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GOVERNMENT FAILURE AND WRETCHED STATECRAFT:  
LESSONS FROM THE BRAZILIAN VICIOUS CIRCLE<sup>1</sup>

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## 1. INTRODUCTION<sup>2</sup>

As happened in most of the world, views on the economic role of the state have changed dramatically in Latin America during the last two decades. By the early seventies, most of the best trained economists in the region had developed a strong belief in the benefits of a wide range of direct government interventions in many areas of the economy. Keynesian triumphalism, then already fading in the US and Europe, still thrived in Latin America, where Iberian tradition and a long and more recent historical experience of government intervention provided an especially fertile soil to the idea of giving the state an important strategic economic role. Impressionistic arguments in favor of government intervention in the allocation of resources were then being replaced in the region by more rigorous ones, under the also latecoming influence of applied welfare economics and its "anatomy of market failures".<sup>3</sup>

Two decades later a totally different view on the economic role of the state has emerged in Latin America in the wake of a row of difficulties imposed by two oil shocks, a long foreign debt crisis, deep fiscal imbalance problems, prolonged stagnation and high inflation. Those difficulties, as well as the market-oriented policies which helped some countries in the region to emerge successfully from the crisis, have amplified in Latin America the recent worldwide fall-of-the-Berlin-wall effect on the dominant view about the desirable economic role of the state.

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<sup>2</sup> The author is grateful to Dionísio D. Carneiro, Marcelo de P. Abreu and Daniel R. de Oliveira for helpful comments and to Mônica Baumgarten for the research assistance.

<sup>3</sup> See Bator [1958].

As the pendulum swings to an extreme market-oriented approach to policy making, overshooting becomes unavoidable as some countries in the region seem to be engaged in a kind of contest to establish the fastest reduction in the economic role of the state. A more balanced view is bound to emerge in the coming years as the difficult choice between market failures and government failures is more pragmatically reconsidered.<sup>4</sup>

This paper deals with some of the issues that should be taken into account in that choice. Most of them are related to the appalling situation of the state apparatus in some countries -- deeply affected by a very long crisis -- and to how this is likely to constrain the policy choice set of those countries in the future. The analysis is basically referred to the Brazil, but some arguments fit well other countries in the region.

Some Latin American economies have overcome the crisis and are apparently en route to growth and modernization. That is however not the case of Brazil. Quite on the contrary, the Brazilian economy -- and that means roughly 45% of Latin America and the Caribbean -- is still struggling with unsolved mega-inflation and stagnation problems. Since the early eighties, recurrent stabilization attempts have not only consistently failed; they have in general amplified the difficulties to be faced. Present political obstacles make it hard to believe that successful stabilization will be attained before 1995.

From 1980 to 1982, the annual inflation rate in Brazil was already over 90%. It jumped to more than 200% from 1983 to 1985 and, after falling to 65% in

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<sup>4</sup> See Hirschman's [1982] insightful discussion on that choice.

1986, in the wake of the Cruzado Plan, reached more than 400% in 1987. Inflation has been above 1000% yearly since 1988, except in 1991, when it went down to 480%. Twelve years of unsuccessful stabilization attempts and half-hearted fiscal adjustment efforts have eroded the state's capability to formulate and implement economic policy, enlarging the scope for further failures in the future, in a vicious circle which has proved difficult to break so far. Analyzing the logic of this perverse process and the lessons that may be drawn from it is the main purpose of this paper.

## 2. GOVERNMENT FAILURE AND STATECRAFT

As it is well known, the possibility of market failures has been the main rationale for government intervention in the economy. Awareness of situations in which market outcomes are inadequate has led to the prescription of corrective policies to deal with coordinating failures of the price system. Such situations may involve public goods, externalities, increasing returns to scale, incomplete information, imperfect competition, cyclical fluctuations in output and employment and distributional inequity. The catalogue of market failures in economic theory has been seen for a long time as a guide for policy analysis and government intervention.<sup>5</sup> Yet there has been a growing concern with government failures. It was perceived that, attempting to correct market failures, government may generate economic distortions that can be even more serious than those which inspired the policy actions. That called for a more balanced view on potential failures. As neatly put by Wolf [1979, p. 132]:

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<sup>5</sup> See, for example, Inman [1991].

