Political Continuity versus Social Change: The Sustainability of Neoliberal Reform in Brazil

Peter R. Kingstone
Political Continuity Versus Social Change: The Sustainability of Neoliberal Reform in Brazil

Peter R. Kingstone*

How sustainable are the neoliberal reforms that almost all Latin American nations have embraced? Most Latin American governments turned to neoliberalism in the 1980s in a context of severe economic crisis. At the time, the set of government and market reforms lumped under the label neoliberalism appeared to be the only solution to the combination of inflation and economic stagnation. Many social scientists initially doubted that the reforms would succeed economically or politically. Nevertheless, most Latin American nations succeeded in controlling inflation, encouraging a new inflow of foreign capital, and generating some growth. Not surprisingly, neoliberal candidates prospered at the ballot box as well. Yet, as of 1997, analysts and policy makers have begun to express renewed doubts. In particular, neoliberalism's failure to address poverty, promote rapid growth, or promote an equitable distribution of growth has called into question its future.

Brazil was one of the last countries in the region to turn to neoliberal reforms. Several factors helped delay the shift in policy orientation. First, import substitution worked better and longer than anywhere else in the region. As a consequence, Brazilians faced less

---

* Ph.D., Univ. of California (Berkeley), 1994; Asst. Professor of Political Science at the Univ. of Vermont. Professor Kingstone has several works in progress, including chapters in forthcoming volumes on financial integration and democracy as well as neo-liberal reform and democracy. He is also the co-editor of Democratic Brazil (forthcoming, Univ. of Pittsburgh Press, Pittsburgh, Pa.). Paper prepared for Second Conference on "The Economic and Political Challenges of Market Reforms in Latin America", Southern Methodist University, Dallas, Texas, 4 October 1997.


3. Phillip D. Oxhorn & Pamela Starr, The Problematic Relationship Between Economic and Political Liberalization (1998). In fact, Dani Rodrik argued in 1992 that at worst neoliberalism could drive a country into economic ruin and at best it could produce a positive environment for development. Rodrik, The Limits of Trade Reform, supra note 1, at 103. In his conclusion Rodrik called for modesty about the claims one made for trade reform. Id. In hindsight, this seems quite prophetic.
pressure to shift to implement neoliberal reforms and the reform process itself lacked a well defined constituency. Second, Brazil had the most sophisticated system of indexing inflation in the world. As a result, the organized segments of Brazilian society enjoyed considerable protection while only the poor and unorganized truly suffered inflation's effects. In general, Brazilian policy makers seemed inured to the plight of at least fifty percent of the population. Finally, Brazil's chaotic political system made it hard to implement any policy, let alone a significant shift in economic strategy. Overall, there were good reasons to doubt that economic reforms, once they started, would in fact endure.

However, quite to the contrary, the reform process is probably more stable in Brazil than almost any other Latin American nation. First, Brazil's 1994 stabilization plan, the Real Plan, was well conceived and well implemented. Moreover, it is the only stabilization plan in the region that has directly benefited the poor rather than hurt them. Second, the success of the Real Plan has lured in billions of dollars of foreign investment, both portfolio and direct. Again, unlike most other Latin American nations, Brazil's size makes it inherently attractive for investors and therefore permits much more policy flexibility and unorthodoxy. Finally, the reform process has generated a considerable political constituency for reforms, while there is virtually no important opposition.

Despite the basis for optimism, some concern remains. First, the Real Plan has relied on an exchange rate anchor to maintain price stability. Exchange rate anchors are very susceptible to external payments shocks, particularly in the current economic context of significant reliance on more volatile portfolio investments. Brazilian policy makers understand the risks of using the exchange rate as an anchor, but they have been unable to pass vital constitutional reforms that would strengthen the currency. Their inability to do so reflects the continuity of a patronage dominated, chaotic, and poor functioning political

At this writing in late 1997, the Brazilian situation has created a tension between a set of social changes that support reforms and a political process that threatens them. Should Brazil suffer a balance of payments shock with an accompanying return of inflation, it is conceivable that the political protection of patronage and particularistic interests will undermine the strength of social support. Should that occur, some sort of retrenchment against neoliberal reform could emerge. The rest of this paper examines the logic and evidence for this qualified optimistic assessment.

I. Economic Reform as a Technical and Political Problem.

All economic reform programs present two principal challenges, one technical and one political. From a technical perspective, the challenge facing policy makers is how to design a sound reform project. Relatedly, policy makers face a technical problem of insuring competent implementation of the reform project. On the surface, this challenge seems simple enough in principle, but often proves more difficult in practice. From a political perspective, reformers face two distinct challenges: (1) how to build and maintain electoral support (in democracies at least); and (2) how to maneuver a reform program through the political system. In other words, policy makers' political problem is how to construct an electoral coalition on the one hand and how to construct a governing coalition on the other.

Brazil's track record looked quite mixed on these two points prior to 1994. Successive Finance Ministers had imposed repeated invasive, poorly designed, and/or poorly executed stabilization plans on Brazilian society between 1986 and 1993.10 These plans put the economy on a roller coaster with wildly fluctuating rates of growth, investment, and inflation. Brazilians had become extremely wary of new government efforts to stabilize the economy and particularly adept at extracting whatever advantage they could through financial speculation.

