Assessment and recommendations

An important player in world economy…

Brazil is well endowed with natural and human resources, though its development during the last decades has not fulfilled its strong potential for growth. This contrast can cloud the reality that Brazil is one the big players in the global economy. With nearly a one trillion dollar economy (measured in purchasing power parity) and 170 million people, Brazil ranks amongst the 10 largest countries in the world. It has a substantial industrial base, and its position in the South America makes it pivotal for the whole region. At the same time as pursuing a strategy of regional integration, Brazil is a key partner in multilateral negotiations, such as trade liberalisation and global action against climate change. It adheres to several OECD agreements and guidelines. In sum, Brazil is a principal actor in the era of globalisation.

… with an increasingly outward orientation

By the end of the 1980s, Brazil's model of inward-oriented development was exhausted. Access to foreign savings had been constrained by the unfavourable dynamics of the external debt. Indexation mechanisms had sustained high inflation and maintained fiscal revenues, but also made the economy increasingly rigid. The use of import substitution to develop an industrial base negatively affected competitiveness in the corporate sector. Democratic institutions were re-established in 1985, and during the 1990s Brazil started transition towards a new development model based on market reforms and outward orientation. Significant reductions in tariffs and removal of other trade barriers took place. A decisive break with high inflation after 1995 brought about deep changes in the Brazilian economy, not least in stopping the regressive effects of the inflation tax that had affected the poorest segments of the population. An ambitious privatisation programme substan-

tially increased the participation of foreign enterprises and banks in the economy. Indeed, foreign direct investments played a major role in the economy during the last decade, though Brazil has always been a significant recipient of foreign capital. All these elements add up to what seems an irreversible change. Now the Brazilian economy faces the further challenge of achieving robust, market-based growth.

For the first time there is a critical mass of reform…

In this light, the core issue for Brazil is whether it has indeed crossed a threshold to sustained growth. This Survey suggests the answer is a cautious, and contingent, yes. It is cautious because there is still significant vulnerability to external shocks given the high burden of Brazil's external debt and dependence on foreign savings. The budget situation has improved substantially and the public debt has been stabilised at below 50 per cent of GDP. But the authorities have limited room for manoeuvre in setting macroeconomic policy as Brazilian public debt still has a short maturity and a significant part is indexed either to short-term interest rates or the exchange rate. The assessment is also contingent on progress with structural reform. While a great deal has been accomplished in recent years, much remains to be done.

… but sustained growth requires continued progress in several interdependent policy areas

There are three highly-interdependent elements by which a threshold for sustainable growth can be assessed. First, the building blocks of a sound macroeconomic framework: institutional arrangements and administrative capacities are required to assure that stabilisation objectives are met, with close co-ordination between fiscal adjustment and an independent monetary policy. In this context, the financial sector has to be sufficiently robust and resilient to shocks. Secondly, the enterprise sector has to be adaptable to adverse fluctuations in the business environment, as well as being able to exploit windows of opportunity to develop. A greater capacity to grow requires more efficient use of physical, financial and human capital. Increased productivity and competitiveness are needed to overcome the balance of payments constraint, which in turn would allow for a sustained investment cycle. The last element is that a continuing process of reform has to be socially acceptable. This is clearly a challenge for a democ ratic society with such high levels of inequality in the distribution of income as those

found in Brazil. Some distributional aspects of growth are a particular concern, and reforms in the areas of agricultural, energy and social policies are a condition for sustained growth. The Survey discusses these policy links.

While the monetary policy framework has delivered its targets, gains in credibility could be locked-in by consolidating the independence of the central bank

The conduct of monetary policy is a prime component of the macroeconomic framework. Exchange rate targeting was abandoned in January 1999, and from the middle of that year monetary policy has targeted inflation. Results have been encouraging, and the bank has achieved its objective of steadily bringing it down by setting a cautious pace in reducing nominal interest rates. It has already faced some significant market tests, and this has increased the credibility of the framework. In 2000, it had to deal with oil-price inflation and a rise in regulated prices. In early 2001 there was turbulence in financial markets, notably there was turmoil in Argentina. The depreciation of the Real began to accelerate, and strong growth in the Brazilian economy showed no signs of slowing. In late March 2001 the central bank decided to increase its reference interest rate (by 50 basis points) for the first time under the new regime. This move surprised the market and induced mixed reactions; but by being pro-active the bank s ent a strong signal that it will defend its hard-won credibility. In this respect, the central bank has made significant efforts to increase its transparency and the information available to the markets. Nonetheless, the credibility gains achieved so far could be locked-in by further strengthening the autonomy of the central bank and discussion along these lines is proceeding in Brazil. Establishing *de jure* operational independence requires new legislation, and would bring Brazil into line with current practices in OECD countries. While central bank independence is important, it should be noted that the credibility of the monetary framework ultimately depends on the degree of co-ordination amongst macroeconomic policies.

