symbols of this new consensus are Brazil, Uruguay, and El Salvador. The Nobel laureate Mario Vargas Llosa, a well-known free market advocate, supported Humala in this election and wrote about the new consensus in the Spanish newspaper *El Pais*:

> "In order for those [social] programs to be successful, it is essential that Peru continue to grow as in recent years; otherwise there

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will be no wealth to distribute. The Chilean, Brazilian, Uruguayan, and Salvadoran socialists understood this and, though still calling themselves socialists, they have made social-democratic governments."

In South America only two countries have largely center-right governments, Chile and Colombia, and even they are moving to a center-left agenda, except in national security.

During the Alan García administration, Peru followed strictly the precepts of the Washington consensus on attracting investment and liberalizing trade. It signed trade agreements with the United States, China, and the European Union, among others. The country became a great success story in the region, with its average growth of 7.2% over the past five years among the highest in the world.

But Peru neglected its social programs, and that was a determining factor for the election of Humala. Poverty had been reduced, but the disparity between the coast and Lima, the rich, and the highlands and the Amazon, the poor, was still very large. This led to popular dissatisfaction and the perception that the fruits of large foreign direct investment in exploitation of natural resources were not being equitably distributed.

Michael Shifter, president of the Inter-American Dialogue (who coined the phrase "Brasília Consensus"), said that the Peruvian election was "a coup against the right," which believed that good policies and economic growth would be enough to solve the poverty problem.

The prescription of the Brasília Consensus combines policies that could easily be on the neoliberal agenda with measures that would scare the hell out of the orthodox.

Countries like Brazil, Uruguay, and El Salvador, the greatest symbols of the consensus; hybrids Argentina and Paraguay; and Chile and Colombia at the center-right are moving to the Brazilian model. They bet on the paradigm of macroeconomic stability — central bank independence, fiscal stability, a floating exchange rate. They share a concern for social inclusion and embrace, to a greater or lesser extent, conditional income transfer programs and raising the minimum wage.

This is a different left from what is found in Venezuela, Bolivia, and Ecuador, where the leftist project is centered on more radical

In South America only two countries have largely center-right governments, Chile and Colombia, and even they are moving to a center-left agenda, except in national security.

The prescription of the Brasília Consensus combines policies that could easily be in the neoliberal agenda with measures that would scare the hell out of the orthodox.

income distribution, honoring socialist precepts. The Bolivarians also tend to resort to changes to the constitution to perpetuate their leaders in power.

However, the Brasília Consensus also embraces some aspects that are less palatable to those embracing the Washington consensus. Some countries are betting on industrial policies with echoes of the import substitution advocated by Raul Prebisch, which is anathema to neoliberals. Humala said that he will invest in that kind of initiative and Argentina is also heading in that direction. Even Brazil's initiative to require suppliers to include more local content in oil rigs for the state-owned oil company, Petrobras, can be seen as part of a program of import substitution.

Another constant in the Brasília Consensus is nationalism as it relates to exploitation of natural resources. In Brazil, the regulatory framework for mining, which is stalled in Congress, is expected to increase the royalties from natural resource exploitation. And one of the priorities Humala has announced is to increase the taxes paid by mining companies. He promises, however, to follow the Chilean model of negotiating with mining companies without breaking contracts.

The Brasília Consensus — which *The Economist* prefers to call Lulism — is rising just as Chavez and the Bolivarian left are in frank decay. Before his illness was revealed, Hugo Chavez's popularity as president was below 50%, historically low. Venezuela is fighting numerous economic problems. While the rest of South America has achieved high growth, Venezuela is emerging from two years of recession. Oil production is falling, blackouts are frequent, and the city of Caracas has the highest murder rate in the region.

The big challenge for other Latin American countries will be how to sustain the Brasília Consensus in a less benign international environment. The international financial crisis, the high indebtedness of European governments, and the prospect of slow growth in the United States foreshadow a weakening in commodity prices. Brazil has relied on high prices of commodities to maintain its model of income distribution; there has been no significant fiscal adjustment.

Without bonus income from commodities, Brazil and other Latin American countries that export commodities will need to revise their tax revenue model to sustain their efforts to pursue social inclusion.