Despite the chaos of the economic scene, or perhaps because of it, successive governments were able to construct and reconstruct coalitions in favor of economic reform.11 Thus, prior to 1994, Brazilian presidents had initiated a privatization program, introduced


9. This way of characterizing the problem of economic change comes from John Zysman.

10. See BAER, supra note 5; Bresser Pereira, supra note 4.

a commercial liberalization plan, radically dismantled the bureaucratic impediments to foreign commerce, and eliminated several important market reserves. The result was that by 1994, Brazil had implemented a series of important reforms, yet still suffered from high inflation and highly erratic growth patterns.

The year 1994 represented a turning point for the country. In 1993, interim President Itamar Franco appointed as Finance Minister a noted scholar and highly respected senator – Fernando Henrique Cardoso. Cardoso used his position to introduce the Real Plan – to date one of Latin America's (and certainly Brazil's) most effective stabilization plans. Since its inception in March 1994, low wage earners saw at least twelve percent gains in real income. Price stability has attracted investors to Brazil with nine billion U.S. dollars in foreign direct investment in 1996 and a projected 120 billion U.S. dollars by 2002. Most importantly, the plan has successfully brought inflation below ten percent per year for the first time in almost fifty years. In contrast to the very short duration of previous Brazilian stabilization plans, the Real Plan has endured over three years at this writing with monthly inflation rates continuing to decline. Ultimately, the sustainability of reforms in general hinges on the future of the Real plan. That turns on how well the Cardoso administration manages the continuing technical and political challenges of the Real plan's consolidation.

II. The Real Plan and the Technical Challenges to Reform.

Brazilian stabilization plans prior to the Real Plan had failed either through an inadequate implementation or an inadequate diagnosis of the problem. Thus, heterodox shocks, such as the Cruzado Plan of 1986, collapsed due to political manipulation of the plan and the Sarney government's failure to address more orthodox elements, such as excess demand and government deficit spending. In turn, more orthodox solutions, such as the Collor government's policy as of 1991, failed because they did not address the significant inertial component that twenty-five years of indexation had induced. Prior plans also failed because Brazilians had become more adept at anticipating the plans and evading their consequences. These evasions included preemptive price increases, withholding supplies at controlled prices, tax evasion, capital flight, and other forms of exit from the formal economy. While illegal, these were understandable methods for dealing with the repeated, invasive attempts to contain inflation. In particular, these attempts tended to void, or badly violate at least, existing contracts. The violation of contracts eroded the basic trust that actors need to make a market function properly. It is no wonder that these repeated efforts collapsed.

12. In particular, Bresser Pereira makes this important observation that Brazil's difficulties with stabilization tend to conceal how much successive governments have actually accomplished.

13. Martone, supra note 7, at 60.


15. See BRESSER PEREIRA, supra note 4; Fishlow, supra note 5.

16. LUIZ CARLOS BRESSER PEREIRA, JOSE MARIA MARAVALL, & ADAM PRZEWORSKI, ECONOMIC REFORMS IN NEW DEMOCRACIES (1993).
The Real Plan succeeded because it differed in fundamental ways from its predecessors. First, Cardoso, as Finance Minister, introduced the Real Plan in December 1993, providing ample time for congressional and societal discussion of its contents. Brazilians knew exactly what was coming when Cardoso initiated the Real Plan. Second, the administration initiated the plan with a new unit of reference, the Unit of Real Value (URV) rather than a new currency. Brazilians had created several units of reference to help them adjust contracts to the rate of inflation. The government introduced the URV as an alternative unit that was linked to the exchange rate. The publicly stated intention was to allow economic actors time to adjust their contracts to the new unit of reference before converting it into the new currency. The adjustment period permitted economic actors to gradually and gracefully prepare for the currency change—an important innovation, especially considering the Real Plan was essentially an implicit dollarization. Third, Cardoso had secured an ad hoc, one time fiscal adjustment through the Social Emergency Fund (FSE)—a measure that appropriated resources constitutionally protected as transfers to the states and municipalities. Finally, Cardoso benefited from Fernando Collor's (1990-1992) legacy of low import tariffs and a relatively sound budget balance.

The combination of well designed heterodox elements with effective implementation of orthodox elements made the Real Plan work. The currency shift occurred virtually without a snag and without requiring new wage and price controls.\(^\text{17}\) On the orthodox side, the FSE left the state with a balanced budget and commercial liberalization hindered preemptive price increases or other efforts to manipulate prices.

The results appeared immediately. Inflation fell from a high of 50 percent per month in June 1994 to less than 2 percent per month on the eve of the October 4 presidential election. Inflation dropped to 12 percent for 1995, below 10 percent in 1996, and was projected around 7 percent for 1997. GDP growth registered 2.5 percent in 1995 then rose to roughly 3.5 percent for 1996 and over 4 percent for 1997 (projected).\(^\text{18}\) Although Brazil's growth rates remained weak, the Real Plan had still accomplished more than any stabilization plan in Brazilian history.

