

Democracy and Growth in Brazil¹

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1 - Introduction

Democracy is a relatively recent achievement in Brazilian history. Since the end of the imperial era in late 19th century, the country has experienced two long periods of dictatorship in 1930-45 e 1964-85, and, for most of last century, political participation was rather limited. It was a convoluted evolution towards democracy, moving forward and backwards up to mid-1980s, when mass democracy was finally established.

Brazil's economic development has been equally convoluted. In the last century, there were many years of strong economic growth followed by severe economic crises. Fiscal and external disequilibrium were rather frequent as well as high inflation. Government played a central role in the country economic development, financing public and private investment, coordinating production decisions, providing protection to selected sectors and setting prices.

Despite the broad literature on the importance of institutions to explain growth, following Douglass North, there does not seem to have a causal relation between growth and democracy. Most rich countries are consolidated democracies. On the other hand, the more distant a country is from the technological frontier, the least predictable seems to be its political regime. Once one controls for country specific factors, however, there does not seem to exist a direct relation between growth and democracy. Still, there appears to exist common factors related to countries history that might affect both their economic and political development.

¹ We thank to Ana Carla Abrão Costa, Mansueto Almeida, Rozane Siqueira and Sérgio Lazzarini who provided references and data. Samuel Pessoa has been very generous and made several comments. Simon Schwartzman was careful in his comments and revisions in a first version.

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The objective of this paper is to explore specific institutional features that tie up both political and economic development in Brazil, which are derived from a very specific, and broad, government economic intervention intended to foster investment and economic growth. Economic development was part of a national project led by public policies carried out by several government agencies.

We propose institutionalized rent seeking as a unifying theme in the development of both political and economic institutions in Brazil, and that it still remains relevant for the challenges the country faces today.⁴

The economic literature has coined the term rent seeking for the process in which special groups manage to obtain privileges and benefits from government agencies. It is commonly understood as a specific process characterized by private interests intended to obtain special favors from government agencies, frequently implemented by obscure mechanisms and negotiations.

In the case of Brazil, however, government intervention to protect selected sectors and provide specific benefits has been seen as a legitimate, and necessary, mechanism to induce economic development. Several public agencies were created in the last century in order to provide stimulus to private investment and production and coordinate economic decisions. Government also played a large role in mediating social conflicts and political representation.

In the absence of a better term, we keep the denomination of rent seeking to characterize Brazil's political and economic development. It summarizes the role played by government and public agencies in providing private benefits. Under democracy, these interests are not restricted to economically powerful groups but are disseminated as a common ground for legitimate political decisions. The underlying costs of government interventions are not perceived due to its diffused nature and lack of transparency. Specific and local decisions, in many cases, are not even accounted for in government budget. Benefits are tangible for the ones who receive them, while their social costs are not.

⁴ A major reference for the interpretation proposed in this paper is Faoro (1957), who first proposed the relation between colonial period, institutional framework and Brazilian economic and political further development.

In the first half of last century, Brazil's underdevelopment was understood as a consequence of a coordination failure. The country was mostly an agricultural economy and the absence of a broad industrial sector was perceived as a restriction for economic development. Moreover, there was a lack of long-term funding to investment. Economic policy aimed at providing incentives and protections to selected sectors. Government also coordinated private decisions in order to assure market demand as well as infrastructure and the access to inputs and capital goods. Private sector growth would be the outcome of government intervention.

Discretionary policies, specific protections and money transfers from public agencies were understood as legitimate mechanisms to allocate resources and foster economic and social development. For most of the twentieth century, however, limited political participation meant limited access to such mechanisms to specific groups. As in the economic side, it was government role to define political representation and also to set government agencies or institutions that mediate economic and social relations and arbitrate eventual conflicts.

Therefore, both in economic and political aspects, Brazilian government have had a distinctive role in mediating and defining social interaction. Several public agencies were created to intervene in specific markets and to provide incentives and protections from external competition.

The range of regulated sectors was quite impressive up to re-democratization in mid-1980s, ranging from financial and insurance institutions to commodities, such as coffee, sugar and steel, whereas several consumer prices were controlled as well. Government limited the access to imports, regulated external trade and set specific exchange rates for different commodities, among several other forms of intervention.

The bold government intervention in Brazil has required several instruments and agencies to concede incentives, protections and privileges, which have proliferated over time, and go far beyond usual tax incentives and cash transfers embedded in government budget. Subsidized loans, protectionism, price controls, off-budget money transfers, mandatory cross-

subsidies in credit markets via earmarked loans are instruments that grant privileges not accounted for in budget and often decided by government agencies without a disclosure of their impact on the rest of society.

In the 1950s, many federal agencies were created to provide long-term financing, such as BNDE, later BNDES, and to induce regional development, as SUDENE. Furthermore, there were state monopolies, as in the case of oil production and reinsurance activity.

In several cases, government agencies were not created as a result of pressure of politically strong groups. It was actually the opposite. The National Developmentalism view that dominated that period up to mid-1980s identified specific sectors that needed protection from foreign competition by means of public policy and specially designed agencies. Several trade and non-trade barriers were introduced as well as incentives and subsidized loans to domestic companies in order to induce their local development, irrespective of the cost imposed to the rest of economic sectors, which were condemned to access less efficient technology or higher consumer prices.

As an outcome of these policies, politically strong groups were created. Incentives or development policies intended to be temporary became long standing due to the pressures produced by the interest groups created by the developing policies themselves. That was the case of some development agencies as well as several incentives introduced later on, such as Zona Franca de Manaus. Policies intended to be temporary turned out to be permanent.

Investment in education and social policies were not a relevant part of this project. Growth required investment, and productivity was the outcome of technology alone, to which human capital was not understood to be a relevant aspect. As a result, social policies in Brazil were rather minimal compared to countries in equivalent level of development. Social policies were restricted to ensure labor protections and it reflected the view that higher participation of workers in national income would be attained via political participation and law enforcement. Income distribution was seen as the outcome of political negotiation rather than a market outcome.

The inconsistency of the model was revealed by the severe political and economic crisis of the early sixties. Fiscal imbalances led to high inflation, low growth and an external crisis under a fixed exchange rate regime. The sum of special groups' demands was revealed to be larger than societies resources. The outcome was an economic and political crisis. A military dictatorship ended this democratic, though limited, experience.

The severe economic crisis of the sixties resulted in economic reforms intended to reduce government provision of privileges and limited the access to specific benefits. Measures to ensure balanced government budget as well as to develop the credit and capital markets were carried out, including the creation of the central bank.