IBRE ECONOMIC OUTLOOK

The Brazilian economy and macroeconomic scenarios

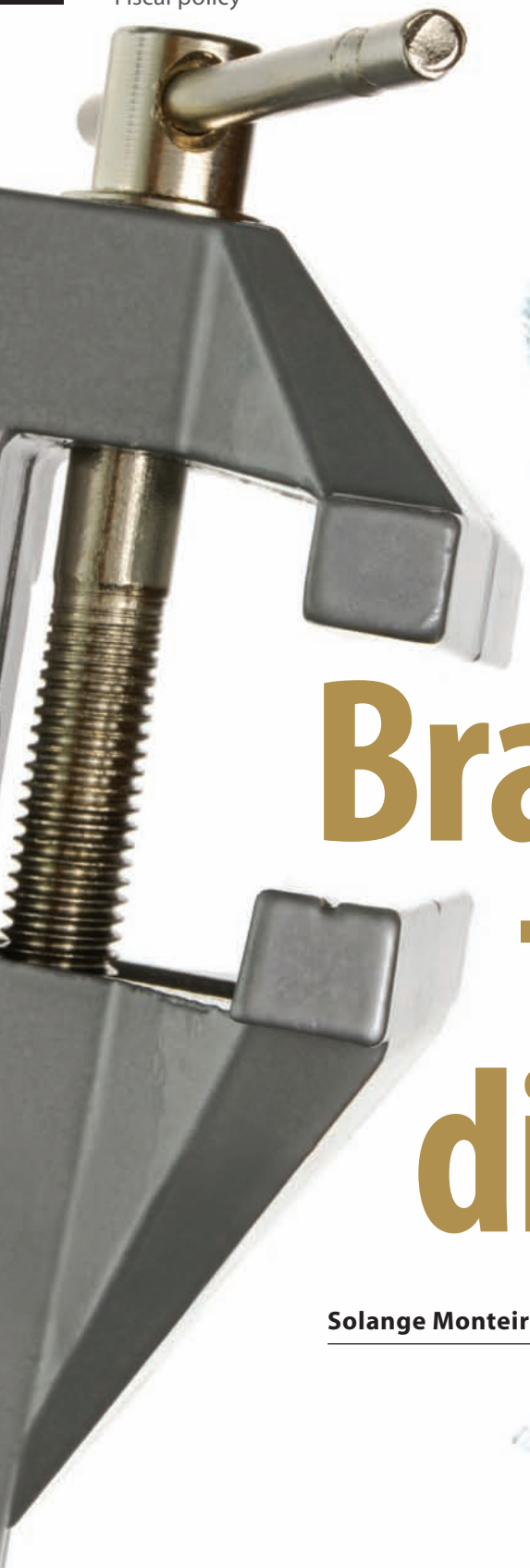
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Brazil's fiscal dilemma

Solange Monteiro, *Rio de Janeiro*





In a break with the expansionist policies of former President Lula, President Rousseff ended her first year in office with expenditure cuts. However, without the record-high 2011 tax revenue and with spending pressure mounting, her administration will face hard choices in 2012.

When Dilma Rousseff became president in January 2011, the markets and society had mixed feelings about whether there would be continuity with the previous administration. In terms of fiscal policy, the previous two years had been markedly expansionist, with the Lula administration adopting countercyclical policies in 2009 to stimulate an economy confronting international crisis and questionably increasing public spending in the election year 2010. There was considerable uncertainty about the Rousseff government's ability to adjust the public budget.

Rousseff began by announcing a budget cut of R$50 billion, spent much political capital to keep the minimum wage adjustment (which involved no gain in real terms in 2011), and achieved a central government primary budget surplus for January through November of R$91 billion; the full-year target was R$92 billion. Political consultant Cristiano Noronha (see list of interviewees at the end of this article, p. 20) says, "The government has managed to create good expectations."

This took more than political skills alone. Tax revenues grew at twice the GDP growth rate: taxes collected in the first 11 months of 2011 totaled R$873 billion, 12% more than in the same period in 2010. "I would say this is big news," says economist Mansueto Almeida, although he points out that since 2009 Brazil has increased revenue more than it has cut spending. The positive combination of increased revenues and ability to meet the minimum wage goal — a key part of

Taxes collected in the first 11 months of 2011 from January to November totaled R$873 billion — 12% more than the same period in 2010.

In 2012 Rousseff will have to demonstrate that she has a consistent fiscal strategy that can meet demands for investment and increased social spending despite a lower tax revenue forecast.



Photo: Velela/Wikipedia.

the government's social policy and the most sensitive point in the public budget — will not happen again. That is why some analysts believe that in 2012 Rousseff will have to demonstrate a consistent fiscal strategy that can meet demands for investment and increased social spending despite likely lower tax revenue. "Rousseff did not use 2011's extraordinary revenue to invest but instead opted to control spending, following a commitment of the Central Bank to cut interest rates," says consultant Raul Velloso. "There are many unknowns about how she will continue."

Compared to 2011 the budget outlook is unfavorable. "The GDP growth that we had in the second term of the Lula government, 4.5% a year, was a window of opportunity that is closed," says economist Samuel Pessoa. Certainly the current policy of adjusting the minimum wage in line with the previous year's inflation plus the GDP growth of the previous two years leaves little room for maneuver. Almeida believes that "This policy has a very high cost because you're giving increases in real terms, and simultaneously you have a natural increase in the number of social program beneficiaries, especially social security at 3.5% to 4% a year. The tendency of that spending is to grow." Meanwhile, increased infrastructure spending, especially related to the World Cup and the Olympics, will leave little room for cuts in investment in 2012. "There's no other way than reducing the primary budget surplus," says public finance specialist Gabriel Leal. "The government will find it hard to meet its target" for 2012. The Brazilian Institute of Economics (IBRE) estimates a surplus of 2.5% of GDP for 2012 compared with 3.2% in 2011.

To prepare the ground for 2012, last year the government worked to prevent Congress from approving measures that would require more public spending. Noronha

says that here the government was very effective, but he points out that the numerous confrontations weakened the governing coalition. "With this year's municipal elections, there is a greater risk of coalition breakdown," he says (see p. 21), and of course pressure for more spending. "The tendency to spend more in election years is part of the Brazilian political culture, but from the standpoint of fiscal policy it's a structural problem," says academic José Álvaro Moisés. Another consequence of such recklessness is the continuing rise in outstanding commitments, a major fiscal risk.

Even with the administration's efforts in Congress, Almeida predicts, despite government optimism, that public spending will hit new records by the end of Rousseff's term. He estimates that by 2014 there will be another R$104 billion in annual spending on investments and welfare and social benefits. That would mean a jump of 1.4 percentage points of GDP over the next three years. "In the Lula administration," he says, "these expenditures increased 1.2% of GDP in the first term and 1.1% in the second." He predicts that central government investment will rise from 1.3% of GDP in 2010 to 1.5% in 2012 — though in fact this is much more a hope than an estimate, given the pent-up demand for better infrastructure.