Nevertheless, the Real Plan revealed several technical problems. First, the government had to clean up the state's fiscal condition to fully consolidate the Real Plan. The Cardoso administration re-negotiated the FSE (renamed the FEF - Fiscal Emergency Fund) in late 1995 and again in 1997. However, deep problems remained in the social security system (Previdencia), the civil service system, and the fiscal system.\(^\text{19}\) Each of these areas contributed to an erosion of the government's finances from a 1 percent surplus in 1994 to deficits in the order of 4.5 percent of GDP through 1995-1997.\(^\text{20}\) Second, in the absence of these crucial reforms, the government had to rely on far less secure and ultimately more destructive methods of securing the currency: these methods included maintaining the

---

17. Although the Franco administration helped Cardoso's electoral campaign by threatening to prosecute any business person who raised wages in the period leading up to the October 1994 Presidential election.

18. Figures from Brazilian Central Bank.


20. Id.
exchange rate anchor; relying on high interest rates to discourage consumption and imports and to help attract foreign investment; and a rapid escalation of public debt, both to sterilize capital inflows and to compensate for growing budget shortfalls.

This policy sharply affected a whole array of other elements of the government's growth policy. For one, credit restrictions sharply hurt domestic producers. Although the administration gradually lowered rates and eventually made credit available at reduced rates for some types of consumers and for some producers, private debt, private default, and corporate bankruptcy rates remained at historic levels. Similarly, the policy hurt the capacity of domestic producers to adjust to import competition. Tight credit combined with an overvalued currency and low tariff barriers shifted all advantages to either imports or foreign investors seeking entry to the Brazilian market. The policy almost certainly contributed to rising unemployment, although there is some controversy over both the causes of unemployment and the actual numbers of unemployed.

The government clearly intended to place its bets on foreign direct investment and the rise of exports from Brazil. Neither bet has proven a good one. Foreign investors have entered at a rapid rate, but without the desired consequences. Foreign investors have not made any impact on employment. In fact, Cardoso himself blames competitive modernization for the country's unemployment rate. As for exports, they have risen, but much slower than imports. Brazil's trade surplus began to erode by 1994-1995. By July 1997, the country's trade deficit had climbed over 4 percent of GDP. Addressing this cluster of problems requires passing the same set of constitutional reforms necessary to finally consolidate the Real Plan. That is a political problem.

III. The Real Plan and the Political Challenges to Reform.

Managing the political process of economic reform in Brazil particularly highlights the tension between political continuity and social change. On one side, Cardoso, like Fernando Collor before him, has had to work to construct a governing coalition in Brazil's chaotic polity. Brazil's political parties are notoriously fragmented and weak. Brazilian politicians are notoriously non-ideological; rather, they focus intensely on access to patronage and service to very narrow, well defined corporative constituencies. Bargaining with this group has been very complex, unpredictable, and usually ineffective. This problem reflects both longstanding features of the Brazilian state as well as more recent problems enshrined in the 1988 Constitution. With the exception of the Workers' Party and a few smaller leftist parties, most Brazilian politicians do not oppose the reform process.

22. This is Cardoso's standard defense whenever the issue of unemployment comes up.
23. Mainwaring, Politicians, Parties, and Electoral Systems, supra note 8; Scott Mainwaring & Timothy Scully, Party Systems in Latin America, in BUILDING DEMOCRATIC INSTITUTIONS: PARTY SYSTEMS IN LATIN AMERICA (Scott Mainwaring & Timothy Scully eds., 1995).
25. Id.
In fact, surveys of Members of Congress suggest that they support it in principle.\textsuperscript{26} However, the Constitutional reforms needed to consolidate the Real Plan have enormous implications for access to patronage and for the entitlements of many of Brazil's best organized lobby groups.\textsuperscript{27}

On the other side, Cardoso faces a process of relatively rapid social change that has provided him with a larger constituency for reform than existed previously. The Real Plan has had marked consequences for the majority of poor Brazilians long neglected by official policy. On the opposite end of the political spectrum, business groups have had to invest in specific adjustment strategies for coping with commercial liberalization. As they have sunk resources into particular strategies, they have become more dependent on continuing the reform process.\textsuperscript{28} Thus, Cardoso has been able to draw political support from important social groups that have emerged as either beneficiaries of or at least stakeholders in the success of economic reform.

IV. Political Continuity and the Obstacles to Economic Reform.

Brazil's political system is one of the least cohesive, coherent, and effective in the western world. Analysts such as Scott Mainwaring, Timothy Power, and Barry Ames, among others, have noted a host of problems ranging from perversities of the electoral system to the fragility of the party system to dilemmas of Brazilian multiparty presidentialism. The Brazilian political system grew out of a set of compromises that preserved the influence of regional elites at the expense of strong national organizations. That diffused quality endured through the post-war period into the New Republic, founded in 1985. In fact, the writers of the 1988 Constitution, concerned about authoritarian tendencies, further weakened any centralizing tendencies.

