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Abstract

Brazil produces the world's eighth-largest gross domestic product, is the largest economy in Latin America, and is an important trading partner for the United States. Unfortunately, the bloated and overly centralized Brazilian federal government has been crushing economic freedom for decades. The state dominates many economic sectors; too many large private or public–private enterprises are protected from competition. Government expenditures have grown to consume more than one-third of GDP. All of this has undercut the development of a more vibrant private sector. On top of that, Brazil is still recovering from its worst economic crisis in more than 30 years that began in 2015 in the aftermath of the crash in global commodity prices. Brazilians face a burdensome regulatory regime and a tax burden that is much heavier than in many other emerging economies. Widespread and high-profile political scandals are evidence that corruption remains high. Private property rights are insecure and the judicial system, although vigorous in prosecuting corruption in recent years, remains vulnerable to political influence. Brazil needs more economic freedom. For the country to achieve it, the government should eliminate barriers to entrepreneurial activity—burdensome taxes driven by fiscal deficits, inefficient regulation, flaws in long-term financing rules, and continuing government-created rigidities in the labor market—and devolve more power to the federal states.

Brazil's reputation as one of the world's most promising emerging markets has waxed and waned over the years. The fourth-largest democracy (and fifth-biggest country) on the planet, Brazil's territory is larger than that of the continental United States, and the country is blessed with abundant natural resources and a relatively diversified economy.

Unfortunately, over the decades, Brazil has proven unable to live up to its promise. Brazil's score fell in The Heritage Foundation's 2018 *Index of Economic Freedom*[1] to 51.4 from 52.9 in 2017. Its ranking fell 13 places, from 140th-freest to 153rd-freest of the 180 economies that were scored in both years.

The main reason for the negative result is the significant deterioration of Brazil's fiscal health—aggravated by decreases in labor freedom, business freedom, government spending, and government integrity.

The data demonstrate vividly how quickly the situation in Brazil has deteriorated in the past few years. The country's sovereign debt leaped from 51.5 percent of gross domestic product (GDP) in 2012 to 73 percent in 2017.[2] Unemployment spiked from around 4.5 percent in 2014 to almost 13 percent in 2017.[3] GDP fell from $2.6 trillion in 2011 to $1.8 trillion in 2016. During the same period, GDP per capita dropped from $13,167 to $8,649.[4] Meanwhile, government spending now consumes more than one-third of GDP.[5]

This downward trajectory in GDP reflects the increases in political, economic, and social instabilities in Brazil during the past five years. Indeed, poverty was, and still is, a serious issue that needs to be addressed—but doing so requires responsibility and fiscal sustainability. Although the programs instituted by populist-leftist President Luiz Inácio "Lula" da Silva to combat poverty through wealth redistribution ultimately proved to be irresponsible and unsustainable, they were continued and even expanded by his successor, Dilma Rousseff—deepening the dive of the economy after the commodity boom crash. By expanding government to be even bigger and more statist, Lula and Rousseff inflicted even greater damage to economic freedom.

A Failure to Build on Past Successes

After solid rates of economic growth through the 1990s until the 2008 financial crisis, with reduced poverty, rising incomes, and a growing middle class, Brazil's economic slowdown began when Lula ramped up spending in his second term—spending that continued under Rousseff.[6]

Little was done during the commodity boom years to extend and deepen the difficult-but-necessary institutional strengthening and other structural-reform processes begun in the 1990s by then-President Fernando Henrique Cardoso. Cardoso's reforms had been aimed at removing the very real obstacles that have limited productivity growth and thwarted Brazil's convergence with more advanced economies.