The existing theory of market failure provides a useful corrective to the theory of perfectly functioning markets. In a similar sense, the theory of nonmarket failure [...] is intended as a corrective for the implicit theory of perfectly functioning governments. Just as market failures or inadequacies have provided the theoretical underpinning for applied *policy analysis*, so nonmarket failures may provide the theoretical underpinning for *implementation analysis*. The analysis of how specific nonmarket activities (public policies) can be expected to operate and to depart in predictable ways from their costs and consequences as originally estimated.

In the conventional analysis of government failures at least four sources of failure are identified.<sup>6</sup> First, the full consequences of many government actions are hard to trace in advance; second, government usually has only limited control over those consequences; third, policy designers do not have full control over policy implementation; and, fourth, there are agency problems, i. e. elected officials and public servants may have incentives to pursue objectives which are not in the public interest.

Of course, there is a large scope for government failures even when economic policy may rely on a good state apparatus. But this scope is certainly bound to be much larger when the state apparatus is somehow crippled, as seems to be the case of some Latin American countries. This point becomes even clearer when each of the four sources of failure mentioned above is considered separately. The worse the state apparatus is [i] the higher the probability of government not taking into account important consequences of its possible actions, when policy analysis and choice are being made; [ii] the lower the degree of government control over unforeseen policy consequences; [iii] the lower the degree of control policy designers have over policy implementation; and [iv] the larger the scope for agency problems.

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<sup>6</sup> See Stiglitz [1986] and Wolf [1979].

Since the importance of government failures may be highly dependent on the condition of the state apparatus, it may be useful at this point to appeal to the notion of *statecraft*, an old North European word for the art of conducting state affairs. This word suggests that the practice of government is an art which demands skill, techniques and judgment, implying that government may be practiced well or poorly.<sup>7</sup> Competent economic policy and the capacity to keep government failures under control is an important part of good statecraft. Accordingly, poor statecraft may have disastrous economic consequences.

It is impossible to understand the deep economic crisis which has affected much of Latin America in the eighties, and is still affecting Brazil, without ascribing much of the difficulties to wretched statecraft. And in the Brazilian case, at least, there seems to be a vicious circle at work in which government failures generated by bad statecraft leads to a deterioration of the economic problems which in turn feeds back into even worse statecraft. In the following sections some aspects of this vicious circle are examined.

### 3. TAKING STOCK: THE MACROECONOMIC EXTENT OF THE FAILURES

From 1940 to 1980, Brazil sustained an average annual growth rate above 7%. This excellent performance was achieved in spite of serious political difficulties which were often faced by the country during those four decades. Expansion was

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<sup>7</sup> See Anderson [1977, p. vii] and the *Oxford English Dictionary*. Notice that lately the term has often been used in a much narrower sense, as in Baldwin [1985, p. 9], to designate "the selection of means for the pursuit of foreign policy goals". However, in this paper the word *statecraft* is being used in its original broader meaning.



not only fast, but remarkably steady. Only in six of the forty years the growth rate was below 4%: 1942, 1947, 1956 and 1963-65. And in only one year (1942) there was a fall in aggregate output. Real GDP increased by a factor of fifteen in forty years, meaning an increase of five times in per capita output, since population has practically trebled in the same period. In 1990 dollars, per capita income grew from US\$ 600 to US\$ 3,000 during these four decades.

These facts allow a proper perspective of the extent and consequences of the slowing down of economic growth in the eighties and early nineties as a consequence the government failure in dealing with macroeconomic stabilization. In the 1981-92 period the average annual growth rate of the GDP was reduced to only 1.2%. In five of the twelve years there was a fall in real GDP. As the average population growth rate was slightly above 1.9% during the period, per capita GDP in 1992 was only US\$ 2,800, approximately 7% below its 1980 level.

Had the historical trend of the previous forty years prevailed through the eighties and early nineties, the value of the Brazilian GDP in 1995 would reach approximately US\$ 1 trillion -- roughly the present size of the British economy -- instead of perhaps US\$ 440 billion, the probable value of GDP in 1995 if real output expansion equals population growth in 1992-95 period. The corresponding level of per capita GDP -- US\$ 6,300, instead US\$ 2800 that will probably be observed in 1995 -- would be equivalent to those of the poorest countries of the European Community today.<sup>8</sup>

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<sup>8</sup> This counter-factual exercise updates a similar one made in Werneck [1988].