Under hard budget constraints, federal autonomy should foster responsible fiscal management…

Building a better fiscal framework has been a major challenge. During the 1990s public spending rose as a result of fiscal decentralisation coupled with wider access to welfare. However, decentralisation was a response to rigidity in the central government's budget that was itself a result of constitutionally mandated revenue sharing and strict rules for managing public employees. Revenue sharing also induced sub-

national government finances to become strongly pro-cyclical, and increased spending was loosely controlled. The absence of effective constraints resulted in large structural budget disequilibria. This was masked for some time by high inflation, which reduced the real value of expenditure and boosted nominal revenue. Once inflation fell, high borrowing costs were no longer sustainable. Against this background, fiscal consolidation efforts, notably those since 1999, have been remarkable. The objective of a consolidated primary budget surplus was met in 1999 and 2000, increasing the credibility of future targets. This outcome required the imposition of tight budget constraints at the sub-national level. To this end, a number of important institutional arrangements have been introduced: debt renegotiation contracts between the federal governments and the states supported by fiscal adjustment at state level; a senate resolution imposing limits on state borrowing; privatisation of most banks owned by state governments; prudential constraints on bank lending to sub-national governments; and finally the 2000 Fiscal Responsibility Law. Together, these add up to a powerful set of budget constraints on sub-national governments. That state and local governments are accepting these arrangements is an encouraging signal that past episodes of slippage in sub-national expenditure could be avoided in the future. These constraints are applied more or less uniformly and, taken together, might become very restrictive in the face of a negative shock to the economy. Unexpected revenue shortfall could then entail very severe retrenchment in the discretionary spending of sub-national governments.

… but new budget regulations should be strictly enforced to reduce moral hazard

In some cases states or municipalities could seek derogations from their present commitments. However, in light of successive bailouts in the past and a tradition of loose enforcement of borrowing controls, it is essential that the Fiscal Responsibility Law and debt agreements should be firmly enforced. This position must be fully supported by legislative bodies, else the government would risk losing credibility. Despite significant spending rigidities in state and municipal governments, it should be emphasised that they do have instruments to adjust their budgets. They enjoy large spending autonomy and revenue raising capacity. Moreover, existing tax revenue sharing arrangements

have the advantage of providing a stable stream of resource. Finally, recent administrative reform also provides some flexibility in managing public employment to reduce public spending. Looking forward, ongoing fiscal adjustment needs further reforms to assure adequate revenue, and to increase efficiency and effectiveness of all spending. In this respect, reform of fiscal federal relations and of the civil service pension systems are clear priorities.

There is a need to reform fiscal federal relations in Brazil…

Tax reform needs to meet partially conflicting objectives. The constitution requires some degree of revenue independence for sub-national governments. Moreover, given the large regional income disparities, any reform has to assure an adequate degree of redistribution. At the same time, the states' main source of revenues, the value-added tax (ICMS), needs to converge to common rates, particularly where it applies to inter-state trade. Presently, differential rates depend on the specific direction of trade, and are set by the federal senate to redistribute revenue from richer to poorer states. The rate for intra-state trade is set separately by each state. This system is administratively complex, results in perverse redistribution and facilitates tax evasion. As the ICMS is origin-based, it has contributed towards aggressive tax competition in which some states have engaged to attract investment. For some time the federal government has attempted to rationalise the ICMS, but negotiations with the states have not reached a conclusion. Another distortion in the system is the existence of a financial transactions tax (CPMF) and cascading taxes applied to enterprise turnover. In introducing these taxes (labelled "social contributions" as the revenue is earmarked to social spending) the federal government has created sources of revenue that are not subject to constitutionally mandated sharing with sub-national governments, but which are quite distortive. Revenues from these taxes have increased substantially to nearly 5 per cent of GDP in 2000. Thus it is presently difficult for the federal government to forego these revenues, as it has no other broad-based tax on which to draw, and direct taxes are largely tied-in to tax-sharing arrangements intended to achieve redistribution. Therefore, the government has focussed on mitigating the most distorting features of the cascading taxes.