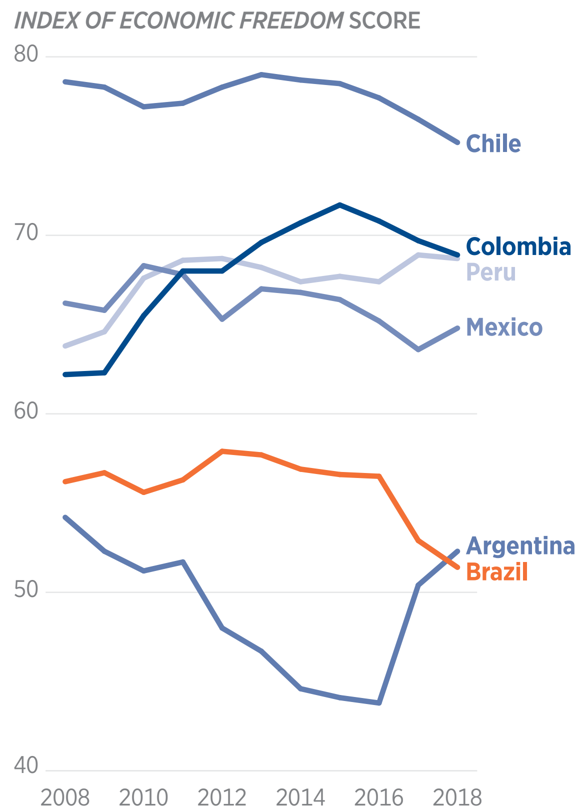
Unfortunately, by 2016, according to *The Wall Street Journal*, Brazil was engulfed in one of the worst downturns since the Great Depression, with debt, deficits, and interest rates skyrocketing, unemployment reaching double digits, and inflation hovering around 10 percent.[7] As the *Financial Times* reported,[8] the economy had contracted by more than 7 percent in the previous two years. Brazilian economist Gustavo Patu called it the worst economic crisis in more than 30 years.[9]

How did it happen? The answer lies in Professor Walter Russell Meade's observation from a few years ago, which still holds true, that the

> past still haunts Brazil. In spite of its tremendous wealth of natural resources and human capital the country suffered countless booms and busts through the 19th and 20th centuries and was the poster child of hyperinflation in the 1980s and 1990s.[10]

CHART 1

Economic Freedom Scores in Latin America



SOURCE: Terry Miller, Anthony B. Kim, and James M. Roberts, *2018 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2018), http://www.heritage.org/index.

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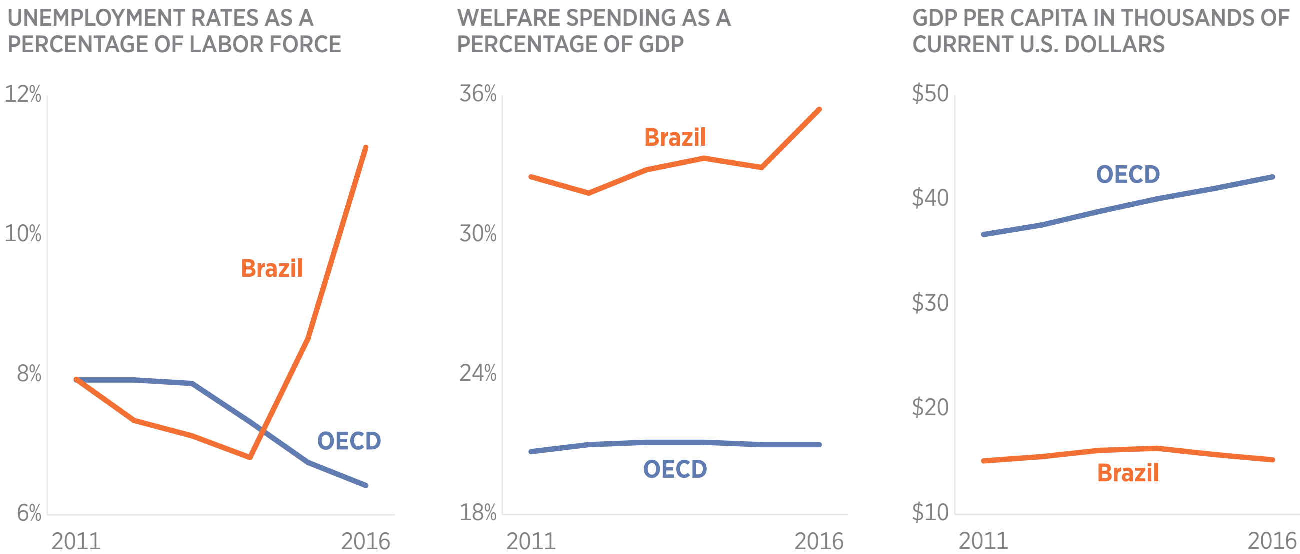
Now the sorry track record of Lula's and Rousseff's dismal economic mismanagement must be added to Meade's long list.