Of course, one cannot argue that fast growth could have been sustained notwithstanding all the difficulties -- the external ones in particular -- faced by the Brazilian economy in the early eighties. But from a long run perspective, this period may be seen as a costly interruption in the growth project of the Brazilian economy. The above counter-factual exercise provides at least an upper bound benchmark for the magnitude involved in the cost of that interruption, which to a large extent has to be attributed to the vicious circle connecting wretched statecraft and government failure to design and implement an effective macroeconomic stabilization policy. For a poor country which has not been able yet to solve its inhabitants' most elementary needs such as food, health, education and housing, the social dimensions of that cost are even more dramatic than the idea of richness forgone.

#### 4. "SOMETHING HAS TO BE DONE" AND "THEY WILL PROBABLY DO IT AGAIN"

Before trying to look into the roots of this vicious circle which is pushing that failure deep into the nineties, it may be useful to understand how this perverse process has been recently affecting the formulation and implementation of macroeconomic policy in the country. As expected, the very critical situation of the Brazilian economy brings about from time to time a widespread feeling that "something has to be done", which means that government is increasingly pressed to act.<sup>9</sup> Under such conditions, poor statecraft may lead to really disastrous results.

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<sup>9</sup> An example may be enlightening at this point. On his 43rd day as Finance Minister, the third in six months of the Franco Administration, Mr. Eliseu Resende was getting the following piece of advice from the press, given from an influential column: "To exorcise the specter of immobilism, the President has no other way out but to adopt a clear-cut economic policy. Orthodox or heterodox, [...] leftist or rightist. It does not matter the tag or whether it is a gradual policy or the announcement of a new package. The only thing that matters is action." *Jornal do Brasil*, April 13, 1993.

Badly designed, often grandiose, measures have proved to be the most probable outcome, as the government tacitly or even openly accepts the Napoleonic dictum -- "*On s'engage et puis on voit*" -- to justify improvised and grossly inconsistent policy packages.<sup>10</sup> And, trying to be credible, policy makers have often taken the decision to "burn the ships" à la Cortez.

This process has been exacerbated by the present Brazilian economic debate. As often happens to countries affected by a very deep and long economic crisis -- part of Eastern European countries, at the moment, seems to constitute comparable cases -- Brazil has become an open fair of ideas, both locally developed and imported, about how to overcome the crisis. Most of those ideas are cranky and simple nonsense, but again poor statecraft leaves the government and, therefore, the country relatively unprotected against them. All sorts of proposals, ranging from another general price freeze to varied forms of default on the domestic public debt, or even resuming economic growth as a form to fight a 30% monthly inflation, are popping up daily in the press. One even finds Finance ministers publicly confessing that they are trying to assemble a new stabilization package combining parts taken from this box of nonsensical proposals.

As policies fail one after another, the economy has to cope with the accumulated long-lasting negative effects of those failures, which tend to turn future policy making even more complex. Expectations generated by the permanent possibility that government may suddenly announce a new policy package, in another major discontinuity in the steering of economic policy, has amplified the difficulties of implementing a successful stabilization plan. As the

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<sup>10</sup> This dictum is well remembered by Wolf [1979] in his discussion of policy implementation.

effects of the last unsuccessful package fade away, the public starts to fear that "they [the government] will probably do it again". In the late eighties those expectations mainly led to widespread pre-emptive price hike-ups, when it was believed that a new price freeze might be announced. As the result was an even faster acceleration of inflation, that often contributed to precipitate the announcement of a freeze.<sup>11</sup>

Lately however -- after a large part of the economy's financial assets has been blocked for eighteen months in the Central Bank by the Collor I Plan, in March 1990 -- expectations have become even more adverse. Though the assets were returned to their holders as promised, the fear that some variant of such measure may be announced again has led to a permanent worry about economic agents making a sudden pre-emptive movement in their portfolio decisions, increasing their demand for foreign currency and real assets. Again, that has turned macroeconomic management even more difficult.<sup>12</sup>

Long-lasting negative effects may also stem from badly prepared and implemented reforms, also induced by the feeling that "something has to be done". The claim for making sweeping and profound economic reforms has led government to try to carry on some of those reforms on a piece meal basis. But, once more, poor statecraft has often led to badly designed reforms, which have put in jeopardy the original public support for them. Such experiences show that though government is often not competent enough to conduct reforms as required,

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<sup>11</sup> See Modiano [1990] for an analysis of the recurrent stabilization shocks of the late eighties.