The current policy of adjusting the minimum wage in line with previous year's inflation plus the GDP growth of the previous two years leaves little room for maneuver.

SOCIAL MODEL

A question permeating the market is whether the administration has a formula to change the fiscal policy mix, which is growth in social spending, tax revenue growth to fund the spending, and very little room for more public investment. Because it takes time for the government to cut operational costs, investments will have to be cut in the meantime. Operations carry both administrative costs and costs for such social programs as subsidies to low-income housing and unemployment insurance, which have been growing steadily. "Since 1999, whenever Brazil tries to make a strong short-term fiscal adjustment, it ends up cutting public investment," says Almeida.

This is corroborated by a study from the Institute of Applied Economic Research (IPEA) on government primary expenditure (excluding interest payments) from 2001 to 2011. IPEA found that while direct expenditures for government consumption and fixed capital expenditures have been stable, transfers — the social safety net enshrined in the Constitu-

To prepare the ground for 2012, last year the government worked to prevent Congress from approving measures that would require increased public expenditures.



Photo: Bruno Spada/MDS.

tion of 1988 to increase the purchasing power of the poorest — have expanded considerably.

For 2001–11 government primary spending as a share in GDP increased by about 2.7%; transfers to households accounted for just over 70%, education and health transfers for 29% and investment for just over 0.3%.

INFRASTRUCTURE AND THE INTEREST RATE

Given the social model of income transfers, Pessoa says, Brazil's subways, roads, and airports will continue to be congested: "To have better infrastructure we would need to save much more than we save, and saving little means there must be more social transfers. That's what society wants." For Almeida, a possible alternative would be for government to rely more on concessions to improve infrastructure: "It's a way to increase investment without pressuring fiscal spending . . . the private sector bears the cost of investment."

But Professor Francisco Lopreato argues that it is feasible to invest more without changing the model of current transfers. "Achievements such as the minimum wage policy and the Family Grant raised Brazil to the next level, and now there is no way back," he says. Meanwhile, he says, "This government is starting to accomplish something that neither Lula nor Fernando Henrique Cardoso did: the removal of indexation of public debt to the central bank benchmark interest rate. But that is taking place slowly."

With regard to public debt, high interest rates distort a relatively comfortable outlook. At 37% in November, Brazil's debt-to-GDP ratio compares well with many other countries. "In Japan, it exceeds 100%, [but] the important difference is that interest payments [in Japan] are equivalent to only 1% of GDP," Lopreato says. Almeida adds, "If we can reach international interest rate levels, it would mean

a major breakthrough, because currently interest payments on public debt are 5.4%." He cites another potential source of income: "Annual tax revenues from deep sea oil could reach 3.5% of GDP, when it has fully exploited its potential," he says.

To earn a fiscal windfall from a decline in interest rates, the need for saving more in the short term is clear, so the Rousseff administration must make tough decisions. "Holding off on adjusting public salaries is important," Pessoa says. "President Lula made all the adjustments to salaries — now it's time to tighten our belts." He also advocates a significant drop in funds transferred from the Treasury to the National Bank for Economic and Social Development (BNDES), even for private parties involved in public concessions. "We need to make concession contracts at higher rates. We will pay more, but it is a way to increase the country's savings," he says. "If you refuse to touch anything, inflation will return." However, Treasury Secretary Arno Augustin disagrees on one point: "With the work of BNDES, we left behind a long period of low investment." He points out that gross fixed capital was only 15% of GDP in 2003 but is now about 20%.

OPEN DEBATE

Leal points out that an alternative for restricting public spending is Complementary Law Project 549/09, which the House Committee on Constitution, Justice and Citizenship is considering. It would amend the Fiscal Responsibility Law to limit spending on federal government personnel and social charges to the amount paid in the previous year, adjusted for inflation plus 2.5% of real gain or by the rate of GDP growth, whichever is less. "Its approval would be a great commitment to fiscal balance in the medium and long term," Leal says. However, given the strained relations between the government and public employees over salary adjustments, the law is not likely to be approved this year.

"The tendency to spend more in election years is part of Brazilian political culture, but from the standpoint of fiscal policy it's a structural problem."
José Álvaro Moisés

Almeida argues that the most important fiscal adjustments will only happen if the government takes advantage of today's good economy to involve society in the discussion, even if there is a cost in administration popularity. He believes that if the need for change is not explained, the president will not be able to convince the population — which favors policies that have immediate impact on

"Today Brazil spends 3% of GDP on pensions, while the average spending in OECD countries is 1.5%."

Gabriel Leal

INTERVIEWEES

ARNO AUGUSTIN, Treasury Secretary.

MANSUETO ALMEIDA, economist, Institute of Applied Economic Research, Brasília.

LOPREATO FRANCISCO, professor of economics, University of Campinas.

GABRIEL LEAL, public finance analyst, Brazilian Institute of Economics of Getulio Vargas Foundation.

JOSÉ ÁLVARO MOISÉS, scientific director, Center for Public Policy Research of the State University of São Paulo.

CRISTIANO NORONHA, partner, Arko Advice political consulting.

SAMUEL PESSOA, consultant to the Brazilian Institute of Economics of Getulio Vargas Foundation.