The external crisis in the mid-1970s, however, led to an ambitious government development plan to foster growth in an adverse scenario, reinstating the National Developmentalism project to an unprecedented level. It was a very complex and detailed project, aiming at the development of several specific sectors. Government agencies provided resources and even larger incentives to private investment and to protect domestic production from external competition. The limited political participation of the period led to few groups with access to demand government intervention. The inconsistency of the model, characterized by several local privileges concessions with diffused and non-transparent costs over all society, derived into another crisis that had similar aspects to the one in the early sixties: high inflation, fiscal imbalances, external crisis and many years of low growth.

Crisis was followed by a political regime shift, this time to a mass democracy, and a long period of adjustment. Brazil spent ten years to stabilize prices, which was a precondition for removing the obstacles to grow. For many decades, fiscal dominance and inflationary financing was the rule of the game, creating unstable macroeconomic environment. Re-democratization led to important and solid reforms that established fiscal discipline and prices stabilization, and an increasing tax burden.

In the nineties, liberal reforms were implemented, and some of sectors protections and benefits were restricted. It was a difficult political move, and not

without severe resistance. Only severe crisis make possible to curb special benefits and privileges which costs are diffused through society.

Since 1988's Constitution, new actors have become vocal in the political arena, which has led to an increase in transfer mechanisms via enlargement of social policies. Since then, the country experienced an increase in social policies and welfare protection, fully accounted for in budget deliberations, which were crucial for reducing inequality.

Social demands for government concession of benefits led to an increasing tax burden from close to around 25% of GDP in mid-1980s to current 37%, higher than the ones observed in most developing countries.

Contrary to mature democracies, several of the policies do not go through an encompassing government budget, but are conceded by means of specific government agencies. Decisions are taken in order to protect a specific group without taking care of total social costs. This is a distinctive feature of Brazil's political processes, with institutionalized agencies able to provide privileges and benefits to specific sectors or social groups without political representation or accountability of the costs imposed on the rest of society.

Brazil's recent democracy, in several aspects, reflects the institutional consequences of the National Developmentalism. Special groups demand benefits and privileges from government agencies, which costs are diffused throughout society. In the democratic period, however, new political groups became vocal. Political pressure on specific agencies may be as influential as economic ones. Minority groups, for example, long seen as underrepresented in the political arena, have had their demands increasingly satisfied by specific agencies intervention.

This phenomenon may be called *reverse capture*. Instead of public agencies captured by the regulated industry, organized minorities pressure agencies directly and publicly for the concession of specific tangible benefits for selected social groups while costs are diffused throughout society or imply cross subsidies to be paid by other consumers or firms.

The political process that leads to these government interventions is very decentralized. Organized civil society points out the need to protect some specific group, from extending health insurance coverage not predicted in the contracts to regulation of market prices to specific groups, from cultural goods to transportation or bank services. Therefore, government agencies are mobilized in order to implement measures that meet these demands. In the credit market, for example, earmarked loans directed to specific groups stand for above 30% to total bank loans, charging average spread around 3% currently, while non-earmarked operations charge on average 20%.

The surprising aspect of this institutional aspect of both political and economic process is the lack of transparency of society's indirect cost of providing specific benefits. In the case of credit market, for example, there is little discussion on the cross subsidy implied by subsidized loans that penalize the remaining credit operations.

Lack of transparency plays a central role in keeping rent seeking policies. Rent seeking policies are characterized by concentrated benefits and diffused costs, while their opacity contributes to their survival over time, despite the harmful impact on growth of many of them.

Moreover, rent seeking, once established, is difficult to end. Beneficiaries reject losing their status quo, becoming an important obstacle for changing government policies. The diffused nature of its costs results in the absence of political opposition to their continuance. Even policies intended for a short period, once introduced, create special interest groups that defend their maintenance. Persistence may be the unintended outcome of such policies.

The result is a large state that fails to deliver adequate income distribution and growth, distinguishing Brazilian experience to those developed countries that also rely on heavy government intervention. In the latter, transparency and democratic control of the programs by society were critical for controlling social costs of interventions, at least until the late twentieth century. Furthermore, up to the 1960s, public spending in education was a priority in developed countries, which contributed to boost productivity, contrasting to the Brazilian experience.

There is an inevitable conflict between rent seeking and democratic institutions. Aside from the opacity of policies that weakens democratic deliberation on public policy, rent seeking requires a political framework that limits access to government benefits to selected groups. Privilege, by its own nature, has to be conceded to a few.

Nevertheless, growing social demands challenge rent-seeking mechanisms. Economic distortions ultimately produce lower growth and limit the progress of the political agenda towards improving income distribution. Without institutions that lead to democratic deliberations of society's budget constraint and priorities, resources are exhausted and government policies become unsustainable as distortions become dysfunctional.

Currently, as the scope for further increase in the taxation wanes, the challenge faced by the government to meet social demands increases, especially after years of excesses in the fiscal policy, higher inflation and low growth over the last couple of years, and more recently, social unrest.

Under democracy, social demands helped to shape the political agenda and, after price stability was delivered, it moved forward towards more social participation and equality. Though income distribution remains unfavorable, the progress of the last decade was remarkable. Society now urges for better public services, such as healthcare and education, aside from infrastructure to promote growth. This agenda requires a more efficient government intervention and political choices, as the tax burden is already too high in comparison to countries in equivalent level of development.

The debate regarding a renewal of the political agenda is still in its early days. Political parties do not appear sufficiently well prepared to discuss alternatives. This story is yet to be told.

Next section summarizes the evidence of the role of institutions on growth, followed by the third section that reviews the impacts of colonial process to Latin America development, and Brazil, in particular. We outline a general framework to assessing Brazilian experience and the peculiar role of government in promoting development.

The fourth section provides a brief history of Brazil's economic history and the impact of re-democratization in the political agenda. The fifth section details some main features of government in Brazil's development process, emphasizing rent-seeking mechanisms. It is a large government, not so much because of the size of public bureaucracy, but mainly due to several transfers to interest groups. The section illustrates main aspects of our argument with detailed public instruments for intervention. It also analyzes the impact of re-democratization on tax-transfer mechanisms and the survival of rent-seeking old schemes. The sixth section summarizes some democratic indicators and Brazil's weak performance compared to other countries, in particular to Chile. The final section makes some comments on the nature of our state and challenges for the future.

We conclude by proposing two institutional reforms in order to challenge rent-seeking mechanisms and providing a more democratic deliberation of privilege concessions by government. First, we propose a government agency responsible for accounting proposals and outcomes of every public policy. Transparency and accountability are essential to provide democratic tools to allow society to decide upon government interventions. Our second proposal is that every government intervention should be fully accounted in budget. It seems a simple proposal, but given the extent of rent-seeking mechanisms in Brazil, it is far from being a modest one.