<sup>12</sup> There are another long-lasting effect that should be mentioned. Though capital flight used to be relatively unimportant in Brazil during the eighties, compared for instance to Mexico, Argentina and Venezuela, defensive behavior in portfolio management after the traumatic experience of the Collor I Plan in 1990 has increased the importance of Brazilian residents' assets held abroad.

in general it is sufficiently empowered to try. And the results may be so bad as to lead to an arrangement which is even worse than the pre-reform one and much more difficult to change, given the natural strong opposition the announcement of still another reform would raise. The best example of such fiascoes is probably the so-called Santana public service reform of 1990-91, which greatly reinforced the deterioration of statecraft in Brazil, as will be seen in the next section.<sup>13</sup>

## 5. THE BUREAUCRATIC ELITE AND THE QUALITY OF THE ECONOMIC POLICY

It is certainly true that the existence of a fine bureaucratic elite does not constitute a sufficient condition for good statecraft. But it is also true that without a reasonably good bureaucratic elite, poor statecraft becomes a much more probable outcome. Since the mid-eighties, there has been a systematic decay of the quality of the highest echelons of the federal bureaucracy in Brazil. That was surely a complex process resulting from the interaction of many determinants. But it may be useful to single out some of them and to show that government failures have played an important role in that process and, therefore, to detect one of the important elements of the vicious circle linking government failures and poor statecraft.

A first link was the perverse effect of the cutback in the value of the federal government's payroll, as part of recurrent, though half-hearted, fiscal adjustment efforts, with severe reduction in the salary level of the bureaucratic elite, particularly since 1990. From 1990 to 1992, the value of the federal government's

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<sup>13</sup> After João Santana, the first Public Administration Secretary of the Collor Administration.

annual payroll, was reduced from 4.3% to 3.32% of the GDP, a 22.8% reduction in two years, as shown in table A. Unable to dismiss public employees, the government resorted to squeezing their salaries. As nominal salaries of top public servants were consistently readjusted well below inflation in the period, in the Ministry of Planning, for instance, the monthly top real salary level for economists during most of 1992 was only approximately 20% of what it used to be in either March 1985 or March 1988, as shown in chart 1 below.<sup>14</sup>

**Table A**  
Brazil, Federal Government Payroll, 1990 -1992

Year	Value as Proportion of GDP %	Index Number Value as Proportion of GDP in 1990 = 100
1990	4.30	100.0
1991	3.53	82.1
1992	3.32	77.2

Source: Departamento do Tesouro Nacional

Immediately after taking office in March 1990, President Collor announced a major public administration reform: this would either dismiss or lead to retirement hundreds of thousands of federal public servants in the country, drastically reduce the number of government cars and sell government housing facilities which were being rented for a nominal fee to high ranking bureaucrats in Brasília. When announced, that reform proved to be a resoundingly popular

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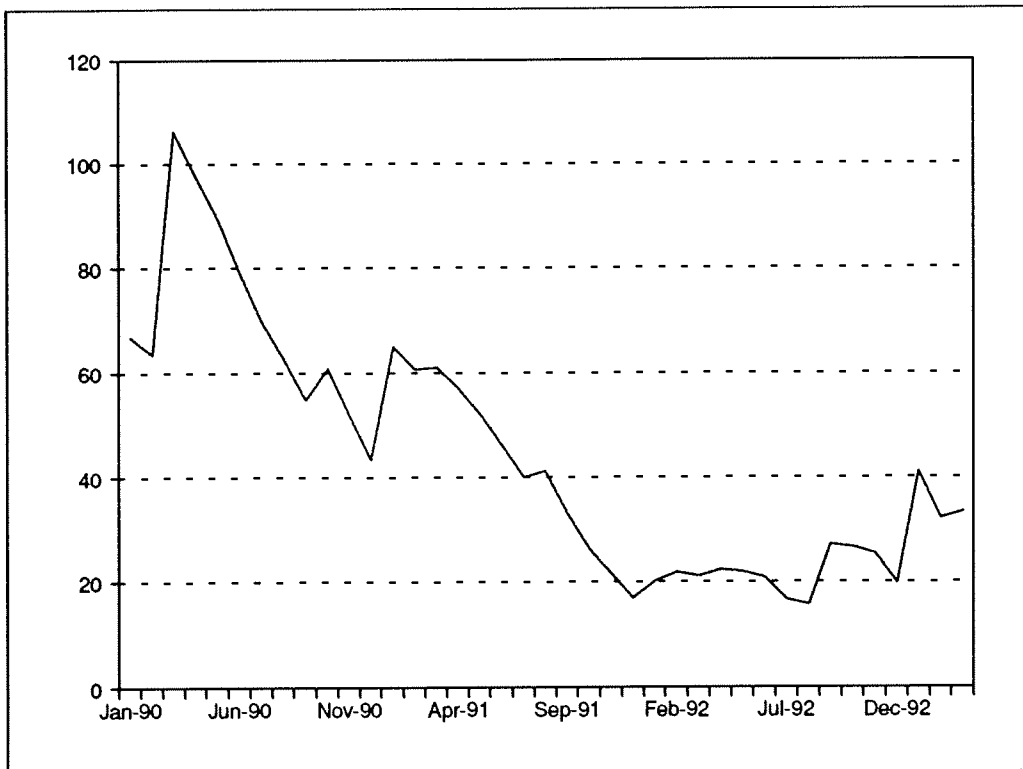
<sup>14</sup> Deflated by IGP-DI, the general price index The author is grateful to Ricardo Varsano from IPEA for supplying the salary data.