RAUL VELLOSO, director, ARD Consulting Associates.

purchasing power — to think long-term, saying, "The president must make it clear that if we do not make any adjustment on the expenditure side, she will have to impose on society a higher tax burden." Among the changes experts support is a review of the policy of granting social benefits to eliminate inconsistencies that distort some social programs. Leal cites as an example current pension system rules: "Today Brazil spends 3% of GDP on pensions, while average spending in OECD countries is 1.5%." Economist Almeida argues for stricter criteria for granting unemployment insurance; currently disbursements are increasing even with the record growth of formal employment in Brazil.

One move that could open 2012 on the right foot would be approval of the Pension Fund of Federal Public Employees, the vote on which was postponed to February. With just over 3% of all social security beneficiaries, social security for public employees recorded a deficit of R$56 billion in 2011. Social Security Minister Garibaldi Alves Filho says that over the next five years 40% of federal employees will be able to retire. If only half actually do so, they would add 220,000 pensioners. Almeida says, "That would have a devastating effect on social security, since the current average pension is R$10,000 a year."

Such a change would be an important signal: "In 2011, Rousseff showed austerity in discretionary spending, but that is a relatively small part of total government spending," says Velloso. "Decisions of much greater impact, such as pension reform and long-term control of personnel spending, will reveal her true fiscal policy. Only at the end of 2012 will that become clear."

Public budget under pressure in election year

The municipal elections scheduled for October 7 will also play against Rousseff administration plans to curb public spending. Historically Brazil has approved more projects and released more funds in election years. "Populist use of the mechanics of government increases with congressional pressure for amendments to the budget and release of resources," says Cristiano Noronha, partner, Arko Advice political analysis.

Senators and representatives support the campaigns of allies, and expect to be repaid when they face reelection themselves. Also, when members of Congress are candidates for city hall, that affects the pace of legislative activity. Noronha predicts a downturn in legislative work starting in May because in June the parties will hold their conventions.

Research by Arko Advice last October found that a year before the elections, 79 deputies and 5 senators had already stated their intention to run for municipal governments, and another 97 members, about 10% of the House, were undecided.



Source: Elza Fiúza/ABr.

Political parties race for leadership.

	Number of elected mayors				
Party	1992	1996	2000	2004	2008
PMDB	1,605	1,295	1,257	1,059	1,203
PSDB	317	921	990	870	786
PT	54	110	187	410	557
PDS/PPR/PPB	363	625	618	550	550
PFL/DEM	965	934	1.028	790	496

Source: Arko Advice.

Although allies in the coalition that supports the Rousseff administration, the Labor Party (PT) and the Brazilian Democratic Movement Party (PMDB) will run independently and try to elect as many mayors as possible, which may cause difficulties for management of the government coalition.

Arko Advice found that in 2012 the PMDB expects to elect 1,300 mayors, up from 1,203 in 2008. Since 1992 PMDB leads in the number of mayors. However, for the PT corruption scandals in 2006 dashed city hall hopes; now Arko estimates that the PT will try to elect 700 to 800 mayors. For this, PT will benefit from federal income distribution programs as well as the support of former President Lula.

The Brazilian Social Democracy Party (PSDB) needs to recover from a downward trend. In 1996, the first electoral contest after the Real Plan, PSDB nearly tripled the number of mayors to 921. It increased its representation slightly to 990 mayors in 2000 in the last race with Fernando Henrique Cardoso as president. PSDB power declined to 786 mayors in 2008.

Among the 26 capitals and 53 other municipalities that have more than 200,000 voters, the PT elected the largest number of mayors, 21, against 17 for the PMDB. These are the cities where the contest will be tough, because they are economically stronger.

Unemployment benefits: An inefficient model

One of the most striking examples of inefficiency in the government's income transfer model is unemployment benefits. A study by economist Mansueto Almeida found that spending on this benefit has increased in Brazil at the same growth rate as formal employment. "Since 2001, spending on unemployment benefits has not stopped growing," Almeida says. Although in low-growth years these costs increase more, the trend upward has not been interrupted when GDP grows faster.

"Today, more than 80% of hired workers in Brazil earn up to double the minimum wage, with almost no training. Under these conditions, they do not see themselves spending 30 years in one company," Almeida says. "When the job market is buoyant, unskilled workers have numerous incentives to leave the market, collect unemployment, and work in the informal sector." In doing so, Almeida says, the worker may see higher income for three to five months as he collects unemployment, and when benefits run out he again seeks a formal job.

Unemployment insurance needs correction; Almeida argues that "Unemployment benefits increased by 80% in 2011 compared with the first half of 2008, before the crisis. That does not make sense, since we have had record low unemployment since 2002," he adds. He believes it is necessary to tighten the requirements for applying for unemployment benefits, which currently are a minimum time of formal employment and a grace period between each application: "In Germany, for example, the benefit



period is greater than ours, one year for someone under 45, but the worker must prove that he is actively looking for work." He also cites the United States, where the benefit period is up to 26 weeks, with the condition that the unemployed report periodically on income received and on job applications. Those unemployed are also referred to jobs available locally and to courses and training that will allow them to apply for better jobs.

A conflict between social and economic goals



Kalinka Iaquinto, *Rio de Janeiro*

Social Security reform is urgently needed. The questions are how to reconcile views and set priorities, and how to maintain economic sustainability while recognizing the social implications. Currently there are three different social security systems: the General System of Social Security (RGPS) for private sector employees, the public employees' pension plan, and the military pension plan. Reform is also necessary to improve Brazil's international image: "If the market believes that our fiscal stance is not sustainable because of social security commitments, Brazil can fall out of favor," says Vagner Laerte Ardeo, deputy director of the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV).