2 - Growth versus democracy in the economic literature

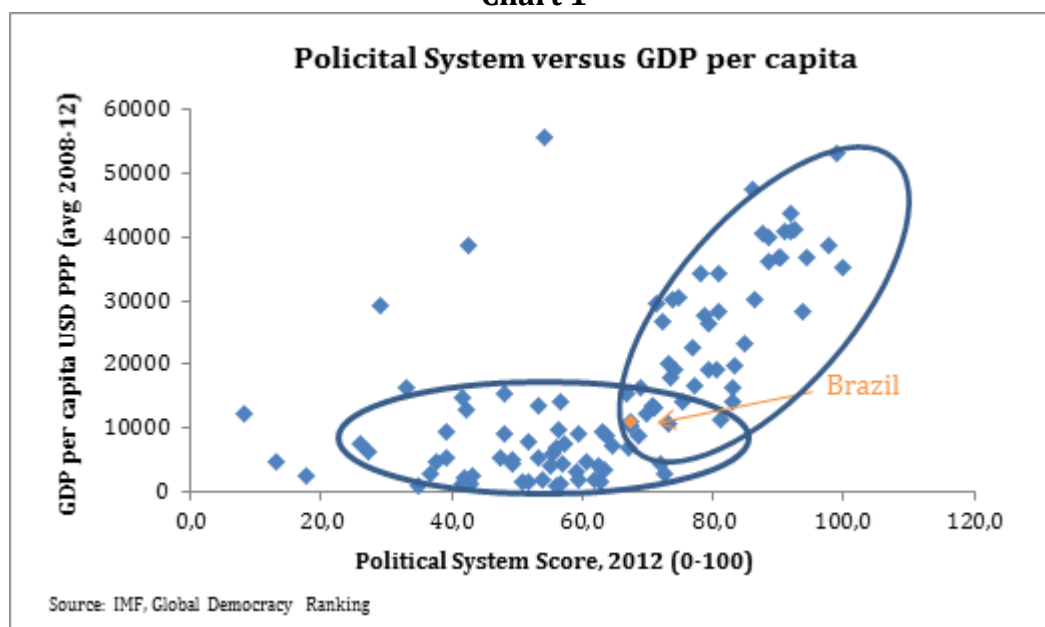
In the last two decades, following Douglass North's contribution, academic research has systematically pointed out the importance of institutions for economic growth, being the most successful hypothesis for explaining the differences in income among countries. Institutions and general rules delimit incentives for individual behavior, including production and investment, which ultimately leads to growth.⁵

⁵ For a survey on growth evidence, see Aghion, and Howitt (2009).

Empirical research from the end of 1990s onwards have been remarkably successful in showing that adequate institutions for growth are the ones that secure property rights, provide stable economic environment and produce efficient incentives for private decisions. Rule of law, judicial systems, and market regulations have been shown to be relevant to explain income disparities among countries.⁶

One might expect that democracy would be an additional factor, but that does not seem to be the case. The relation between democracy and per capita income displays a curious picture that shows a large diversity of political regimes or degrees of democracy among poor countries, while when it comes to richer ones, the diversity is reduced, with a much clearer relation between democracy and income (Chart 1). The more distant a country is from the technological frontier, the least predictable seems to be its political regime. The richer ones, on the other hand, tend to have fully established democratic regimes. Democracy seems to be a fate for most of the rich, even though it alone does not indicate the future of the poor.

Chart 1



⁶ See Pincus and Robinson (2011) and Acemoglu and Robinson (2012).

Lipset (1959) proposed a causality relation from economic development to democracy.⁷ Constitution and stability of democratic regimes may depend on the development of institutions as well as social and economic conditions: prosperity, education, existence of a middle class and absence of severe inequalities, rules allowing opposite parties and freedom of speech, and a set of beliefs accepting the rule of law and human rights.⁸

Empirical evidence does not support any hypothesis of causality between democracy and growth.⁹ Acemoglu, Johnson, Robinson and Yeared (2008) showed that the relation between democracy and growth becomes non-significant once one controls for country fixed effects.¹⁰ This suggests the existence of country invariant factors that affect the evolution of both growth and democracy over time, and once these specific factors are taken into account there is no causality between both variables. They propose that due to historical reasons, some countries have fostered institutions that protected rule of law, property rights, and growth, and, at the same time, have led to a more democratic participation and social inclusive policies, such as education.

The absence of correlation between democracy and growth is also a feature of the Brazilian experience (Chart 2). Democracy and authoritarian regimes alternated a few times in the last century. Similarly, business cycles have been unusually wide. Periods of robust economic development have been followed by severe crises and years of low economic growth. Democracy and growth, however, do not seem to be correlated.

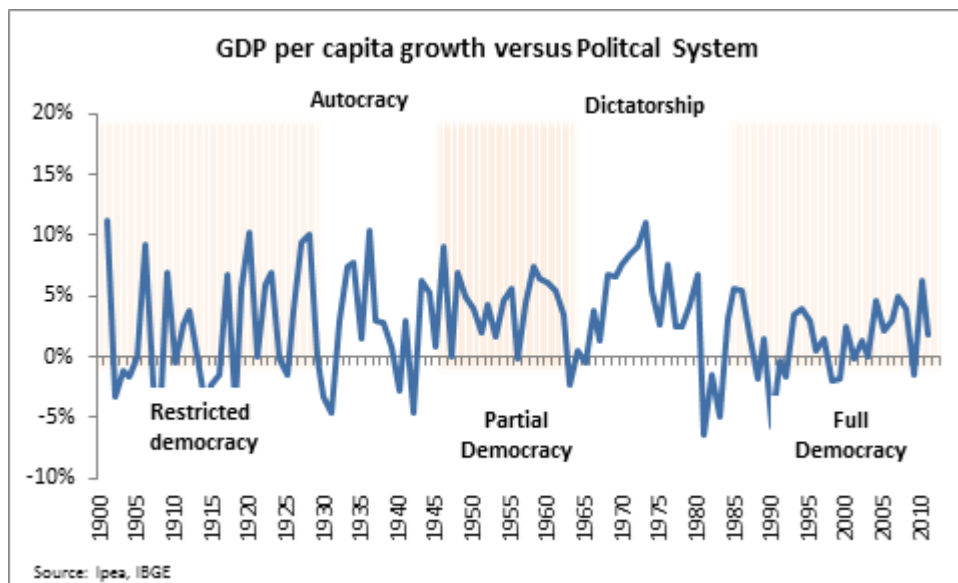
⁷ See Lipset (1993), Barro (1999) and Przeworski and Limogi (1993).