program. It also introduced the so-called *regime único*, which meant that the contracts of all public employees would have to be submitted to a same set of specific rules, different of those which regulate work contracts in the private sector. And that imposed a change in the work contract of a large number of public servants that had been hired under the rules which applied to the private sector.

Chart 1

Brazil, Planning Ministry, January 1990 - March 1993  
Top Monthly Real Salary Level for Economists

Top Monthly Real Salary in March 1985 = 100



Source: IPEA

As already mentioned above, the reform ended up being a total fiasco. A provision of the 1988 Constitution establishes that after five years in public service a public employee may only be fired when accused of a very serious fault, and that

left most of the federal bureaucracy sheltered from the government dismissal plans. Approximately 50,000 public servants were in fact dismissed, relatively few compared to more than one million paychecks in the federal government's payroll. Furthermore, under the new *regime único*, it became much more difficult, both politically and legally, to protect the salary levels of the bureaucratic elite, a large part of which used to be hired through public foundations and other autonomous public agencies, which had their own salary policies. Incentives for early retirement, when coupled with the drastic reduction in real salaries in 1990, led to the retirement of a large part of the most talented high level public servants.<sup>15</sup>

Recruiting new high ranking public officers has become extremely difficult, as new ministers have rapidly found out. Not only salaries have become very unattractive, but housing costs in Brasília for new-coming staff went up dramatically as 11,000 government apartments in the federal capital were sold for a small fraction of their market value to the public servants which were lucky enough to be occupying them during the 1990-91 period. Yet, people are often attracted to work for the government having other benefits in mind, as for example power to influence decisions or following a political career. Therefore, the above mentioned difficulties to recruit new high level public servants could perhaps be somewhat circumvented if they had not been amplified by the extremely high ministerial turnover, particularly in the ministries responsible for the steering of economic policy.

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<sup>15</sup> As a result of mass retirement, some strategic functions of the federal government apparatus -- as tax collection -- were gravely affected. Undermanning has become a major problem in *Receita Federal* -- the tax collection agency --, which has been forced to function with less than 5,000 tax officers nationwide, half of them allocated to customs clearance and bureaucratic tasks. Training new tax officers takes at least four years. On the early retirement of some of the most competent tax officers, see "Longe do Poder, mas Perto do Dinheiro", *Exame*, April 14, 1993.



As may be seen in table B, from March 1985, when the military regime reached its end, to March 1993, Brazil had eight different Finance ministers, not

**Table B**  
**Brazilian Finance Ministers**  
**March 1985 - March 1993**

Administration and Ministers	Period	Number of Months as Minister	Average Number of Months Each Finance Minister Lasted
<b>Sarney Administration</b>	<b>Mar. 85 - Mar. 90</b>		15.0
Francisco Dornelles	Mar. 85 - Sep. 85	6	
Dilson Funaro	Sep. 85 - Jun. 87	20	
Luiz Carlos Bresser Pereira	May 87 - Dec. 87	7	
Mailson da Nóbrega	Dec. 87 - Mar. 90	27	
<b>Collor Administration</b>	<b>Mar. 90 - Sep. 92</b>		15.0
Zélia Cardoso de Mello <sup>a</sup>	Mar. 90 - May 91	14	
Marcílio Marques Moreira <sup>a</sup>	May 91 - Sep. 93	16	
<b>Franco Administration</b>	<b>Oct. 92 -</b>		2.5 <sup>b</sup>
Gustavo Krause	Oct. 92 - Dec. 92	3	
Paulo Haddad	Dec. 92 - Feb. 93	2	
Eliseu Resende	Mar. 93 -	?	
Overall Average Number of Months Each Minister Lasted			12.0 <sup>b</sup>