A brief summary of institutional design problems in Brazil makes clear the obstacles to coherent policy-making. Brazil has a proportional representation system for the lower house of the Congress. Candidates run in state-wide districts with open lists -- meaning that elections are very expensive and depend on candidates with significant name recognition or very well defined constituencies. As a consequence, parties exert little control over their candidates since they have little to offer them. Instead, candidates focus primarily on obtaining resources for their constituencies -- whether geographic or functional (referred to as corporativist in Brazil). Furthermore, P.R. has allowed a proliferation of small parties that clutter the political system. The result of these features is that bargaining is extremely complex within the legislature and between the legislature and the executive. Party leaders face sharp limits in how much they can promise and how effectively they can deliver party votes.

This is particularly aggravating for executive-legislative bargaining because the Brazilian President in fact must pass almost all of his or her agenda through Congress.

\textsuperscript{26} Bolivar Lamounier & Maria Teresa Sadek Ribeiro de Souza, Depois da Transição: Democracia e Eleições No Governo Collor (1991).
\textsuperscript{28} Power, The Pen is Mightier than the Congress, supra note 8.
This has resulted in two qualities of Brazilian governance. First, Brazilian presidents are engaged in a constant process of coalition building and bargaining over compensation for political support. Second, every president in the New Republic has relied extensively on provisional measures that have the power of law for thirty days before either the Congress votes on it or the President reissues them. That practice has hurt Congressional-Presidential relations as well as hopelessly clogging the Congressional agenda with provisional measure votes.

The impact of these qualities on economic governance has been mixed. On the one hand, venal, patronage demanding politicians have been willing to support most policies as long as executives have been willing to pay the price. In fact, survey work shows that large majorities of members of Congress support the whole array of reforms that Cardoso has tried to push. These reforms have included support for privatizations, the end of market reserves for domestic producers, commercial liberalization, financial liberalization, deregulation of several areas of the economy (most dramatically in the area of foreign commerce), as well as civil service, social welfare, and tax reforms. These statements of support have not been merely rhetorical. The Congress has approved most of the items noted above.

However, they have not yet approved any real reforms to the Constitution in the area of civil service and only very limited reforms to social welfare and the fiscal system. Successive presidents since Fernando Collor have tried without success to pass these reforms. Collor’s effort, dubbed the emendão (giant amendment), was tabled permanently. Under Itamar Franco, Congress met to review the Constitution in 1993. Led by Finance Minister, Fernando Henrique Cardoso, the government sought the same set of constitutional reforms with virtually no success. Opponents and supporters alike swamped Congress with over 30,000 amendments and ultimately only passed six, including the Social Emergency Fund (FSE). Since Cardoso’s inauguration in January 1995, the government has made repeated efforts to pass these reforms without success. As of late 1997, they still have made little headway.

The reasons for this failure are readily apparent. Despite the majority support for these reforms in principle, few members of Congress want to record a vote that cuts them off from important sources of patronage or visibly affects an important, well-organized lobby group. Civil service reforms threaten well organized public sector employees (of which there are many in Brazil) as well as threaten an important source of patronage for legislators. Social welfare reforms threaten public sector employees and retirees in particular as well as threaten access to an important source of patronage. Finally, the fiscal system favors the states and municipalities (and their ability to finance their crucial patronage systems). Consequently, a powerful array of forces stand against changes in the system. This remains true even though the state governors support some change to relieve their budget problems and that fiscal reform is widely understood as the linchpin of successful consolidation of the Real Plan.

29. Id.
30. Id.
This confusing, chaotic, and ineffectual political system dates back to the beginning of the New Republic and back even into the formation of the modern Brazilian state. Political reform is something that every politician, political analyst, and journalist discusses and perceives as crucial. Nevertheless, the obstacles to reforming the political system are even more daunting than the obstacles to economic reforms. Thus, the political system has shown remarkable continuity through the 1980s and 1990s and promises to continue to do so. As long as it does, it will present the most pressing challenge to consolidating economic reforms.

V. Social Change and the Bases of Political Support for Economic Reform.

If political continuity represents a vulnerable point for the future of economic reforms, social changes in the 1990s represent the strongest base of support. The success of the Real Plan since 1994 provoked rapid and significant social changes that stand in sharp contrast to the continuity of the political system. Those changes occurred primarily within the Real Plan's two most important constituencies: the business community and the poor. In the case of the business community, price stability allowed competitive adjustments that firms had put off previously. As both domestic and well-established MNC's invested in particular strategies, they became more dependent on the successful continuation of government policy. Brazil's poor, roughly 50 percent of the population, historically paid the highest price for inflation. This large, poorly unorganized group of voters discovered the benefits of price stability as their real incomes increased substantially. Both groups represent important sources of political support for the Cardoso government and the reform process. Nevertheless, there remain vulnerabilities in both sources of support.

A. Business.

One of the most important constituencies for the reform process lies in the business community. Domestic business groups had been calling vociferously for market and state reforms since 1985. Although the state protected domestic business (as well as MNC's producing in Brazil) for sixty years, business leaders recognized the need for change. Chronic high inflation, eroding state finances, and a shrinking internal market among other problems convinced business leaders that the status quo was not viable. As a result, a broad coalition of industrialists, bankers, and merchants were available to support the reform process.