… which would be supported by better institutional co-ordination

There are no standard rules on what is optimal in this situation. Ultimately, it is a political judgement on whether to focus on the worst distortions or, alternatively, seek a broader reform from the outset. However, in any case, federal systems need effective consultation and co-ordination mechanisms to promote agreement and consensus building. Better co-ordination would facilitate the dialogue and ease negotiations, notably for the reform of the tax system. OECD experience of tax reform in federal systems is that one of the parties, typically the federal government, needs to take the lead in achieving the desired overall efficiency gains. This puts a premium on getting federal finances into a strong position so as to create room for such bargaining.

Progress has been achieved in reform of the general pension scheme…

At about 9 per cent of GDP, Brazil's public pension expenditure is relatively high, especially in view of Brazil's young population, and is above the OECD average. This drains resources away from other areas, such as much needed social investment in health and education. Recent reform of the general regime have gone a long way to ensuring a fair, equitable and transparent pension scheme, available to all workers. An adjustable formula (*fator previdenciário*) relates pensions to the duration and level of contributions, and life-expectancy. It introduces some welcome flexibility to the system, as benefits are automatically adjusted for the affects of population ageing. However, it is not clear whether recent reforms will be sufficient to ensure the long-term actuarial and financial balance of the general system. The large share of informal employment, the weight of non-pension benefits imputed to the system and the inadequate mechanism of pension indexation all pose a threat to the system's future balance. The solution to these challenges cannot be found in isolation from wider tax and labour market reforms. Finally, a complementary fully-funded pension system has recently grown rapidly. But its development will depend on modernising the regulatory and supervisory framework.

… but the priority is now to reduce generous civil service pensions and privileges

The main challenge is to reform the special pension regimes for civil servants. These represent about half of total pension expenditure, attesting to the extreme inequities of the Brazilian pension system. While estimates about future spending trends are sensitive to assumptions, it is likely that,

in the absence of further reforms, pension expenditure under these schemes will not decline as percentage of GDP over the next 10-15 years. This would reinforce inequity and create difficulties for fiscal policy. Initiatives to date, such as changing the employment conditions for civil servants joining since 1998 will only bring benefits in the very long-term. Benefits remain generous, and not sufficiently linked to the amount and length of contributions. Hence more forceful measures are required to address existing distortions. Benefits should at once be capped at less than 100 per cent of last salary. A more ambitious reform would introduce, as in the general system, an adjustable formula for all civil servants. This latter measure would ease portability between the public and private sectors, reduce incentives for early retirement and facilitate introduction of a fully-funded complementary pension scheme.

The financial system has proved resilient to crisis, but has room to develop

The final element in the macroeconomic framework is the financial system. In this regard, the Brazilian banking system has proved to be more resilient to international shocks and currency crisis than those in many other emerging markets. While the financial position of large federal banks has been affected by quasi-fiscal losses engendered by their conflicting objectives, most private banks remain well capitalised and well provisioned. The entry of foreign financial institutions has been instrumental in the process of bank re-structuring and privatisation, notably in the case of state level banks. Prudential supervision has been strengthened. These are positive developments, though the Brazilian banking sector still needs to increase its role in financial intermediation. Instead of intermediating credit to the private sector, banks had mainly engaged in short-term treasury operations. Furthermore, domestic capital markets have not played a big part in promoting growth. Brazilian companies have had to finance their investments largely from retained profits, whilst most long-term lending is provided by federal banks. High and volatile real interest rates, and the crowding-out effect of public debt, were major impediments to medium- and long-term lending. With the normalisation of macroeconomic conditions, bank lending should increase.

Among other factors, imperfections in the legal system have hindered the development and cost of financial intermediation

For the time being, the lack of secured lending and the lack of effective bankruptcy procedures are important factors in raising the cost of financial intermediation. Under existing commercial legislation, enforcing claims on collateral is difficult in view of the prior ranking of debt to all levels of government as well as to employees. A new law is under discussion. A further factor accounting for the high banking spreads prevailing in Brazil is the reserve requirement on demand deposits. These have declined, but were still at 45 per cent of total demand deposits at the end of 2000. Further decline on these reserve requirements will continue only slowly, since the central bank will have to ensure that banks handle this additional liquidity prudently. Finally, another source of distortion is the existence of compulsory credit to agriculture and for housing. Indeed, effective support to these sectors could be given in a more transparent way than through distorted access to credit.

A deeper capital market will not develop without better corporate governance

Given the relatively open capital account and global environment in which Brazilian enterprises increasingly operate, they may migrate to foreign capital markets if the domestic market is not competitive. In this context, the imposition of a financial transaction tax (CPMF) is clearly an issue. Poor protection of minority interests, taxation (including the CPMF) and a lack of competition have retarded the development of the local capital market and the emergence of an equity culture. The standard of reporting could be improved, and generally it is only the largest companies (with securities listed abroad) whose financial disclosure is in line with international norms. In all of this, both new legislation (on bankruptcy and collateral) and reform of the judiciary have a part to play in deepening the capital markets and increasing financial intermediation. An important step will be taken with the adoption of the new company law, which was approved in the lower house in late March 2001. Also the creation of a New Market, with listing requirements that focus on better corporate governance, testifies to the demand for improvement. Ultimately, better corporate governance should help to create a virtuous cycle of development in the capital market.