Notes: (a) Minister of Economy, as the Collor Administration extinguished the Ministry of Finance, which was later re-created by the Franco Administration; (b) Does not include Eliseu Resende.

included the present one. On the average, each of them lasted approximately 12 months. The average is a little higher for the Sarney and Collor Administrations:

15 months in both cases. But it has been reduced to only 2.5 months in the present Franco Administration, again not including its third and present Finance minister.<sup>16</sup>

Another link in the vicious circle connecting government failures and poor statecraft is therefore established. As ministers tumble one after another, on the wake of unsuccessful stabilization programs, both the new minister and people who he tries to attract to work with him know that he will not last long; probably a few months. Assembling a competent economic team under such conditions becomes exceedingly difficult. And, of course, the mediocre team that he will finally be able to form will only make his fate even more helpless from the outset. In fact, this has made the recruitment of ministers and Central Bank chairmen increasingly difficult, as lately many talented candidates have kindly refused invitations from the presidency. As every few months a brand new economic team is in charge of policy formulation and implementation, it is not surprising that results have been, to say the least, so disappointing. Moreover, the high turnover of economic teams has turned the federal government much more exposed to the effects of the widespread rent-seeking behavior of important segments of the Brazilian society and to outright corruption as well.

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<sup>16</sup> Even though a historical benchmark is difficult to establish, 2.5 months is certainly a very low average. From 1946 to 1954, during the Dutra and (second) Vargas administrations, this average was 20.6 months. It went down to 5.7 months during the unstable period that followed the Vargas suicide and up again to 20 months during the Kubitschek administration (1956-61), falling to 6.3 months in the also unstable period of the Quadros and Goulart administrations (1961-64). During the military period (1964-1985), each Finance minister lasted an average of 50.4 months. See Abreu [1990].

## 6. POLITICAL CONSTRAINTS ON THE QUALITY OF THE ECONOMIC POLICY: DEMOCRATIZATION, CONGRESS, FEDERALISM AND THE CONSTITUTION

A large part of the roots of poor statecraft since the mid-eighties are to be found in the difficulties faced during the redemocratization period after the end of the military regime in early 1985. Unluckily, Tancredo Neves, an able and influential politician who had been elected the first president of the civilian regime by an impressive coalition of political forces, died before taking office, opening the way to a considerably less endowed and less influential vice-president. During the first three years of his Administration, Congress was drafting the new Constitution which was finally promulgated in late 1988. Unfortunately, the long and delicate political negotiations which brought about the new Constitution took place exactly when the central government was notably feeble, due to the shortcomings of President Sarney, accidentally inducted into office, and continuously mobilized by the quest of a higher degree of legitimacy.

In fact, the central government had become even feebler after the failure of two stabilization shocks, in 1986 and 1987. In another link of the vicious circle, the room for even poorer statecraft would be substantially widened through a major constitutional reform blunder in 1988. As the complex coalition of political forces which have been assembled behind Tancredo Neves could not be maintained, a newly formed coalition in Congress, strongly influenced by state and local governments, managed to approve a new Constitution which redesigned the previous fiscal federalism arrangement, diminishing the fiscal means of the Union and greatly enlarging the federal government's expenditure obligations. It was not only an inconsistent fiscal federalism arrangement that were being established. As well put by Bacha and Lamounier [1992, p. 23], "the abstractly desirable goal of decentralization prevailed over any consideration of timing, further weakening the

central government at a moment when the Brazilian inflationary monster seemed again untamable".

These changes in the fiscal federalism arrangement deserve a closer attention.<sup>17</sup> As it is well known, the Brazilian state is a particularly complex and multifarious entity, that unfolds in three different government levels, comprising the central government, more than two dozen state governments and approximately five thousand local governments. Each one of them having both Executive and Legislative branches. The legal framework which regulates the intergovernmental relations within this intricate system has shown to have many deficiencies after the 1988 Constitution in which, as just seen, the interests that should have been defended by the central government were not properly taken into consideration.