⁸ See Lipset (1993) for a detailed discussion of these conditions.

⁹ Barro (1996) studies a panel of several countries and controls for additional institutional factors such as rule of law index and share of government consumption on GDP, in which case there is no significant impact of democracy on growth.

¹⁰ Fixed effects are time independent effects that are possibly correlated with the regressor. If omitted, it biases the estimate of the independent variable impact on the estimation.

Chart 2



Institutions, however, are the outcome of society's choices, and people rather to be rich than poor. If there are institutions that provide more income in the long run, why should one choose less? Why do some countries choose a set of rules that lead to a Pareto inferior equilibrium? Why are specific institutions chosen in certain countries and not in others? This is the subject of next section.

3 - Colonization, Development and the Puzzle of Pareto Inferior Equilibrium

In a series of influential papers, Engerman and Sokoloff proposed that natural endowments were decisive to the pattern of colonization process – exploration versus settlement -, which shaped institutions and influenced the future political and economic development of American colonies.¹¹ Following a similar path, Acemoglu, Johnson and Robinson (2001, 2002) investigated the relevance of the colonization model to explain current income differentials among American countries, and the last lingering influence of institutions introduced in the colonial period.

¹¹ Engerman and Sokoloff (1997, 2012), and Sokoloff and Engerman (2000).

The climate and conditions of North America induced settlement and the production for local consumption, while reproducing several aspects of their previous life in Europe. The model that prevailed was one of a more egalitarian society with smallholdings trading with neighbors in a competitive production of grains, leading to specialization, logistics, innovation and gains of productivity.¹² Settlers adopted institutions to protect property rights and guarantee the enforcement of contracts, and introduced institutions that replicated their European counterpart. Society started more egalitarian, and initiatives that threatened this backdrop had been less successful.

Tropical areas, on contrast, provided favorable conditions to produce efficiently valuable goods to Europe by exploration of land and labor. The intention was not to settle, but to explore natural resources. Colonization induced large-scale production and controls that enabled income appropriation by local and metropolis elites via government mechanisms. This growth model required institutions to enforce rent-seeking mechanisms, which resulted in an unequal society and concentrated access to political power. Government rent-seeking mechanisms were an essential part of this model. More than half of Portugal government income came from transfers from Brazil in this period, according to Mattoso (1993).¹³

At the end of the colonial period, American colonies displayed a surprising division. There were two Americas. In the north, settlers produced mostly for domestic consumption, and more egalitarian. The several areas in south were richer due to trade with Europe, but unequal. The Caribbean had the highest per capita income, overcoming North America until the nineteenth century.¹⁴

After independence, however, development paths inverted and tropical areas underperformed in comparison to North America, a pattern that persisted during the twentieth century. Acemoglu, Johnson and Robinson (2002) appropriately referred to this process as a “Reversal of Fortune”. Institutions

¹² Sokoloff and Engerman (2000).

¹³ We learned Mattoso evidence from Caldeira (1999, p. 229), which has a very original and provoking economic analysis of Brazil in colonial times and its economic activity.

¹⁴ For example, Cuba per capita income was 167% of the US in 1700 and 122% in 1800, according to Sokoloff and Engerman (2000).

adequate to colonial periods persisted after independence movements and proved to be less suitable for market economies.

If economic fortune has been inverted, the same cannot be said about political participation and income distribution. In former exploration colonies, such as Brazil, high inequality and restricted political participation have been persisted after the colonial period,¹⁵ as well as poor social policies and access to education.¹⁶

Why have sub-optimal colonial institutions persisted? Why did tropical areas choose not to follow the North American institutions that proved to be more successful after the late nineteenth century? Why has Latin America fell behind? Why have some democracies flourished and revealed to be resilient while some have proved to be very susceptible to current events?

Given the rules of the game, defined as institutions and incentives that rule individual behavior, people make choices to maximize their welfare. Whether that implies a Pareto inferior equilibrium, it is either because people do not perceive the benefits of changing the rules or because some groups with veto power that would be worse off in the new environment could obstruct changes, while society has no credible way to compensate them for possible losses.

This seems to apply to rent-seeking societies, which rely on institutions that concede special benefits and privileges to selected few and restrict the participation of remaining social groups.¹⁷ This design ultimately helps to explain to the survival of this inferior equilibrium.

In Brazil, rent seeking is quite stable, despite its sub-optimal outcome. The long prevalence of rent seeking may be due to some main factors. First, beliefs in an economic model must be consistent with society outcome, as pointed by Greif (2006).¹⁸ There is a widespread view that as Brazil is far from

¹⁵ Sokoloff and Engerman (2000) present data on voting rules as well as literacy rates for several American countries in the nineteenth century.

¹⁶ Sokoloff and Engerman (2000) argue that the importance public primary schools were recognized all over America in the late 1800s; however only in US and Canada they were actually implemented.

¹⁷ For an economic model of rent seeking, see Barelli and Pessoa (2010).

¹⁸ According to Greif (2006), institutions should reflect society or decision makers' beliefs for the political and economic processes to be sustainable. Moreover, the system needs to deliver what

the technological frontier, it would require alternative policies to catch up. Furthermore, for several decades in the last century, Brazil economic model based on strong government discretionary intervention was successful in generating high economic growth.

Second, uncertainty about the outcome of the intended changes may create incentives to alliances that impede those changes. Agents may have uncertainty, for example, about the specific consequences of trade liberation on their particular market.¹⁹ Third, rent-seeking policies create political vocal groups that depend on those policies and react to proposed changes. Fourth, lack transparency and accountability. Opacity and hidden costs of benefits conceded by rent-seeking mechanisms make more difficult a public discussion base on cost-benefit analysis of the policies, even after re-democratization. Rules and procedures are Taylor-made, adjusted to beneficiaries needs, and costs are diffused throughout society. Furthermore, there is almost no timely enforceable evaluation of policies' outcomes. Once conceded, privileges are somewhat protected from public discussion, fixed by several legal mechanisms that make harder future reversal.²⁰

4 - Historical perspective

Since colonial period, Brazil has experienced many political cycles and troubled democracy since republic. During this long period, rent-seeking mechanisms were not only preserved but also enhanced, being incorporated as an essential aspect of the country's development project, reflecting a widespread view, or beliefs, about the priorities of government policies: to provide protection, incentives and benefits to selected sectors in order to promote growth.

expected by society. Otherwise, questionings about rules and institutions would arise, leading to a reassessment of the policies undertaken.

¹⁹ See, for example, Rajan and Zingales (2006) for a theoretical model in which uncertainty prevents reforms.