The bleak outlook of perpetual political and economic instability was given one, albeit brief, respite: the return to democracy through the 1988 constitution, and then with implementation of the groundbreaking "neo-liberal" policy reforms of the Washington Consensus—daringly begun in the early 1990s by finance minister (and later two-term president) Fernando Henrique Cardoso. That period of relative stability was, surprisingly, reinforced and strengthened by Lula in his first term. Ironically, it

CHART 2

How Brazil Compares to the OECD



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was Lula's continuation of Cardoso's reforms that finally broke the back of Brazil's chronic hyperinflation and set the stage for record growth.

Lula reaped direct political benefits by sticking with those pro-growth policies. Brazil's prosperity enabled Lula to increase social spending in his first term on education, health care, and other programs for more than 11 million households living in poverty. For example, funding for Lula's conditional cash transfer (CCT)[11] *Bolsa Familia* (Family Stipend) program was made possible only through tax proceeds generated by private-sector-led economic growth.[12]

Buoyed by booming global commodity prices, Lula's early adherence to Cardoso's neo-liberal reforms boosted the emerging Brazilian middle class while also lifting up the poorer classes.

Unfortunately, in his second term, Lula instituted increasingly assertive and statist "neo-developmentalist"[13] industrial policies—primarily implemented through the state-owned National Bank for Economic and Social Development (BNDES).[14] He also gradually abandoned earlier efforts at decentralization and federalism (that were inherent in the 1988 constitution) in favor of recentralization.

The tendency to backslide toward statism in Lula's second term set the stage for the repetition of past mistakes that followed—reversing Cardoso's efforts to rein in Brazil's inefficient and bloated central government. The state resumed its interventionism in the marketplace. Propelled by the powerful forward economic momentum generated by Cardoso's reforms and still-booming commodity prices, Lula successfully engineered the election of his protégé and former chief of staff, political neophyte Dilma Rousseff, to succeed him in 2011. Rousseff's election kept the presidential chair warm for Lula to run for another term in 2018, and retained control of the presidency for Lula's socialist Workers' Party (*Partido dos Trabalhadores*).

Once in office, Rousseff continued full bore with Lula's statism until she was finally removed from office early in her second term in 2016 amidst a collapsing economy, the unfolding of huge political graft scandals, such as Operation Car Wash, and allegations of budgetary mismanagement in the months prior to her 2014 re-election.

Government Spending Spiked—Then the Economy Collapsed

Back when high global prices for commodities were boosting Brazilian exports and fueling rapid economic growth, they caused a spike in government revenues. The government spent them all, and then some.

Although the commodity boom (prior to its collapse after 2009) had helped to keep inflation under control through increased inflows of foreign currency, the role of the state in the economy has been heavy and even increasing since the boom ended. Total government expenditures, including consumption and transfer payments, now consume more than 36 percent of GDP.[15] Meanwhile, the efficiency and overall quality of government services have degraded, in spite of thousands of newly hired public-sector employees during the Lula/Rousseff era.

Government expenditures massively increased to fund corruption-prone public-works projects for the 2014 World Cup and the 2016 Rio Olympics; along with Lula's and Rousseff's radical expansion of welfare programs, it added an astronomical burden to the federal and local governments' budgets. As is always the case with huge public-works and construction projects, in addition to their enormous budgetary burden, they provided lucrative opportunities for graft.

At the same time, programs such as *Bolsa Família* (monthly payments to more than 13 million families[16]), and *Ciência Sem Fronteiras* (Science Without Borders, a large, ill-designed program to fund undergraduate and graduate students abroad), played a huge role in the expansion of public spending. The federal government of Brazil expanded *seguro-defeso*, a monthly benefit to fishermen during the months in which they could not fish, despite a lack of any institutional mechanisms to ensure accountability in the program.[17] Such programs, which functioned as political pay-offs to constituent groups, were often poorly designed. Media reports of fraud in them are common.[18]

In addition to all the public-works spending and welfare-transfer programs, lavish and unsustainable public pension programs surged under Lula and Rousseff. By the end of Rousseff's tenure in office, a typical Brazilian government federal retiree was slated to receive a pension that was four times greater than that of the average pensioner in the private sector.[19]

Lula's and Rousseff's governments also hired thousands of new public-sector employees, thereby ramping up future governmental budget obligations for their salaries and pensions (not to mention expanding the membership rolls of dues-paying members of left-leaning public-sector unions).