More competition is the best way to enhance competitiveness

Brazil needs foreign savings to grow and has found itself constantly bumping up against an external constraint. Brazil has in the past attempted to solve this problem by becoming less dependent on imports. However, direct policies to shift specialisation away from primary goods towards manufactured products had some effect, but proved costly. Despite the intensive industrialisation of the 1970s, by the end of the 1990s Brazil's historical trade specialisation had re-emerged. As such, the bulk of Brazilian exports are constrained by considerable trade barriers in international markets, notably on agricultural goods and some semi-processed products. In this context, it is claimed that retaining a certain degree of protection can be a negotiating tool for further trade liberalisation. But this entails deadweight losses for consumers and the enterprise sector. In modern industries, trade is a two-way game. Imports of intermediate goods and equipment are a key source of competitiveness. This is the rationale for the low barriers to trade in such products amongst OECD countries. With its accumulated stock of foreign capital, the Brazilian economy is becoming more interconnected with world markets and has room to develop both as a large exporter and importer of manufactured goods.

Further distortions should not be used to compensate for the so-called "Brazil cost"

Greater export orientation of Brazilian enterprises has to result from the right incentives. Companies will not focus on exports if their domestic market provides comfortable rents. Therefore, trade liberalisation initiated in the late 1980s, that paved the way to a more open and competitive economy, should be pursued. In this context, increased openness to foreign trade and investment means removing existing domestic bias instead, for example, of using export promotion to compensate for a collection of additional costs associated with operating specifically in Brazil ("Brazil cost"). A "similarity test" for certain imports of capital goods, mainly applied to public procurement, creates unnecessary uncertainty about policy objectives and over access to the Brazilian market. Credit facilities conditional on buying local equipment can prevent companies accessing the most modern technology. Increased competitiveness and propensity to trade will also be strengthened by appropriate regulatory oversight, notably competition policy. Improvements to the

legal framework and the effectiveness of the competition authority are both warranted. The effect of cascading taxes on competitiveness should be addressed on its own. The suggestion to introduce further taxes on imports to compensate for the effect of cascading taxes would merely create a further distortion on top of existing ones. As general point, the predictability of trade policy is hindered by the large numbers of laws, provisional measures, decrees and resolutions that have created an intricate web of statutes. Their rationalisation and simplification would greatly benefit transparency.

Relative success in large privatisation, though the regulatory regime has yet to be tested

Overall, Brazil's large privatisation programme has been well managed. The process, co-ordinated by the national development bank, has been transparent. A well-defined regulatory framework is essential to make sure that privatisation delivers its expected benefits. In designing such a framework, Brazilian policy-makers benefited from a number of foreign experiences. The framework for telecommunications seems to be functioning effectively, with strong market growth and increasing competition. While privatisation has been used as an opportunity to open up legal or *de facto* monopolies to competition, co-ordinating decisions ahead of privatisation has sometimes been complicated by the particular web of ownership linking the federal government and local state authorities. This was relevant in the energy sector where some sell-offs predated the establishment of clear norms and regulations. Therefore, transforming regulatory rules into actual policy measures has proved more difficult. The regulatory issue is not only about how to address these problems, but who should address them. This requires a greater degree of co-ordination across regulatory agencies. In particular, all problems of price discrimination or predatory behaviour should be dealt with by the competition agency.

Energy sector reform is needed to meet future demand

The energy sector in Brazil represents perhaps the most complex case in terms of implementing a regulatory framework that meets both developmental and efficiency needs. Brazil's energy system is one of the least carbon-intensive in the world. In addition to a large use of hydropower, the experience in the use of biomass fuels could be

an interesting example of the new solutions needed to face the global threat of the climate change. Nonetheless, the demand for energy is expected to grow quickly, outpacing energy supply available from renewable resources. In particular, electricity needs will increase much faster than GDP. Meeting this demand will be a policy challenge, and the government alone will not be able to sustain the necessary level of investment. Indeed, the government has started to reform the energy sector to allow and attract private capital and to reduce costs through increased competition. The current focus is on constructing gas-fired plants, which will be fed with gas imported through the newly opened Bolivia-Brazil pipeline, using state-led investment. This may be the quickest way to increase capacity and diversify the sources of energy supply, though the government needs to ensure that it does not undermine the policy of liberalisation and that there is sufficient competition in this market. Another issue is that energy policy in Brazil has always had a strong social component in a country where some 15 to 20 million people still lack access to electricity. Increasing rural electrification is a top priority of the government. However, the government should ensure that these social objectives are carefully designed not to undermine the financial viability of the electricity sector.