The Organization for Economic Cooperation and Development (OECD) says that reform of Brazil's pension system would be beneficial to savings and investment because it costs close to 9% of GDP and the cost is expected to rise as the population ages. The OECD recommends that Brazil set a minimum age for retirement, which is being considered along with new rules for retirement by public employees, the end of the social security factor, and new pension eligibility rules.

Adjustments

The federal government is working for adoption of the Supplementary Pension Fund for the Federal Public Employees (Funpresp) and is not raising pensions above the minimum wage, though it promises to review the budget during the year to assess the possibility of a real adjustment of benefits. But everything depends on what happens with the international crisis. Ardeo explains that "Europe is making adjustments to its social security arrangements. It is essential that we make adjustments now so that we do not find ourselves in a difficult situation in the future."

"The current social security model is not sustainable because young persons entering

"If the market believes that our fiscal stance is not sustainable because of social security commitments, Brazil can fall out of favor."

Vagner Laerte Ardeo

the labor market help to pay for the benefits of those who are retiring. The contributions they make are not for their own future pensions," says Gabriel Leal de Barros, an IBRE economist, who reminds us that Brazil's demographics today are quite different from three decades ago.

Because the policy of raising the minimum wage, which began during the Cardoso administration, was intensified under Lula and has been maintained by Rousseff, there has been a growing gap between pensioners who receive a minimum-wage pension and pensioners who receive more than the minimum wage. In most years adjustments to the minimum wage have exceeded adjustments of social security benefits. This has led workers and pensioners to pressure Congress for similar adjustments. However, matching the adjustments would be a step toward breaking up social security.

Ardeo explains that "The biggest difficulty we face in social security as a whole is the link of pensions to the minimum wage, because this affects not only the short term but also the future. We can discuss how you manage the interests of the current generation over future generations, but I think it is also in pensioners' interests that social security be sustainable." He adds that the ideal would be a minimum benefit indexed to inflation.

Today, Brazil has 24 million RGPS pensioners, of whom 18 million have a minimum-wage pension; its benefits increase, because each year it is adjusted for inflation plus real GDP growth. "The policy of increasing the minimum wage serves 40 million active workers and most pensioners. The 30% of pensioners who earn above the minimum wage should have another adjustment rule," says Artur Henrique, president of the Workers Central Union (CUT). For him the proposal to adjust pension benefits for those earning more than the minimum by inflation plus 80% of GDP, or even the creation of an index by age, should be examined closely.

Mismatches

"When we were working and contributed to Social Security according to our salaries, our expectation was that when we retire, we would receive benefits accordingly. But when we retire, we lose because of the social security factor[1] and we have also lost over the years because the government gives a 14% adjustment to the minimum wage and 7% for pension benefits," complains Nelson de Miranda Osório, chief financial officer of the Confederation of Retirees and Pensioners of Brazil (Cobap).

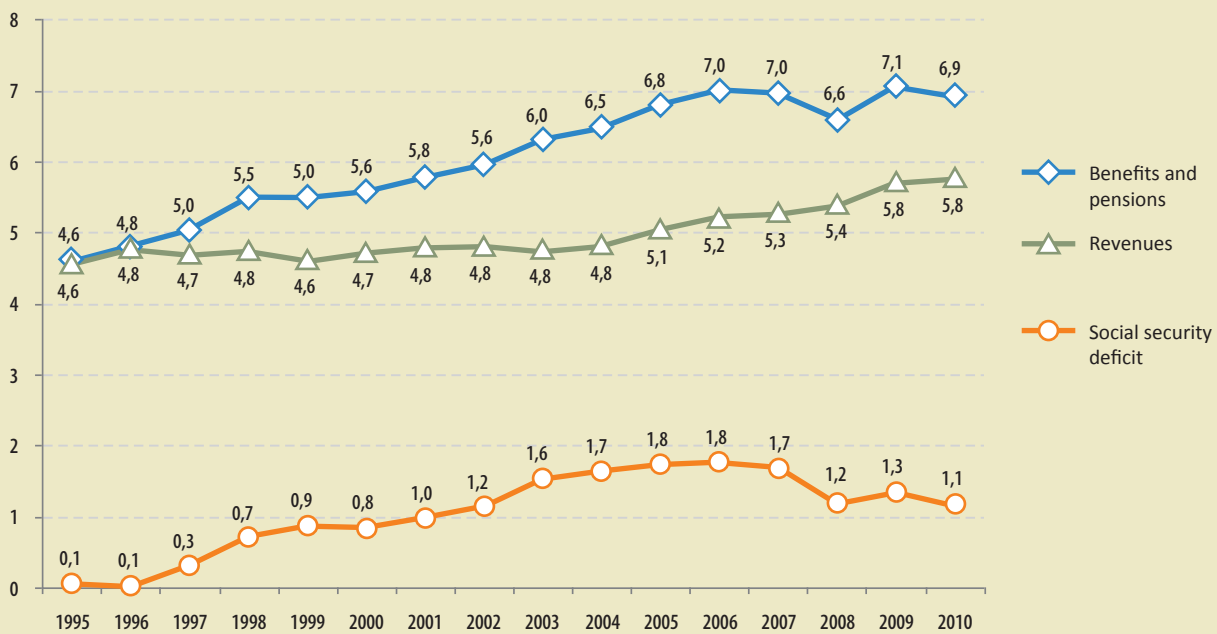
However, "the issue is complicated," says Gilberto Guerzoni, legal adviser to the Senate. He says that since the Real Plan in 1994, social security benefits have not lost any purchasing power because yearly adjustments are based on the National Consumer Price Index (INPC). He says, "If today [a retiree] goes to the supermarket to buy with

current income, that person will be able to buy the same things she used to buy in 1994. Her neighbor, who continues to earn the equivalent of a minimum wage, will buy twice as many things because he has had more significant increases, and it is this comparison that gives an impression of loss." Leal de Barros agrees: "Pensions have been adjusted by inflation and the purchasing power of retirees' pensions is not being eroded."