²⁰ Tullock (2005) proposed the first model of rent seeking, a term later introduced independently by Krueger (1978). Tullock works anticipate Douglass North's conjecture of the role of Glorious Revolution in England posterior economic development.

After 1929, economic development became gradually a government project, which was to some extent aligned with the world environment of 1930s and 1940s that leaned towards protecting economies. The external crisis along with nationalism shaped economic policies that intended to induce domestic production and lower dependency on trading.²¹

At the beginning of the project, during Vargas long dictatorship (1930-1945), political rights were limited and government increasingly assumed the role to mediate both economic and political decisions and conflicts. Government agencies monitored and played an important role on investment decisions and resources allocation, as well as on mediation and ruling of social conflicts. Government defined private institutions to represent the many social groups and rules to manage and arbitrate conflicts. Special courts as well as rules severely limited private agents' scope on negotiations, as in labor market.

The intervention in the economic sphere was equally widespread. Several restrictions and government agencies limited market outcome to allocate goods and services. Government arbitrated many prices besides quantitative restrictions on several markets. The invisible hand of Adam Smith was replaced, by a large extent, by a government hand, not invisible, however quite diffuse and opaque.²²

After World War II, under restricted or an elite democracy, Brazil chose a strategy that put government at the center of its development project, following many developing countries in Latin America. The ideological framework that provided a justification for government's intervention was called "National Developmentalism".²³

According to this view, underdevelopment was the outcome of negative externalities, lack of coordination and resources to finance private investments. From this perspective, the public sector role would be to overcome these

²¹ For a general overview of Brazilian development, the role of institutions and government policies, see Left (1991). For a discussion of Brazil's response to 1929's crises and the beginning of the National Developmentalism project, see Malan, Bonelli, Abreu and Pereira (1980).

²² See Abreu (1990b).

²³ Bielschowsky (1988) summarizes the National Developmentalism Ideology.

limitations by granting protection and adequate incentives to selected economic sectors.

Industry was the sector elected for protection. Income generated by export agriculture was transferred to the industrial sector through many mechanisms, including taxation on several agricultural goods and a complex system of multiple exchange rates in the 1950s, which along with trade barriers, protected the industrial sector from external competition and provided incentives to import inputs and capital goods.²⁴ Beyond that, the government also organized a regular agenda with the private sector to coordinate production and investment decisions and adjust public policy. Several public monopolies were created, from oil to reinsurance, and state owned companies provided public utility services. Furthermore, government would also supply the necessary infrastructure as well as public banks, and protections to provide policies and incentives to specific economic sectors and regions.²⁵

Government funds financed both private and public investment, such as the construction of a new capital, Brasilia. Nevertheless, forced savings and increasing indirect taxes have not enough to prevent large public deficits and inflation acceleration.

High inflation was considered the result of supply restrictions rather than excess demand to be tamed via monetary and fiscal discipline.²⁶ Therefore, policy recommendation was to stimulate investment and production in order to relieve supply restrictions.

By late 1950s, macroeconomic imbalances led to high inflation and severe external restrictions. The Cold War added heat to an already difficult economic

²⁴ For the economic history of this period, see Abreu (1990a).

²⁵ For the history of the institutional development that supported National Development in Brazil, see Campos (2004). By the end of the century, BNDES has become one of the largest development banks in the world. There is an extensive literature on the role of government in promoting development and the reasons behind the few cases of success but less debate around the more numerous cases of failure. Bhagwati and Panagariya (2013) discuss the failure of government intervention in India and provide some general discussion on public policy, growth and development. See, also, Pack and Saggi (2006) and Robinson (2009). For the Latin America experience, see Edwards (2010). For a more optimistic view of some public interventions to foster growth, see Rodrick (2007).

²⁶ For a survey of this economic perspective in Brazil up to late 1970s, see Bielschowsky (1988, section 2.3.4) and Pinto, Assail, Prado e Marinho (1978).

and political environment. Political instability and social unrest increased, with claims for a more equality. The combination of privileges and benefits to specific groups and sectors, lack of accountability of public resources, macroeconomic instability and growing social demands became explosive.

The worsening of economic and political conditions in the early 1960s led to an unfortunate political outcome, a military coup in 1964, which ended up in a 21 yearlong dictatorship.

Economic crisis and political centralization were the ingredients for unexpected economic reforms in mid-1960s. Several liberal market-oriented reforms were carried out along with government spending control. To mention a few, the creation of the Central Bank, regulation of capital markets and the introduction of several credit instruments. Liberal reforms induced productivity gains and, in conjunction to a favorable external environment, fostered growth for the next years.²⁷

As growth rebounded in the late 1960s, however, the usual instruments of economic policy resumed and enhanced, such as strong government intervention, incentives and concessions of privileges and price controls. Fiscal policies became increasingly expansionary leading to inflation acceleration and rising current account deficit. The macro policy regime was clearly one of fiscal dominance, meaning the inflationary financing of fiscal deficits. As a response, government created several instruments to introduce the indexation of the economy, aiming at postponing macro policy adjustments.

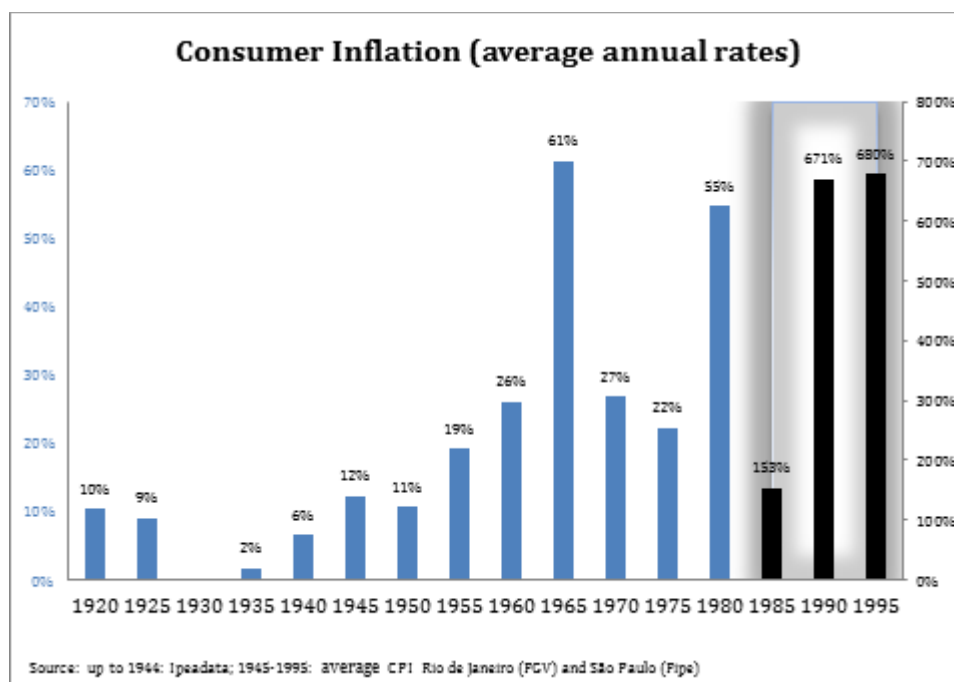
Government reaction to the severe mid-1970s was to “double the bet” and reinforce the National Developmentalism project, this time supporting imports substitution. Sectors chosen to receive government funding and protection ranged from naval industry to capital goods, basic sectors and infrastructure.