However, reforms proceeded in fits and starts between 1985 and 1996. Industrialists and bankers put off making competitive improvements in a context of sharp uncertainty. The uncertainty of the reform process also weakened business resolve in supporting the

33. Id.
34. Power, Why Brazil Slept, supra note 8.
changes. By 1994, there existed constituencies within the business community for further reform as well as for some sort of retrenchment.36

That situation changed when Cardoso successfully implemented the Real Plan. Price stability attracted imports and foreign investors, both of which forced domestic producers to decisively choose their adjustment strategies. Brazil’s largest banks swelled as they consumed smaller, weaker banks long protected by inflation profits. The commercial class prospered as new consumers entered the market. Among industrialists, domestic producers faced a choice: to compete, to associate in a variety of ways with foreign capital, or to exit the market. As of 1997, this process was still underway, but the evidence clearly pointed to rapid decision-making along these dimensions.37

Domestic industrialists that have chosen to compete depend heavily on the continuation of the constitutional reform process. This group, made up of large numbers of small and medium sized enterprises, suffers from highly uncompetitive capital and labor costs, as well as an extraordinarily inefficient tax system. This group has indicated in a variety of fora that it is open to both continued market reforms as well as some kind of retrenchment of the reform process. However, their continued support for market reforms depends on Cardoso completing the constitutional reforms that promise to reduce what Brazilian business people refer to as the “Brazil cost.”

Newspaper and business association reports as well as personal interviews suggest that many domestic industrialists have sought some sort of association with foreign capital. These include mergers, sub-contracting arrangements, becoming licensed distributors of MNC goods, as well as participation in conglomerates with MNC’s. This category of producers has made a definitive choice in favor of continuing the reform process and, along with the new big banks and imports/exports traders, is unlikely to support a retrenchment of the reform process.

While this new clustering of businesses favoring market reforms is important, there are several crucial limitations to this support. First, their behavior has not supported the Cardoso administration strategy. Many of these new foreign investors and domestic partners have focused primarily on the internal market. Brazil’s mix of payroll taxes, infrastructure problems, and other assorted costs of production weaken it as an export platform. The Cardoso government moved to improve export conditions, mainly by repealing several export related taxes.38 Exports have increased since 1994, but far below the pace of imports. Some of the existing and a lot of the anticipated foreign investment is targeted at purchasing privatized assets — some of which exports, such as the Compania Vale do Rio Doce (CVRD) while others, such as the anticipated telecommunications investments, do not. Another large segment of foreign investment has been buying existing firms in order to acquire their distribution networks. Thus, MNC’s and their new domestic partners are limited as contributors to a pro-exports strategy.

38. An action taken through the Brazilian Ministry of Industry, Commerce & Trade in 1997.
A second limitation is that the process of modernization has eliminated over two million jobs since 1990 and has left the unofficial unemployment rate hovering around 16 percent. The continued reform process is unlikely to quickly change the employment situation. While Cardoso has maintained his political support overall, polls have shown that voters have given failing marks on his employment policies.

Finally, given that many foreign investors have focused on the internal market, they may still support some sort of retrenchment as long as it does not restrict their access to that market. The clearest indication of that came out of the negotiations with American auto makers on the location of their production within Mercosur. As American auto producers, such as Ford, threatened to relocate production to Argentina, the Cardoso administration unveiled their “auto industrial policy” – a thinly veiled protectionist policy. Despite the furor the policy produced in Japan, Korea, the United States, as well as Mercoser partners (notably Argentina), the plan worked. In fact, since the decision, auto producers have pledged upwards of 16 billion U.S. dollars in investments by 2002. Similar deals are imaginable among producers of most consumer durables.

B. Poor Voters.

The other crucial constituency for market reforms has been poor voters. Brazil’s poor roughly comprise 50 percent of the population. As such a large bloc, they constitute a critical voting group. In August 1994, low income voters shifted their preferences from Lula to Cardoso as they became aware of the effects the paternity of the Real Plan. Since 1994, they have remained an important source of political support for Cardoso, largely because of price stability.

This sharply differentiates the Brazilian case from other Latin American cases of neoliberal reform. Typically, the poorest members of society bear the brunt of stabilization. However, Brazil’s sophisticated indexation system altered that pattern. Introduced by the military government in 1967, the indexation system allowed all actors in the formal economy to adjust wages, prices, tax payments, and all other contracts to the rate of inflation. This made inflation very hard to eradicate (inertial inflation), but it also provided a degree of protection from inflation’s worst effects. Unfortunately, workers in the informal economy had no protection at all. Thus, inflation acted as a brutal tax on the poor informal sector workers while sparing virtually everybody else.