As a result of government expansion during the Lula and Rousseff years, a study by Brazilian economist Raul Veloso concluded that more than 50 percent of Brazilians were receiving a monthly paycheck from the government by 2010.[20] That level of government dependence is on a par with Organization of Economic Cooperation and Development (OECD) countries. Brazil (with a GDP per capita of $15,243 versus the OECD average of $42,161[21]), however, can ill afford the burdensome cost of a huge, European-style welfare state. In fact, the average OECD country cannot afford it, either.

In 2014, total disbursements for pensions had generated a fiscal deficit of 68.9 billion *reals* (approximately $20 billion U.S. dollars). The next year the negative result was 95.1 billion *reals* ($27.6 billion). By 2016, the pension system deficit had jumped to 151.9 billion *reals* ($44 billion).[22]

The government of current President Michel Temer is finding it nearly impossible to "right-size" the government by laying off some of these unnecessary employees, since the civil-service laws make it difficult to terminate them, except in extreme situations.

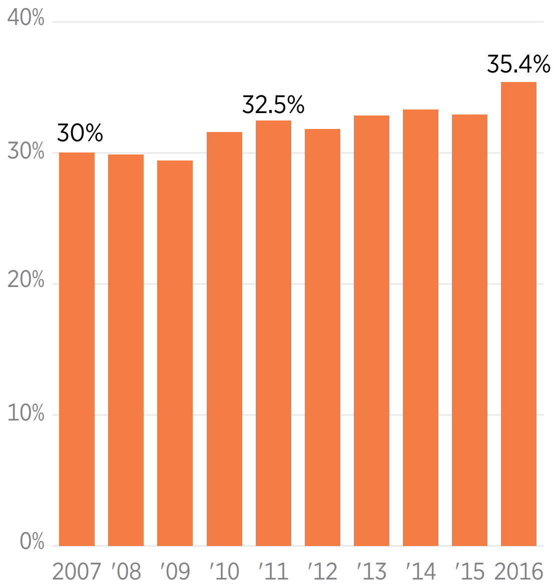
A Bitter Legacy: Corruption Scandals and a Political Crisis

Fallout from the mismanagement of the Lula and Rousseff years has gradually fomented a legitimacy crisis for the Brazilian government at all levels. Massive demonstrations that began in 2013 as an amorphous, grassroots rebellion were followed by even larger, better-organized protests against Rousseff—with increasing calls for her impeachment. By March 2015, one million people took to the streets of São Paulo to stage a massive demonstration. Widespread

CHART 3

Welfare Consumes One-Third of Total Government Spending in Brazil

PERCENTAGE OF TOTAL PUBLIC-SECTOR SPENDING



SOURCE: OECD iLibrary, "OECD Economic Surveys: Brazil 2018," https://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-brazil-2018_eco_surveys-bra-2018-en#.WrQFm-SWxlk%23page3 (accessed March 8, 2018)

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protests sprang up elsewhere across the country, too, demanding that Rousseff step down.

The legislative branch has not fared much better. In a reflection of the bitter legacy of the Lula/Rousseff years, a recent poll revealed that just 11 percent of Brazilians trust their representatives and senators.[23] In fact, Brazil's entire political system—long plagued by infighting and instability—has become virtually paralyzed in recent years by the presence of the more than 25 political parties that hold seats in Brazil's Congress.

Not one of those parties has a claim on more than 15 percent of parliamentary seats. To make things worse, a majority of the parties are little more than personality cults or regional interest groups that lack overarching philosophical principles or a coherent body of ideas. Too often they will auction off their support to whichever party is in control of the executive branch. This chaotic fragmentation of political power has damaged Brazil's institutions of public administration, making them less predictable and more unstable. Long-term planning is especially difficult.

Perhaps nothing exemplifies this sad situation better than Operation Car Wash,[24] the massive money-laundering investigation being conducted by a courageous team of prosecutors against corrupt politicians, which has turned into the biggest graft scandal in Brazilian history.