How to transfer the economy's productivity gains to pensioners who earned above the minimum wages is a political decision, Guerzoni says. "This is a decision that involves prioritizing. What is most important for the country?" asks Senator Paulo Paim (PT-RS). He says the government is reluctant to adjust more pensions above the minimum wage because of concerns about creating imbalances in social security accounts. However, he argues that the amounts the government gives up through tax exemptions plus withdrawals from other budget accounts are higher than the expenses resulting from adjustment of pensions. He explains that "The government in 2010 withdrew R$45 billion from the social security budget to use elsewhere. In the current budget bill, waivers for contributions to social security totaled R$23.3 billion. Thus

The structural social security deficit has grown as a result of generous benefits and extending benefits to groups that contribute little.

Percent of GDP



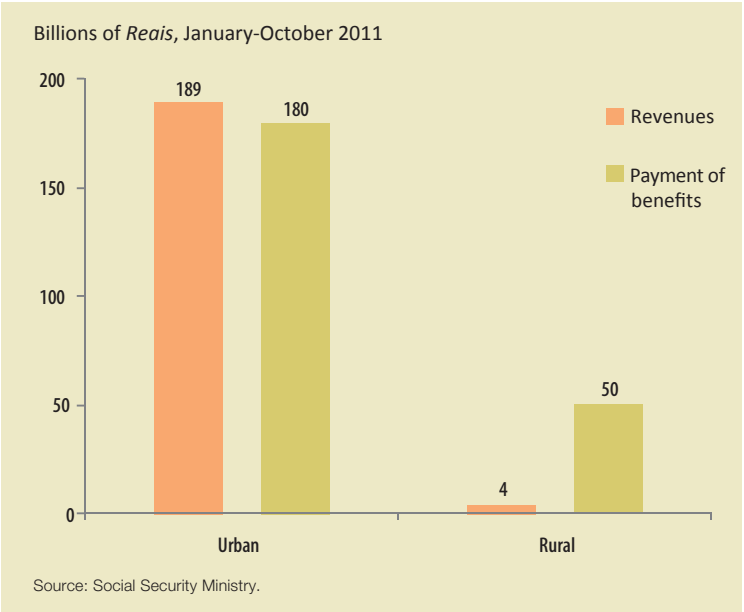
Source: Statistical Yearbook of Social Security.

there is almost R$70 billion that was diverted from the social security budget."

Denize Campello, a lawyer specializing in public law and the public budget, argues that "Adjusting pensions by past inflation plus 80% of GDP growth would increase the costs of social security by R$10 billion. This could be done without any impact on social security accounts." Leal de Barros disagrees: "When the government gives tax incentives to an activity or sector, it is a public policy for development. Regardless of the tax incentive, the government, in net terms, is paying the same. A tax incentive is discretionary; at any time it can be removed. The pension issue must be resolved in a coherent and sustainable way."

Reallocating resources within the budget has no substantial effects on social security accounts, in the opinion of Eduardo Pereira, coordinator of statistics of the Ministry of Social Security: "The way the government operates the social security budget, it needs to replace any missing money." Paim responds, "If it does not matter, let's approve the law that forbids social security resources being used for other purposes."

Geographic imbalance: The social security deficit result in part from pensions paid to rural workers who contribute virtually nothing to social security.



Source: Social Security Ministry.

Premature

Paim also argues for the end of the social security factor, created in 1999 after the government was not able to agree on a minimum age for retirement. "I support a universal pension, equal for all, without privileges to anyone," he says. "Since the executive, legislative, and judicial branches, which have the highest salaries, have no social security factor, we should end the factor once and for all. This inequality is inadmissible."

The effect of the factor can be quite significant, especially when people retire at an early age, because one of the bases of calculation is Brazilian life expectancy. "A woman who began working at 16 and contributed to social security for 30 years should be able to retire at 46, but the reduction factor will be more than 47%," Guerzoni says. In his analysis, moreover, the factor did not give the government the success it expected, which was that retirement would be postponed; "this has not happened." People have been ask-

ing for retirement as soon they are eligible and then continue working elsewhere after they retire, so in practice the pension becomes a second source of income. Guerzoni explains that "A person can retire, still work, and contribute to social security; and when she decides to stop, she can renounce her pension and apply for a larger or full retirement pension, nullifying the effect of the social security factor."

Two controversial options to end the social security factor have been put forward: the 85–95 formula, which provides that age plus years of contribution to social security should equal 85 years for women and 95 for men; and adoption of a minimum retirement age. The CUT, for example, accepts the 85-95 formula but "We are totally against the minimum age because it is harmful to people who start work early. They cannot retire by time of contribution due to the high turnover of labor," Henrique says. Senator Paim says he is not against the minimum retirement age, but there should be a transition rule so that workers are not harmed.

Ardeo supports a minimum retirement age and identifies another issue: the generous rules for granting pensions, which, for example, allows the family of a person who dies after contributed only one time, to receive a full pension benefit. "Messing with orphans and widows usually does not make good headlines, but something must be done," Guerzoni adds.