The advent of price stability produced immediate positive benefits for informal sector workers. Real income grew 12 percent in the first two years of the Plan. Prices of basic goods remained stable with wages growing at a faster rate than prices across much of the economy. As a result, poor consumers were able to purchase goods they had never bought before. Poultry, meat, televisions, radios, washing machines, cement for building, and fast foods among others all reached record levels of sales. Nationally, five million people in urban centers were lifted out of poverty in the first two years of the plan. This represented a decrease in the proportion of poor in these urban centers from over 40 percent of the

39. Statistics from Brazil’s Departamento Intersindical de Estatistica e Estudos Socio-Economicos (DIEESE).
40. Veja, June 1996.
population to just under 30 percent. Thus, it is not surprising that Cardoso has maintained a strong constituency among low income voters. Should inflation remain low, Cardoso will very likely gain these votes in 1998 as he did in 1994. In fact, in interviews conducted in June 1996, business elites explicitly identified this group of voters as the principal reason for confidence in the sustainability of the reform process. Business people repeatedly observed that these voters would penalize politicians for behavior hurtful to the reform process.

However, this confidence is almost certainly overstated. First, this level of support is intimately linked to the fate of the Real Plan. Should inflation return, poor voters’ support is likely to evaporate quickly. This is especially true because voters have given the Cardoso government low marks on virtually every other area of concern to them. In particular, as of 1996 voters had given the government failing grades on each of the five social policy issues Cardoso campaigned on in 1994. Furthermore, while Cardoso has retained his personal credibility, corruption issues have tainted the government. Thus, the Cardoso government remains quite open to attack on several critical grounds. Second, these poor voters lack any real mechanism of influence over Members of Congress. Their voting power lies in executive elections where their votes can decide outcomes. However, Members of Congress must remain particularly alert to the concerns of well organized lobby groups that may have interests that threaten the stability of the Real Plan. Against them, poor voters have no influence. In fact, polls suggest that this group of voters has no understanding of the links between the stability of the Real Plan and Cardoso’s Constitutional reforms -- which many lobby groups resist on particularistic rather than ideological grounds. The final important consideration is the character of this voting group. Low income, informal sector workers are notoriously unorganized and unconnected to formal political life. They have neither partisan, organizational, or ideological links to any political party (although the Workers’ Party (PT) has tried to organize them). As a consequence, they represent a dangerous political base that can shift very rapidly. If inflation returns, this mass of unorganized voters will be up for grabs.

VI. Reasons for Optimism.

The analysis above highlighted the tension between political continuity that threatens the sustainability of economic reform and social change that strengthens the process. The analysis also identified ways in which social support may erode if political paralysis undermines the Real Plan. However, three additional factors influence the political process and point towards an optimistic conclusion. First, foreign investors are intensely interested in Brazil, primarily due to the size of its market. As a result, investors have tended to forgive Brazil a degree of policy incoherence that other countries could not afford. Second, Brazilian

42. In fact, a review of opinion polls over the period 1994 to 1997 shows how volatile public opinion can be. Cardoso and his government have ridden a roller coaster between high levels of approval and confidence in the fate of the Real and disapproval and low confidence. The changes have come in response to political events, such as the claim that Sergio Motta, Cardoso’s Minister of Communication, participated in a scheme to buy votes in the Congress. Public anger over the charge drove support levels down.
elites seem to be willing to tolerate a confused policy-making process and limited policy success as long as they can believe that some future event will solve their problems. This faith in the future has sustained Brazilian elites through all four presidents of the New Republic. Finally, Cardoso and his commitment to the reform process remain safe as long as there is no real alternative. That has been and as of 1997 remains true of Brazil's political situation.

A. Everybody Loves Brazil.

Brazil is one of the few countries in the developing world that everybody wants to succeed. Foreign investors with mobile capital are relatively indifferent to the success or failure of most developing nations. However, Brazil's growth potential is tremendous due to the potential size of its market. Foreign capital flowed out of Brazil during the chaotic latter half of the 1980s. Little new capital entered during the chaotic early 1990s. Interviews with MNC's already in Brazil suggested a widespread "wait and see" attitude. With the onset of the Real Plan, the situation rapidly changed. Less than 18 billion U.S. dollars in new foreign investment entered Brazil in 1992. Just under 80 billion U.S. dollars entered in 1996. Inflows included very sharp increases in currency loans, portfolio investment, and direct investment. This occurred despite repeated failures to pass constitutional reforms Cardoso himself identified as central to consolidating the Real Plan. This occurred despite hints of scandal that the government managed to leave unexamined, but which remain as possible sources of trouble. This occurred despite a rapid increase in public debt and the commercial deficit. In return, the Brazilian stock market has rewarded investors with some of the best returns in the world.

43. FOREIGN CAPITAL INFLOWS, BRAZILIAN CENTRAL BANK (1997).
44. Id.

U.S.$ Millions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Inflows</td>
<td>17,791</td>
<td>32,667</td>
<td>43,073</td>
<td>53,885</td>
<td>78,999</td>
</tr>
<tr>
<td>Portfolio</td>
<td>3,863</td>
<td>14,971</td>
<td>21,600</td>
<td>22,559</td>
<td>24,684</td>
</tr>
<tr>
<td>Direct</td>
<td>1,325</td>
<td>877</td>
<td>2,241</td>
<td>3,285</td>
<td>9,580</td>
</tr>
<tr>
<td>Currency Loans*</td>
<td>7,979</td>
<td>11,031</td>
<td>8,756</td>
<td>15,883</td>
<td>28,078</td>
</tr>
<tr>
<td>Financing</td>
<td>2,332</td>
<td>3,286</td>
<td>4,353</td>
<td>4,576</td>
<td>6,828</td>
</tr>
<tr>
<td>Prepaid Exports</td>
<td>1,119</td>
<td>1,421</td>
<td>1,908</td>
<td>4,273</td>
<td>7,073</td>
</tr>
<tr>
<td>Other</td>
<td>1,173</td>
<td>1,085</td>
<td>4,215</td>
<td>3,309</td>
<td>2,756</td>
</tr>
</tbody>
</table>

Source: Brazilian Central Bank, April 1997.