The list of powerful people implicated so far exceeds 100 prominent names. The group includes the last speaker of the House (now in jail), the last speaker of the Senate, former presidents Lula (now in jail)[25] and Rousseff of the Workers' Party, and the main figures of the major opposition group, the Party of Brazilian Social Democracy. Overall, as many as one-third of the members of Brazil's Congress and many key figures in the cabinet have been either investigated or prosecuted.[26]

A second huge and ongoing scandal involves the giant Brazilian construction company Odebrecht, which made payoffs, bribes, and kick-backs to politicians not just in Brazil but all over the world to secure multibillion-dollar public-works-infrastructure construction contracts.[27]

On a brighter note, the very fact that the Operation Car Wash investigation has gone as far as it has, with successful prosecutions of a former Brazilian president and other high-level officials, is evidence that would partially explain the improvement in Brazil's *Index of Economic Freedom* "judicial effectiveness" score, while illustrating the current political instability in the country.[28]

The Obstacles to Greater Economic Freedom for Brazil Are Daunting

Establishing fiscal stability and sustainable long-term economic growth in Brazil will require policymakers to confront a number of deep structural problems. For example, the Brazilian Constitution (the fifth in the country's history) is replete with promises that are expensive to fulfill. The full implementation of all of the constitution's enumerated rights and mandates would strain the resources of even the most advanced OECD country (let alone an emerging-market country such as Brazil). These include the following very expensive entitlements and budgetary obligations:

- Free education from pre-K through graduate school (some major cities in Brazil also offer free public transportation for all students, regardless of income level);
- Free universal health care; and
- De facto lifetime job security and pension benefits for public-sector employees, whose employment is notoriously difficult to terminate.

Other obstacles to economic growth include Brazil's burdensome labor laws, which are heavily and rigidly regulated at the federal level. The federal labor code (CLT) dates from 1937 and was inspired by Mussolini's *Carta del Lavoro*.[29] The CLT establishes and mandates numerous rights for workers. If they were fully to comply with every CLT regulation, most private companies would have great difficulty hiring workers.

Although a recent reform signed into law by President Temer has improved some aspects of the CLT, there is still much to be done by the government to improve and make the labor code more flexible. Part of the problem is that labor law reform needs more public support, and that would require a public education campaign to explain to voters why the reforms are needed and why the ongoing failure to make the reforms drives unemployment higher and is a drag on economic growth.

The government continues to dominate too many areas of the economy, undercutting development of a more vibrant private sector. The efficiency and overall quality of government services continue to be inadequate, particularly because of poor public finance management. Public-sector wages and transfer payments account for a large portion of government spending (total government expenditures, including consumption and transfer payments, consume more than 40 percent of GDP) and are significant sources of fiscal pressure. Compared to other emerging economies, the overall pace of Brazil's regulatory reform has slowed.

Furthermore, Brazil has been too dependent on commodity exports for economic growth and runs the risk of "Dutch disease," whereby revenues from natural resources make the Brazilian *real* relatively stronger and thus make imports cheaper, and Brazilian manufactured products more expensive and less competitive globally.

While the government was busy expanding expensive welfare programs, such as *Bolsa Família* (which has no time limit or job search requirements), it was also failing to address barriers to entrepreneurship and private-sector job creation. For example, according to the World Bank's Doing Business survey, Brazilian entrepreneurs need 80 days to open a business (versus a world average of under 20 days).[30]

Other problems resulting from bad public policies have become deeply rooted. The entitlement, dependent, and collectivist mentality that has become so deeply entrenched in Brazil defies easy eradication. For example, a recent proposal to charge tuition even for some executive-level mid-career graduate programs at public universities created a backlash among students.

Free, universal health care is enforced by the constitution, and no elected official ever mentions the possibility of changing it—viewing such a suggestion as politically suicidal.

A recent report by the World Bank highlighted the lack of efficiency in public spending in Brazil. The shortcomings in Brazil's education system are having real-time consequences for the country. A 2017 report by the World Economic Forum described the acute skills shortage and its economic impact on Brazil and other Latin American countries.[31]

The World Bank reported that efficiency of public schools could be improved by 40 percent—without any additional budgetary expenditures—through better management. One way to do that, according to the World Bank,[32] would be to raise the inefficiently low teacher-student ratio, require larger class sizes taught by better-trained teachers, and tie teachers' salaries to merit and performance.

What to Do

Brazil must undertake fundamental reforms, not just to increase economic freedom, but just as importantly to break the economically destructive and enervating "boom-or-bust" pattern that has emerged in the recent years of governance in constant crisis mode.