Agrarian reform needs to distinguish between social objectives and economic efficiency

Agriculture has a vital role to play in Brazil's continued economic development. The sector's direct economic importance is accompanied by extensive linkages throughout the economy, most notably in downstream processing activities. Investment in poor rural areas is seen as having the potential to widen the economic base of development and to reduce income inequality. It is important that Brazil's policies on rural credit and land reform reflect a clear view of the role that agriculture is expected to play in the country's economic development. It is difficult to gauge the extent to which the future of traditional farm households and their descendants is likely to lie outside agriculture, and there is some uncertainty over the ability of rural credit policies to generate a new class of commercial farmers from today's subsistence and semi-subsistence sector. This means that it is difficult to be sure that rural credit programmes have struck the right balance. Nevertheless, the

presence of appraisal systems, and continual refinement in the targeting of these programmes, suggests that policies have the capacity to adapt as experience from the early years of implementation comes in.

There is genuine demand for social expenditure, which needs better targeting

Significant inter-regional differences and income disparities mean that Brazil cannot afford to ease up on development of its social policy. Neither can it simply grow its way out of poverty, given the regressive nature of a large part of its social outlays. Notably, for a country with significant numbers of people in poverty and a very unequal distribution of income, it is perverse that most "welfare" expenditure is on pensions. The system of unemployment insurance is also open to abuse. There is an incentive for workers who simply wish to change jobs to seek redundancy as this gives access to benefits. These structural flaws swallow resources that could more properly be targeted towards those genuinely in need. Furthermore, most welfare spending by sub-national governments is universal rather than targeted, which has disproportionately benefited those on higher incomes. Where means-tested programmes do exist they often miss out people employed in the informal sector. Also, Brazil has some room to improve the way in which public expenditure is converted into tangible outcomes. Examples of successful targeting are in basic education (B*olsa escola*), preventative healthcare and the rural pension. Better targeting of welfare programmes is particularly powerful in Brazil, since many of those living in poverty are not very far below the poverty line. Apart from the intrinsic value in improving the quality of public spending, improving welfare delivery would in due course support higher levels of sustainable growth.

In the search for a new development path, Brazil is a model of the opportunitiies and tensions offered by globalisation

Forging social consensus and political momentum are needed to progress towards a new development path. Consolidating a "social pact" among different entities and groups has been a laborious process, especially in a federal country characterised in the past by large swings from centralised to decentralised forms of government. The experience of OECD countries helps illustrate the policy choices, but the task of managing reform where there are such large social disparities and different levels of development

remains a daunting one. In this respect, the issues facing Brazilian policy-makers are similar to the worldwide challenges in regulating and managing the process of globalisation. Indeed, the world economy is also characterised by tremendous income disparities. At the same time, the gains from increasing integration and greater use of market mechanisms are potentially very large. The reform process will create the conditions for the private sector increasingly to be the driving force in the economy, as the role of the government evolves. Despite the presence of growin g areas of bureaucratic efficiency, Brazilian policy-makers face the challenge of strengthening transparent, accountable and assertive governance in public administration and the judiciary.

Summing up

Brazil has made significant progress in facing problems that are a legacy of the past. Macroeconomic stabilisation has been reinforced since the devaluation of the Real in 1999 and, for the first time in a decade, the economy was able to benefit from an export-led recovery. In 2000, this recovery became more broad-based, which has induced a significant increase of tax revenues and softened the impact of fiscal adjustment. Nonetheless, the dependence on foreign sources of finance, and thus the vulnerability to external shocks, remains significant. Brazil now faces the challenge of pressing ahead with the reforms that are needed to sustain growth. This encompasses a number of areas, in which the government is working. Reform of the fiscal federal relations is needed, and the pension system remains fiscally unsustainable in the absence of a reduction in benefits and privileges for civil servants. The financial sector could play a more important role in financial intermediation, while enhancing competitiveness requires further trade liberalisation and greater competition in the domestic market, including an effective regulatory framework. Better targeting of social expenditures is needed to promote the reduction of disparities, whilst strengthening human capital in the priority areas of education and health. All in all, Brazil has reached a turning point that opens up a perspective of sustained growth. Continuing to focus on its reform agenda can make this prospect a reality.