Public employees

Today, the largest social security deficit is in the public sector: about R$57 billion more was paid to 960,000 retired public employees in 2011 than was taken in for that purpose. To reduce this deficit, the government is working to get approval for the Supplementary Pension Fund for the Federal Public Employees (Funpresp), under which public employees (excluding the military) would contribute 11% toward the social security pension ceiling (R$3,691). Public employees who want pensions above the ceiling would have to contribute to a pension fund similar to private pension funds.

The initiative naturally raises questions. Guerzoni says, "The proposed fund has problems. One is the pension fund's autonomy to manage its resources. The political risk of these funds is significant. They may be used as instruments of government economic policy — this is an old story."

"The current social security model is not sustainable because young persons entering the labor market help to pay for the benefits of those who are retiring. The contributions they make are not for their own future pensions."

Gabriel Leal de Barros

Funpresp would at first generate more federal spending, since all its effects will not be felt for 30 years. Unlike the RGPS, social security for public employees has more problems related to today and yesterday than tomorrow. Most public employees are retired or will retire on very favorable terms; for instance, their pensions receive the same adjustments

"I support a universal pension, equal for all, without privileges to anyone."

Paulo Paim

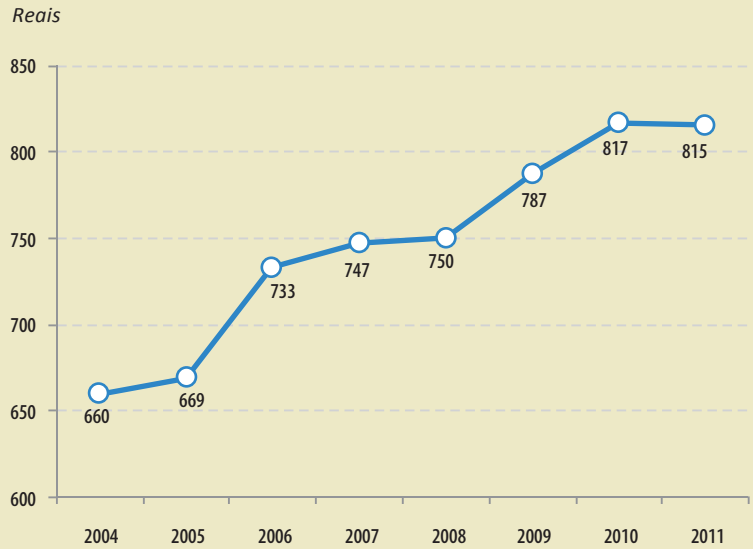
that are granted to active-duty public employees. This is not sustainable.

This issue is as controversial as the others but agreement seems to be closer: "Last year's discussions addressed most of the concerns put forward about the proposal," says Jaime Mariz de Faria Junior, Secretary of Supplementary Pensions of the Social Security Ministry. He believes Funpresp should be approved by both House and Senate by the end of March "... and we'll have a comfortable majority to pass."

[1] The social security factor was created to discourage early retirement: The lower the retirement age, the greater the discount on a full pension and hence the lower the value of the benefit.

Generous benefits have also helped to increase the social security deficit.

The average benefit has increased 23% in real terms since 2004.



Source: Statistical Yearbook of Social Security.

Social security: "A tragedy foretold"



Garibaldi Alves Filho

Social Security Minister

Kalinka Iaquinto, Brasilia

In a speech in the House of Representatives in December 2011, Social Security Minister Garibaldi Alves Filho, who has four decades of public experience, said that the Brazilian social security system was "a tragedy foretold," "a real hot potato." Fixing the system, he said, begins with the Supplementary Pension Fund for Federal Public Employees, Funpresp. Alves Filho here points out that social security pensions are today the main cause of the public deficit. He also emphasizes two other factors: the need for a minimum retirement age for new pensions and for a policy for adjusting pension benefits that are higher than the minimum wage.

***The Brazilian Economy* — The variations in the social security numbers always raise controversy. How can the different pension regimes that make up social security be reconciled?**

Garibaldi Alves Filho — Some of the social security regimes are financially healthy and others run deficits. The Rousseff administration is addressing the one that produces the largest public deficit; as we speak, they are discussing Funpresp. Last year the public employees' social security account recorded a deficit of R$51 billion, and that deficit is projected to grow 10% a year. To solve the problem, the Supplementary Pension Fund of the Federal Public Employees is being established so public employees — whose pension ceiling is R$3,691 — will be able to complement their pensions by contributing to the fund 8.5% of their own salaries.

Photo: Nicolas Gomes

How would the government participate in the supplementary fund?

Today, the government contributes 22% to everything. The government will contribute 8.5% of what would be the pension ceiling and the public employees will contribute 8.5%, and the 17%, capitalized over 35 years, will allow public employees to retire with pension benefits equal to or greater than they have now. The major change is that the government abandons the pay-as-you-go system, which every month collects taxes from those who are working to pay for retiree pensions. In this system there is no accumulation of capital to pay for future pensions. The pay-as-you-go system is only viable when you have four workers for one retiree, but the ratio is now almost one to one. So the project will change the current exhausted system for federal public employees to a funded system.

The vote for the Funpresp project was postponed to this year. The impetus to approve the project is the number of public employees who will retire in 2012. How many are ready to retire?

Over the next five years 40% of the 1.1 million public employees will be eligible for retirement. The government will have to hire new public employees [to replace them] and wants them to start working under the new pension regime. Because capitalization of pensions will take a long time, this is essential... The current pay-as-you-go system is feasible when we have three or four public employees working per one retiree. The ratio is currently 1.17 workers to one retiree; hence the deficit.