Since over-reliance on exports of commodities is a major contributor to that boom-or-bust problem due to the inherent volatility of global commodities markets, one of the policy components to improve stability in government should be to incentivize development of the non-commodity sectors of the Brazilian economy.

Strengthening the foundations of economic freedom is critical to extending the current mild recovery of economic growth. Policymakers must take advantage of the relative political stability established by the Temer presidency to ensure a better economic future for Brazil. In addition to tackling the fiscal problems outlined above, that means strengthening institutions that consistently confront corruption on an ongoing basis, taking legislative and administrative steps to better secure private property rights, and fixing problems (such as non-transparency, delays, and jurisdictional overlap) that have long made the Brazilian judicial system less effective and more vulnerable to political influence.

Fortunately, an increasing number of Brazilian voters are recognizing the need for the reforms outlined in this *Special Report* that will increase economic freedom in Brazil. The 2018 general elections will provide them with an excellent opportunity to send that message to the country's political establishment.

Specific Recommendations for Brazil

- **Develop the non-commodity sector.** Brazil must continue to make the reforms necessary to incentivize growth in the non-commodity sectors of the economy, such as eliminating barriers to entrepreneurial activity, burdensome taxes, and inefficient regulation, and fixing poor access to long-term financing and a rigid labor market.

- **Reform the public pension system.** The current system is not sustainable and must be modified. Individual retirement accounts (based on the U.S. 401(k) model) may be a good alternative for Brazilian policymakers to consider.

- **Decentralize/devolve federal powers.** Under its 1988 constitution, Brazil is a federation, but during the Lula and Rousseff era the central government continuously expanded its power and resources. Decentralization, through a strengthened federal system, would devolve some revenue-raising powers and thus greater resources to the states, which could *inter alia* also be permitted to function as public policy "laboratories." For example, in the United States the State of Florida has experimented with innovative public school choice and voucher policies.

- **Permit the enactment and enforcement of state laws.** Unlike the federal system in the United States, legislatures, prosecutors, and courts in Brazil's 26 state governments are not permitted to adopt and enforce their own labor laws, or criminal statutes, or to implement innovative tax laws and other fiscal policies. It would benefit the entire country if steps are taken to weaken central government control in these areas and to empower the states to take over these functions.

- **Reform the civil service.** Change the law to abolish lifetime job security for public-sector employees. Make it easier to terminate non-performing employees and tie their pay and promotions to merit-based performance standards. The status quo disincentivizes (and sometimes punishes) those relatively more productive public employees, squelching their creativity. It also limits the flexibility that government should have to manage and better target its labor pool to respond to changing policy priorities.

- **Promote and incentivize private-sector financing of public works.** Create fee-based or concessionary partnership agreements with private companies to construct public-works projects and retain an equity interest in them in order to improve the country's outdated infrastructure (especially in areas like airports, highways, and ports). The current system of government monopoly control in many infrastructure areas (such as road construction and administration) inhibits private investment.

- **Reform the labor code.** Recent changes by the Temer administration succeeded in updating Brazil's 1930s-era labor laws to make them somewhat more business-friendly. Additional improvements are needed, however, such as the elimination of the government-run and very poorly managed FGTS plan (Fundo de Garantia do Tempo e Serviço—equivalent in English to the Severance Pay Indemnification Fund), which mandates compulsory savings of 8 percent of a worker's salary.

- **Privatize state-owned enterprises.** Many public companies in Brazil would operate much more efficiently if they were privatized. Aircraft manufacturer Embraer, for example, was previously a state-owned company and became a global leader in aviation only after it was privatized. Other large companies, such as the giant state-owned oil company Petrobras (an infamous nexus for corruption and graft in the ongoing political and campaign-finance scandals), are ripe for full privatization. Other companies, such as Eletrobras (electric utilities), Correios (postal services), Infraero (airport services), and at least one of the two large banks managed by the federal government (Caixa Econômica and Banco do Brasil) should follow the same path.

Brazil has both the natural and human resources to enjoy long-term political stability and economic prosperity. But such stability and prosperity cannot thrive without the rule of law and economic freedom, for which free-market policies are essential. Sacrificing those resources to middlemen and politicians in a bloated and corrupt central government will simply generate more economic repression, crushing any economic freedom and prosperity.

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