Government decision to cope with inflation was to strengthen the indexation mechanism instead of promoting a fiscal consolidation, which turned inflation dysfunctional in the 1980s.

²⁷ For an empirical investigation of reforms and the impact on growth, see Veloso, Villela and Giambiagi (2008). Lara Resende (1990) provides a description of economic policy at that time.

Chart 3 shows the evolution of annual inflation at five years interval. Due to the impressive increase of inflation after 1980, the three last five-year have a different scale on the right side.

Chart 3



Unexpected high inflation, however, was not the only government finance mechanism. Brazil distinguishes itself by the existence of many financing instruments available to provide privileges and benefits out of public scrutiny. The lack of transparency of costs and the lack of valuation of outcomes is a common feature of rent-seeking models, as emphasized by Buchanan (1967).²⁸

National Developmentalism delivered robust growth until the end of 1970s, but produced an unstable macroeconomic environment, frequently subjected to external shocks or internal crises.²⁹ On average, growth rates were robust, close to 7% a year, from early 1950s to late 1970s. However, one has to take into account Brazilian fast demographic growth. Growth rates per worker

²⁸ We thank Rozane Siqueira for this reference. A forthcoming paper by her and coauthors emphasizes the rent-seeking nature of government taxes and money transfers in Brazil.

²⁹ Carneiro and Modiano (1990).

were high but not superior to other development countries at that period, such as Korea, even in the years of Brazilian high growth of early 1970s.³⁰

Inequality of income was high and worsened significantly in the 1970s. The provision of standard public goods, as education and healthcare services, lagged behind even some much poorer countries than Brazil.

In the beginning of the 1980s, on the back of Volcker's monetary tightening, a severe crisis disrupted. The growth model collapsed. On the political side, social pressure led to re-democratization and waves of deep and broad reforms.

Democracy allowed increasing social participation. The political agenda in the 1980-90s was price stabilization, since the dysfunctional inflation rate of the period was detrimental to growth and worsened economic inequality. In the 2000s, as inflation had receded and fiscal equilibrium was obtained, social demand shifted to enhance consumption and to further improve income distribution. More recently, society has claimed for better quality of public services. This is the subject of next session.

4.1 – Re-democratization

The regime shift in mid-1980's led to a new constitution in 1988 and, for the first time in Brazil history, to a full democracy. Around ten thousand unions were created in the aftermath of the new constitution. Larger social participation and vocalization of changing social demands played an important role in shaping the economic agenda over time. Starting with prices stabilization and moving towards higher economic growth and more equality.

Re-democratization was a game changer in the political arena. In the first ten years, debate and policy actions were concentrated on macroeconomic

³⁰ Korea had a similar development project, largely based on industrial policy and government intervention. However, government budget remained relatively balanced during most of second half of last century, resulting in much lower inflation rates. The economic intervention was concomitant to large investment in education. Furthermore, benefits and protections were limited are coupled with foreign competition. Transparency of public benefits, accountability of policy outcomes and social investment distinguish the Korean experience from the Brazilian one. For an analysis of Latin American development process and some comparison to East Asia and Korea for that matter, see Edwards (2010).

stabilization strategies, which limited the scope for a broader economic agenda. Moreover, the political environment was troubled, due to a stream of unsuccessful plans to control inflation, which culminated with President Collor (1990-1992) - the first president democratically elected by direct voting - resignation in 1992, amid a severe economic crisis and corruption scandal.

Still, some important market-oriented reforms were implemented in the period: gradual trade and financial liberalization and the start of a privatization program. Moreover, consumer protection agencies were created.

Society desire for macroeconomic stability reflected in the election of President Cardoso (1995-2002), who was the finance minister that launched the successful stabilization plan named "Plano Real" (1994). The consolidation and sustainability of a low inflation environment required a sound fiscal regime and led to several reforms, including the pension system and a broad privatization program, followed by the creation of regulatory agencies.

Taming macroeconomic volatility was critical for accelerating growth and somehow improving income distribution via the end of the inflationary tax. Moreover, some experiments for improving income distribution started in this period, via cash transfers policies and restoring the purchase power of minimum wage. A particular successful program was "bolsa-escola" that provide cash transfers to low-income families with kids at school. Later on in President Lula's government (2003-10), some of those cash transfers programs were unified in a single program named "bolsa-família".

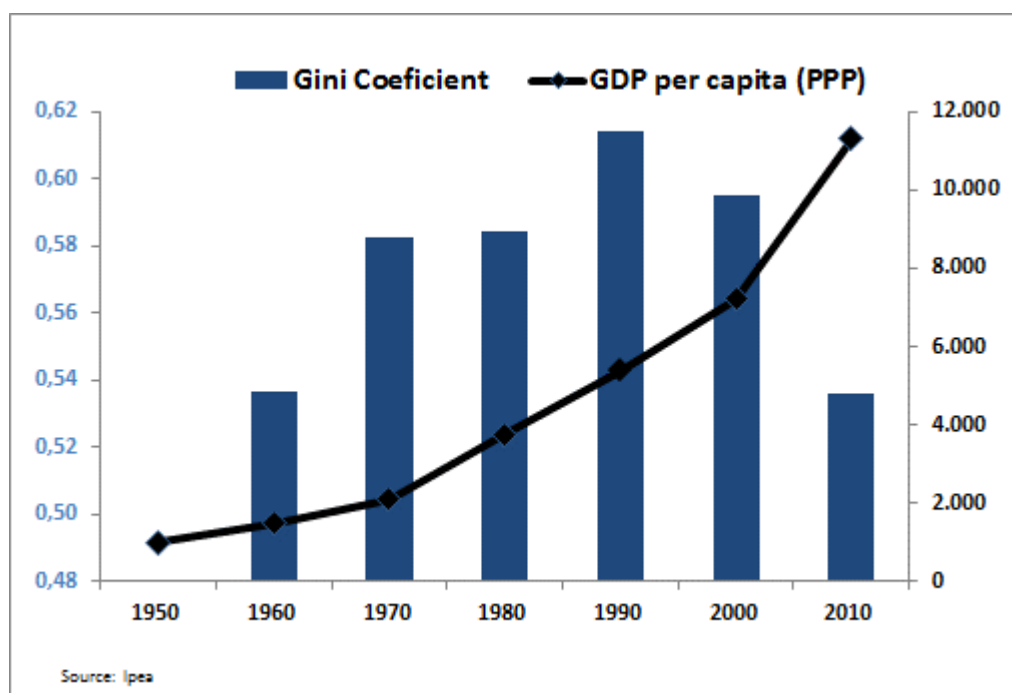
The severe economic crisis of 2002 was meet by a surprisingly orthodox economic policy in Lula's first administration. The government focused on macroeconomic stability and promoted several market-oriented reforms in the credit and capital markets.