What will be the financial impact of this new policy?

In 2011 the pension funds for public employees recorded a deficit of R$57 billion — this is the size of the budget of the Ministry of Education. Of this amount, 40% is for the military, who are not included in the proposed bill because the Constitution does not consider them to be civil employees. With Funpresp, in the medium and long term, the 60% of the deficit related to public employees would be gradually reduced to zero. We are talking here of a saving of nearly R$30 billion a year forever. That is a real structural reform.

Politically, do you think the government will face a lot of resistance in passing Funpresp?

No. Last year there was resistance, including some from members of the governing coalition, but the bigger problem was the scramble for votes at the end of the year. What happens now is that Funpresp is a matter of urgency under the Constitution, so it has priority. Until it is voted on, other laws, except provisional measures, cannot be. In my view there was a strategic retreat to defer voting to February,

Over the next five years 40% of the 1.1 million public employees will be eligible for retirement.

when the environment will be much better. But I believe Funpresp will be approved.

By both the House and Senate?

Yes. I think that in the Senate, speaking from the voice of experience we will conduct a more tranquil process. After all, this matter has been in the House since 2007. The Senate tends to be more agile because of the dynamics, and the number of parliamentarians.

In 2011, what was the situation for social security, the general (urban and rural) and the public sector regimes?

The public sector has 1.1 million active employees and 960,000 pensioners. General social security pays benefits to 29 million pensioners. From January to November 2011, the general social security fund had net revenue of R$215.4 billion and spent R$256.6 billion, that is, there was a funding gap of R$41.2 billion. The urban social security fund had a surplus of R$10.7 billion, but by November the rural sector had already recorded a deficit of R$ 5.8 billion.

General social security expenses are almost 7% of GDP; adding the public sector regime, which is about 3%–4% of GDP, total social security expenses are close to 10%–11%.

On one hand, some say that our welfare program is generous and comprehensive; on the other hand, there is the reality of thousands of retirees. Is our social security model ideal?

Too generous social security is not ideal; just look at other countries. — In Europe the welfare state went bankrupt because they were very generous, but it was unsustainable. In my opinion, good social security should be sustainable because it gives a guarantee. You give your future, your home, your rest to social security. So it has to be sustainable. Now it is running deficits and marching to bankruptcy.

Brazil must find a way — this is the great debate — to have a minimum retirement age.

Recently you said on the floor of the House of Representatives that the current situation of Social Security is "a tragedy foretold," and we should begin to reform the system. What reform bill would you like to see adopted during your administration? What do you consider essential to ensure that the system is sustainable?

We have our proposals, but they must pass through the sieve of the ministries of Finance and Planning and the Chief of Staff. Only then they are presented to the president. Our proposals include the pension reform for public employees. In general social security, I believe we must change especially pensions, which are very laxly regulated. We now pay 6.7 million pensions that total R$31 million a year. Brazil must find a way — this is

the great debate — to have a minimum retirement age.

A minimum retirement age would be an alternative to the social security factor, which you were against.

People speak badly of the social security factor, but it was created in 1999 precisely because there is no minimum retirement age. But — the factor has become unbearable and much more pernicious to the pensioner than a minimum age would be.

How would a minimum retirement age be implemented?

We do not yet have anything consolidated. The proposal being designed by the Department of Social Security has transition rules because any change in pension rules must be gradual. You should not introduce reforms without transition rules because you hurt people who are expecting to retire soon. You cannot say to someone, "Go back to work five or six more years."

Adjustments for retirees' pensions above the minimum wage are lagging as a result of past economic stabilization plans and higher adjustment for the minimum wage. What is your assessment of the situation? Should we have another index for adjustments to retirement benefits?

To resolve this problem there is need for a specific policy, like today's policy for adjusting minimum wages. One cannot just give an increase that has a huge impact. For now the question is: 32% of pensioners earn pensions above the minimum wage. We are not able to increase their pensions as they are asking. During preparation of the budget, it was argued that there should be an increase for pensions above the minimum wage without a government policy, which incidentally would have to be proposed in the legislature. This is not a desirable solution for either the government or retirees. The Social Security Ministry has created a group with representatives from trade unions, retirees, and the ministry, and they have given recommendations on the issue. ... I support a policy to solve the problem, but it must be much more gradual.

The pay-as-you-go system is only viable when you have four workers for one retiree, but the ratio is now almost one to one.

If the markets understand that social security is unsustainable because of our political situation, could our economic credibility be harmed? What measures could be taken to ensure that what we see happening today in European countries does not happen here?

This is the key question. Market participants have a very critical view of our social security arrangements today. That's why we are making this effort to signal that things will change. It is not enough

to make speeches; we have to do something. I think we're really taking a big step, and without cutting any pensions. ... No one will have their rights affected. Those retiring now will retire under the current regime. We will change the pension regime for those entering the system now. This will signal to the market that social security will change.

It is not enough to make speeches; we have to do something.

Social security for urban beneficiaries is in surplus but for rural beneficiaries it is in deficit. Is the government thinking of a reform to separate these beneficiaries, creating a policy of assistance for those who live in the countryside?

You cannot, at this point, change the benefits of rural beneficiaries. In the field we have a minimum contribution. Rural pensions are paid for with a specific tax, but this revenue is very small. To change this is very difficult. Now, a possibility for the future [might be to tax] agribusiness, is growing at about 4%, and the industry only managed to grow 1.5%.

Those retiring now will retire under the current regime. We will change the pension regime for those entering the social security system. This will signal to the market that social security will change.



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