*Currency loans include foreign bank loans to private industry, rural financing, mortgage financing, debt renewals, export financing, and bonds and fixed/floating interest rate notes placed by the public sector and the private sector. While the data is not broken down further here, as of 1996, the large majority of this category was private sector loans and private sector placement of fixed interest rate notes (of which roughly 45 percent was placed by banks, 45 percent was placed by non-financial companies, and 10 percent by the public sector.)

It is beyond the scope of this paper to account for shifts in capital flows. One thing does remain clear. As long as new inflows keep coming into Brazil, the government will retain the capacity to secure the Real Plan and finance its trade deficit. Sylvia Maxfield has reported that research on capital flows shows that OECD interest rates account for over 80 percent of capital flows to the developing world. If that is true, a rise in rates may reverse the flow of portfolio investment to Brazil. However, the government has slowly been reducing the risk of such a shock. As of 1996, foreign reserves stood at roughly 60 billion U.S. dollars. The government had also contained its fiscal deficit through a combination of minimal social security changes, new tax revenues, renewed growth (and thus improved tax revenues), and lowered real interest rates. Thus, the country's vulnerability to an external shock has reduced somewhat. Meanwhile, the data for 1997 show even greater capital inflows.

46. See FOREIGN CAPITAL INFLOWS, supra note 43.
47. Id.
49. See generally Fishlow, Is This Plan For Real, supra note 5.
B. AS LONG AS THERE IS HOPE.

A second reason for optimism has to do with how Brazilian elites have responded to political signals in the past. Elites look for signals that a program or government will fail or succeed. That does not always depend on specific failures or successes in the policy-making realm. Brazilian business elites in particular have repeatedly looked to future events to solve their problems. As long as hope can be deferred to the next event, elites can discount the weight of current policy struggles. Thus, support can endure even though governments accomplish little.

During the latter part of Sarney's term in office, Brazilian business elites looked particularly to the 1989 election. Many Brazilian business people expressed confidence that the first directly elected President of the New Republic would solve the problems that Sarney could not. Similarly, during the Collor and Franco governments, business elites pointed to the 1993 referendum on the political system as well as the scheduled 1993 Constitutional Review. After the failures of both the referendum and the Constitutional Review, business elites pointed to the 1994 elections. After the disappointment of Cardoso's first three years, business elites began pointing to the probability of Cardoso's 1998 re-election and the possibility of a new Constitutional Review in 1999. This pattern, strongly reinforced during interviews with business people in 1991-1992 and 1996, suggests that the signals of failure have to be very strong before they undermine the hope in future events.

Cardoso has been particularly skillful at manipulating the political agenda to feed that hope. Each time Cardoso has confronted growing obstacles to his policy program and the resulting public criticism and pressure, he has deftly changed his tactics. This occurred most notably in mid to late 1996. With repeated failures to pass social security and civil service reforms, Cardoso faced a rapidly growing chorus of public and business criticism. To forestall the criticism, Cardoso announced a retreat from constitutional reforms. Instead, he turned to a series of incremental reforms and renewed his call for a constitutional amendment allowing presidential re-elections. By late 1996, the business community leadership dropped its critical tone and raced to endorse Cardoso's re-election as the only possible solution to the stalled reform process.

C. IT'S THE ONLY GAME IN TOWN.

The final factor that strengthens the reform process against the patronage logic that threatens the Real Plan is that there are no coalition alternatives to Cardoso. Analysts have noted the general intellectual bankruptcy of the Left in Latin America since the collapse of the Soviet Union. The Brazilian Left presents a contradictory picture. On the one hand, the Workers' Party is one of the most vigorous and competitive left-wing parties in Latin America. On the other hand, they are riven by internal conflicts that have hurt most of their efforts at governing at the municipal level. They have also failed to articulate a clear alternative to Cardoso's economic program. During the municipal elections of 1996, the

50. Congresso Revisor.
51. William R. Nylen, Contributions of the Workers' Party (PT) to the Consolidation of Democracy in Brazil, in Democratic Brazil. (Peter R. Kingstone & Timothy J. Power eds., forthcoming, Pittsburgh Univ. Press, Pittsburgh, Pa.).
PT leadership began articulating a program that called for slowing the pace of economic liberalization. However, their antipathy to Constitutional reform makes a business-labor alliance unlikely. In any event, their own internal splits and the rising influence of the "Shiites" make it unlikely that they can stand by that program.