When the Constitution was promulgated, it was greeted by many analysts as an important advancement of power decentralization in the country, as it reduced the central government importance. However, since 1988 the deficiencies of the new fiscal federalism arrangement are becoming increasingly clear. The central government has lost a substantial part of its tax revenue to states and local governments, without being able to transfer to them any significant part of its spending programs. Nevertheless, as the new fiscal system is being phased in, states and local governments are not only quickly adjusting their spending in response to their fast growing revenue. They are spending well above their recently enlarged means.

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<sup>17</sup> For a fuller discussion of fiscal federalism in Brazil, see Afonso [1992].

The present fiscal federalism arrangement is clearly imposing severe difficulties to stabilization policy in Brazil. What happened in 1990 well illustrates the involved difficulties. The central government fiscal austerity efforts was partly offset by state and local governments overspending in the wake of an electoral campaign. And this also had a serious impact on the steering of monetary policy, since part of the higher borrowing requirements of state and local governments was financed by the states' banks, which ended up being bailed out from bankruptcy by the Central Bank, under the political pressure of governors with great ascendancy over the presidency.

Facing the need to make a permanent fiscal adjustment, the central government has been constrained by the obligation to transfer to lower level governments a large proportion of the revenue stemming from personal income tax, profit tax and excise taxes on industrialized products, knowing in advance that any transfer will be immediately spent by state and local governments. This leakage reduces the effectiveness of the fiscal effort, and the possibilities of stabilization policy.<sup>18</sup> That has created a search for exotic federal taxes, capable of generating resources not shared with state and local governments, which in turn has meant a deterioration of the quality of the tax system.

Most state governments in Brazil have become clearly overindebted. And the federal government has been pressed hard by state governors to "solve" their debt problems. Facing the possibility of rejection by Congress of the fiscal adjustment package submitted in late 1991, the federal government finally agreed to include in the package an ample rescheduling of the states' debt. The part of the

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<sup>18</sup> See Werneck [1992] for a fuller analysis of the present difficulties imposed by fiscal federalism on stabilization policy in Brazil.

debt owed to either the federal government itself or any of its financial institutions would be rescheduled to be paid over 20 years. The state bonds held by the private investors, which pay a very high interest rate, would be exchanged for lower cost federal bonds.

The new legislation only established the guidelines that bilateral rescheduling agreements between each state and the federal government should follow. To avoid inducement to a large increase in the states' deficit, the federal government succeeded in including in the debt rescheduling legislation a restraint on the states' new debt issues. To be able to reschedule its debt, any state would be required to agree not to issue any new debt for a number of years, the penalty for failing to obey that clause being simply to make the rescheduling agreement null.

Before any agreement has been signed, the largest states were manifesting their resistance to accepting that clause and considering the possibility of making Congress approve the required changes in the legislation. Negotiations that should lead to those agreements were suspended during the political crisis which ended with the impeachment of President Collor. A new debt rescheduling law was approved by Congress in late 1992, but states are still resisting to accept any limits on their power to issue new debt, even the narrow restraint the new rescheduling law imposes on debt issued in the form of state treasury bills. Without the imposition of such limits, debt rescheduling will be just another policy blunder, that will simply reestablish the states' capability to become again overindebted in the future, maintaining their soft budget constraint and, therefore a major source of macroeconomic disequilibrium.<sup>19</sup>

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<sup>19</sup> See again Werneck [1992].

Besides introducing an inconsistent fiscal federalism arrangement which amplified the Union's burden in the required fiscal adjustment effort, the new Constitution did not contribute to the task of endowing the state which emerged from the long military period with "a coherent [...] machinery against the multiple pressures of an emerging mass democracy, of a huge electorate [and] of a new generation of independent and aggressive labor leaders"<sup>20</sup>. In fact it amplified the scope for the historical widespread rent-seeking behavior of many segments of the Brazilian society, imposing upon the federal budget a considerable additional burden, exactly when the Union's fiscal resources were being reduced in favor of state and local governments.<sup>21</sup>

## 7. BUILDING UP A NEW STATE: THE QUEST OF BETTER STATECRAFT

There is a widespread view in Brazil today that the key to overcome the economic crisis that the country has been facing for more than a decade is a deep public sector reform. So deep that perhaps it would be more appropriate to say that what is needed is to reconstruct the public sector from its present ruins. Reconstructing the public sector constitutes a challenge that will probably take many years to be properly faced.

Both in Brazil and abroad, there are many who believe that what is happening in the country is the failure and bankruptcy of the state, in flagrant contrast with the vigor of the private sector and the liveliness of the civil society.