Available evidence suggests these reforms have successfully improved markets efficiency and have led to a fast credit expansion. Microeconomic reforms played a central role in stimulating the formalization of the economy, granting firms access to capital markets and promoting the emergence of the

new middle class. Furthermore, the government focused on the expansion of social policies initiated under Cardoso administration.

The result of this broad set of structural reforms was a rebound of investment, productivity gains³¹ and improvement in income distribution, as displayed in Chart 4.³²

Chart 4



Re-democratization has implied an important change on government transfers, granting access of government benefits to social groups understood as underrepresented in the political arena. Government budget allocations to social policies have increased since the late 1980s, and increasing further in the 2000s. Social policies were an important factor for reducing income inequality in the first half of 2000s. Gini index dropped 1.2% per year between 2001 and 2005 and income from the 20% poorest grew 5 percentage points above average

³¹ See Lisboa and Pessoa (2012) and Veloso, Vilella and Giambiagi (2008) for a survey on the evidence of impacts of the institutional reforms in productivity and growth during this period.

³² For a very complete analysis of the evolution of income distribution in Brazil in the last decades, see Barros, Foguel and Ulyseia (2007a).

income. Barros, Carvalho e Franco (2007b) estimates that half of inequality reduction derived from non-labor income.³³

Those transfers rely on more transparent mechanisms than in the past, as a reflection of new fiscal rules that came with re-democratization aiming at guaranteeing fiscal discipline.

Aside from the focus on social policies, democracy was also important for the promotion of solid economic reforms. Surprisingly, some economic reforms of 1960s and early 2000s were quite similar. Liberal market oriented and pro-growth reforms. Institutional reforms that intended to provide adequate regulations and general framework similar to the ones observed in developed economies.

Nevertheless, reforms under democracy require negotiations and evolve more slowly, while they proved to be more solid and resilient, and not always a response to crises, being in some cases a natural political development as social demands change, particularly those that do not impose losses to interest groups, which usually come after crisis.

The most important example of successful reform compared to the 1960s is the consolidation of the fiscal regime. Fiscal dominance prevailed up to mid-1990s, but social demand for low inflation required fiscal discipline. The latter was implemented via a broad set of instruments, such as privatization, renegotiation and consolidation of state public debt, (partial) social security reform, introduction of primary fiscal surplus rules for the federal government and the creation of the Fiscal Responsibility Law that restrain fiscal policy in all government levels.

Another example would be central bank autonomy. Under dictatorship, it was legally established in 1964 and single-handedly dismissed right after in 1968 by the president. On contrast, under democracy, autonomy to the central bank has not been granted, but the monetary authority appears independent *de facto*, which is an essential element for the inflation target regime, established in 1999.

³³ Barros, Carvalho and Franco (2007) and Barros, Carvalho, Franco and Mendonça (2007) analyses the reduction of income inequality and provides estimates on the impact of government policies on income inequality. Barros, Fogel and Ulysses (2007b) summarize the results.

The road towards a more liberal market economy was, however, partial. On Lula's second administration, economic policy slowly moved from the path initiated in Fernando Henrique Cardoso administration and back towards the old National Developmentism. That change became particularly clear after the global crisis of 2008.

Old habits die hard and government reaction to the crises, as in the mid-1970s, has been in an increasing government intervention and the resuscitation of old rent-seeking mechanisms. Market distortions and transfer mechanisms have recently been reintroduced, like tax incentives and protection to selected sectors and groups. Monetary transfers proliferated, as democratization meant new interest groups being eligible for government policies, many of them hasty and without clear diagnoses or monitoring of results. State banks credit concessions increased significantly in the last six years in order to finance private sector investment. BNDES credit alone became close to 11% of GDP in this decade. It was government, a larger part of society, belief that by restoring old incentives the country would be able to overcome the difficult external scenario. Six years later, the economic outcome has frustrated several analysts and government officers.

Total factor productivity and commodity prices were the main drivers of economic growth in Lula's government. Since the external crisis, and the government respond to it, productivity growth has been reduced as well as economic growth. The introduction of several market distortions, the uncertainty about economic policy and government commitment to contracts lead to a more volatile macroeconomic environment.

Fiscal policy was relaxed and monetary policy was slow to react to a higher inflation, though very far from the levels observed in last century, while economic growth disappoints. The backdrop of macroeconomic deterioration adds to the failure of government agencies to deliver acceptable quality of public services, despite the high tax burden.

The low quality of the public services is at the center of the debate in Brazil today. Tax burden is high and quality of spending is low. This backdrop is

mirrored in the low position of Brazil in global ranking for government effectiveness, even taking into account spending-to-GDP ratio.

The low effectiveness of government policies turns out to reinforce rent-seeking pattern of social policies, as the government looks for shortcuts to compensate the poor. This would be the case of cash transfer programs, housing subsidies and minimum wage policy. Government working as an “arbiter of income transfers” as a way to compensate the poor to its inability to provide high quality public services.³⁴

Society has reacted intensely to threats to the status quo, surprising analysts and politicians. Social unrest, reflected in above 700 protests in more than 300 cities in June 2013, suggests that government needs to resume pro-growth reforms, paralyzed since 2005, and to improve the effectiveness of government policies in order to reconcile social demands for a better quality of public services and fiscal discipline.

Seeds of a legitimacy crisis brewing might be a reflection of government failure to understand and deliver society demands, against a backdrop of a political system that needs reforms to improve social representation.

Democracy and rent seeking do not match. The widespread concession of special treatments, tax breaks, subsidized loans and economic distortions reduces efficiency and economic growth. Probably reflecting the diffused nature of government intervention and policies, there is no clear agenda of reforms, except by an equally diffused democratic challenge to current policies and several new social demands. There is a sense of frustration with public policy and the very modest economic recovering after a few years of low growth.