A second alternative coalition began to emerge in 1996 in the context of growing frustration over Cardoso's legislative failures. Paulo Maluf, the former Mayor of São Paulo, began to assert himself as a rival political force. Assisting him was Delfim Netto, a Senator and the architect of the Brazilian Miracle. With Netto talking in business associations about the Brazil Cost and the government's errors and Maluf marshaling his forces within the PPB (the fourth largest party after Cardoso's PSDB), the possibility of a rival seemed real. Maluf's platform mirrored the PT's call for a slowdown in the pace of economic liberalization. However, Maluf's platform was sympathetic to the concerns of business and to the need for Constitutional reform. Maluf's influence seemed to have hit its peak during the 1996 municipal elections when his hand-picked successor, Celso Pitta, handily beat all other candidates for the position. This was particularly striking given that Pitta was an unknown, not particularly charismatic, and of African heritage in a primarily white city. Cardoso's hand-picked opponent, José Serra was well known, a Minister in Cardoso's cabinet until the campaign, and aggressively supported by Cardoso and the PSDB Governor, Mario Covas.

As significant a rival as Maluf appeared, his threat ended with the revelation of a public finance scandal that tainted both Pitta and Maluf. By early 1997, Maluf was essentially out of the picture negotiating to keep himself out of the inquiry rather than threatening Cardoso. Thus, as the 1998 elections approach, the PT has weakened, Maluf is out and the remaining threats are small. Jaime Lerner, the popular former Mayor of Curitiba left his party and tried to join Cardoso's PSDB. Itamar Franco, the former President — a man who as Fernando Collor's Vice-President inspired Dan Quayle comparisons — remains as the most aggressive challenger. If elites see Cardoso as the only real game in town, it is because as of 1997, he is.

VII. Conclusion.

Overall, the economic reform process seems fairly strong in Brazil. Strong constituencies exist for privatization, despite the slow pace the government has pursued. Strong constituencies have supported deregulation of the market place. The constituency for commercial liberalization has grown stronger since 1994. Finally, a large majority of Brazilian policy-makers and elites understand the need for reforms that address the "fiscal crisis of the state." Indeed, the vast majority of Brazilians have benefited from price stability and support the continuing defense of the Real Plan -- even if many do not see the connection between the Real Plan and Constitutional reform. In short, the social support for continuing the reform process is robust.

There are some clear vulnerabilities in the Brazilian situation. The government record on social issues, such as education, health, land distribution, employment, and security, remains weak. Corruption, a widespread problem encouraged by perversities of the political system, has repeatedly destroyed political careers in recent years. It still lingers as a possible threat. On the economic side, the export promotion policy has not offset the inflow of imports and in fact has consistently lost ground over the last two years. While the trade deficit has been manageable due to enormous capital inflows, there are limits to how much
of an imbalance the country can finance. In addition, the government's continued reliance on the exchange rate anchor has forced them to keep growth rates low (in the area of 3-3.5 percent). The combination of an overvalued exchange rate and high interest rates has yielded record numbers of bankruptcies, hindered further exports, and limited the possibility of creating new jobs.

The good news is that the government understands that. The Cardoso administration, on the whole has acted quite competently. Their problem is that the solution to the economic problems lies in passing difficult reforms through a Congress committed to protecting the narrow interests served by the existing Constitution. The Cardoso government has made numerous attempts using a variety of tactics, from patronage to appeals to the media to hurling insults at Congress. To date, almost nothing has been done. As long as capital continues to flow in, the country can get away with it. Clearly, that is not the preferred solution for anybody.

Should an external payments shock occur, inflation could return. Without indexing, even relatively small increases in inflation might rapidly erode the support of the big mass of poor voters. If that occurs, potential rivals could find chinks in Cardoso's armor quite easily. What would an alternative coalition look like? It is doubtful that it would involve a reversal of the economic program that has progressed in fits and starts for the past eight years. Rather, it is more likely that it would involve some sort of retrenchment—a digging in of heels so to speak. That might include some limited use of protection to ease the speed of commercial liberalization. It may very well include more attention to a range of social issues. However, as Bresser Pereira has observed, at the heart of Brazil's problems lies the fiscal crisis of the state. Solving it requires state reforms and some degree of reliance on new capital inflows from foreign investors. Any political program will have to face that. Thus, even if a retrenchment of some sort occurs, the new economic program will likely continue to point in the same direction.

Bibliography


ECONOMIC LIBERALIZATION: NO PANACEA (Tariq Banuri ed., 1991)

Luis Carlos Bresser Pereira, Economic Crisis and State Reform in Brazil: Toward a New Interpretation of Latin America (1996).


Albert Fishlow, Is the Real Plan for Real?, in BRAZIL UNDER CARDOSO (Susan Kaufman Purcell & Riordan Roett, eds. 1997).


Peter R. Kingstone, *Crafting Coalitions for Reform: Business Preferences, Political Institutions and the Politics of Neoliberal Reform in Brazil* (unpublished manuscript on file with the author).


Dani Rodrik, *The Limits of Trade Reform in Developing Countries*, J. of Econ. Perspectives, Winter 1992, at 87.


*Democracy, Markets, and Structural Reform in Latin America: Argentina, Bolivia, Brazil, Chile and Mexico* (William C. Smith, Carlos H. Acuña & Eduardo A. Gamarra eds. 1993).