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<sup>20</sup> Bacha and Lamounier [1992, p. 26]

<sup>21</sup> On the perverse effects of rent-seeking behavior on macroeconomic performance, see Olson [1982]

According to this view, a fundamentally healthy society is being precluded from exploiting its ample possibilities by a sick state. As all evils are circumscribed to the state, what should be done is to excise them so as to pull the state up to the level of the Brazilian society.

Unhappily, that is a distorted view, even though it sounds attractive, being simple, relatively optimistic and easy to exploit for political means. What is happening in Brazil is much more than the failure of the state. The present state is largely an endogenous outcome of the Brazilian society. The crisis is therefore much deeper and much more comprehensive. It reflects the failure of a society in dealing with the basic political problem of organizing and maintaining a state capable of acting according to the fundamental interests of that society.

The state in Brazil continues to be what it is and to badly serve the interests of the majority of the Brazilian society simply because that society has not found yet proper forms of political organization to make a better state feasible. That means that the problem is a much more serious one. It is not simply a crisis that may be just circumscribed to the sphere of the state. It involves the society as a whole and poses a great challenge to its elite.

Discouragement in face of that challenge has increased the seduction of the idea of a national project that practically makes the state dispensable. Of course, that is nothing but a mirage. Looking at modern societies, one may see that there is ample room for choice. There are cases in which the state has assumed great importance and other cases in which it plays a much more limited role. And in many societies the state has acquired excessive proportions and most of them are now painfully trying to cut it down to a manageable size. But there is no case of a



national project that has done without a modern state, endowed with a fairly competent and scrupulous bureaucracy, able to play with acceptable efficiency roles that in any circumstance will always be reserved to the state. Modernization and development are not feasible without constructing a modern state, no matter how economically and politically liberal the development path is. That is the hard reality the Brazilian society has to face today.<sup>22</sup>

Reconstructing the public sector will require many constitutional amendments. In early October Congress will start to discuss what could become a major reform of the Constitution, following a clause which opens up the possibility of having amendments approved by a 50% majority for a limited period, five years after the Constitution has been promulgated. Such reconstruction involves first of all a tax reform, broadening the tax base, reducing tax rates and modernizing the tax collecting apparatus. It also involves rebuilding the public service, correcting the blunder of the disastrous administrative reform of 1990-91 and eliminating the rigidities and wrong incentives imposed by the impossibility of dismissing public servants. The reconstruction of the public sector also demands a new fiscal federalism arrangement, in which the distribution of fiscal resources among the three levels of government is consistent with the way expenditure functions are distributed among them.

Imposing fiscal responsibility to state and local governments is one of the most urgently required measures. And that means granting the Central Bank sufficient political autonomy to assure that public-owned financial institutions --

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<sup>22</sup> Part of the difficulties which have to be faced in the task of constructing a modern state may be ascribed to the fact that "competent government" is actually a public good, which therefore tends to be undersupplied. See Stiglitz [1986].

federal ones included -- are managed in a way which is not detrimental to macroeconomic stability. Reconstructing the social security system and restoring the public sector savings generation capability -- in order to resume government social investment programs -- constitute other required measures.

It certainly is a very heavy reform agenda that probably will take years to be properly faced. But the Brazilian vicious circle will not be broken before a wide enough political coalition can assure the joint implementation of a reasonably large part of those reforms.

Much attention has been given today in Brazil to the idea of redesigning the political representation itself, the "network of relationships and procedures which formally determines who authorizes whom to do what, under which conditions".<sup>23</sup> The reintroduction of a parliamentary system was rejected by the electorate in a plebiscite held in late April 1992.<sup>24</sup> But a sizable segment of the Congress is becoming more sensitive to the idea of overhauling the electoral legislation in order to strengthen political parties and improve the quality of political representation. What is envisaged is the emergence of a stable majority coalition which may finally lead to higher degree of commitment of the Congress with the steering of economic policy. That would certainly open up room for a much better statecraft. And the general elections to be held in late 1994, in which both a new Congress and a new president will be elected simultaneously, may provide a unique opportunity for a more collaborative relationship between the Executive and Legislative branches in the second half of the nineties.

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<sup>23</sup> Bacha and Lamounier [1992, p. 26].

<sup>24</sup> There was a short-lived parliamentary experience in the country after the Quadros resignation, which lasted from September 1961 to January 1963.

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