4.2 Evolution of education

One important benefit of democracy was the increase of public investment in education, as 1988 constitution established universal access to education. Rising female participation in the labor market and in the political

³⁴ We thank to Marcos José Mendes for this contribution, including the term “arbiter of income transfer” to qualify government social policy.

scene might have been one driver for this shift in the economic agenda since the 1980s.

Since middle of last century there is a large evidence of the impact of education on income and growth.³⁵ Furthermore, in an impressive sequence of studies, Langoni (1973, 1974) showed the significant importance of education in explaining a large share of Brazilian high-income inequality at that time.³⁶

Despite the evidence, education was not a priority for most of the twentieth century. Mass education played no role in the National Developmentalism. Industrialization was understood as the outcome of capital accumulation and labor, regardless its quality.³⁷ Knowledge was required only to the extent that it provided access to new technologies, and the priorities of the investment in education were universities and R&D.³⁸

Government spending on education had been historically low compared with other developing countries, resulting in higher illiteracy ratios and low labor productivity. In the 1950s public expenditure in education amounted to 1.4% of GDP, fluctuating around 2.7% during 1965-1985.³⁹ According to Pessoa (2008), in the 1950s, 6 out of 10 children aged 7 to 14 were out of school. Years of low concern with public education left their marks. Chart 5 shows the poor evolution of education in Brazil.

³⁵ Aghion and Dourlaf (2009).

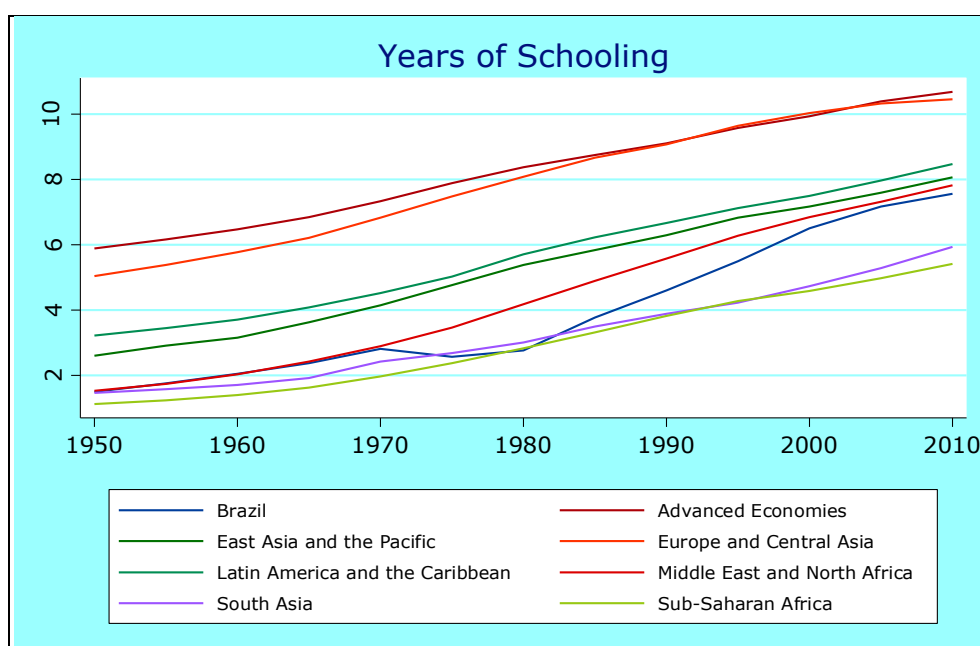
³⁶ Langoni (1973 and 1974) showed that education explained most of Brazil income inequality and that the rate of return on education was higher than in any alternative economic sector.

³⁷ For the lack of relevance of education on the economic debate at that time, see Bielschowsky (1988) where, despite its comprehensible analysis of the economic thought of the time, the theme is barely discussed. For a further discussion of the evidence, see Pessoa (2008).

³⁸ For some of the consequences of this approach, see Schwartzman (2011).

³⁹ For a survey of the debate on education and income inequality, see Lisboa and Menezes-Filho (2001).

Chart 5



Source: Barro and Lee (2012)

Under democracy, government spending on education climbed to close to 3.8% of GDP in 1990, accelerating to 4.5% in 2005 and reaching 5.7% in 2009, which compares to 5.8% of GDP in OECD countries. As a share to total public spending, expenditures in education accounted for 16.8% in Brazil versus 13% in OCDE countries, ranging from less than 10% in the Czech Republic, Italy, Japan and the Slovak Republic, to more than 19% in Chile, Mexico and New Zealand. These figures put Brazil in a more favorable position, at least in terms of spending.

Table 2: Public expenditure on education

	% of total public expenditure				% of GDP			
	1995	2000	2005	2009	1995	2000	2005	2009
OECD	11.7	12.6	13	13	5.3	5.2	5.3	5.8
EU21	10.4	11.4	11.8	11.5	5.3	5.1	5.3	5.8
Brazil	11.2	10.5	14.5	16.8	3.9	3.5	4.5	5.7

Source: OECD (Education at a Glance, 2012)

Democracy, therefore, may have led to a more transparent and collectively decided transfer mechanism, one that is fully accounted in government budget and subject to social scrutiny. That means that democracy may have led to the development of mechanisms more similar to the ones observed in developed economies.

Despite the increase in education investment, Brazil has not reaped the rewards in terms of closing the gap to successful stories in education, like Korea, or even Chile. The catch up in terms of years of schooling is still yet to be seen. Moreover, there has been a lot of questioning on the quality of spending. The performance of Brazilian students in international evaluation lags far behind peer countries.

From this perspective, Brazil challenge is to improve quality of spending more than increasing the budget for education, in order to boost labor productivity and growth potential.

It is reasonable to assert that Brazil is still in its learning curve regarding improving the quality of public services, including education. Priority in the last couple of decades was to provide universal access to education, eliminating the gap of decades of poor investment in education. Priorities change. Now it is time to move forward and provide egalitarian access to good quality education.

A major challenge for public policy is to understand the reasons for such a poor outcome of public spending on education, its incentives and rules. Why do our schools perform so badly and pedagogical tools seem to be so ineffective? How should incentives and rules change in order to foster a more efficient use of public resources? These seem to be the challenges ahead.

5 – Brazil Rent-Seeking Mechanisms and Democracy

Government intervention is broadly accepted in Brazil as a strategic tool to promote economic development. An important reason for the survival of rent-seeking mechanisms has been the lack of transparency of their underlying costs to the society. Benefits, however, are concentrated and tangible for the

recipients. Diffused costs and concentrated benefits are at the core of the persistence of rent-seeking mechanisms.

Democracy was built and shaped under this belief as well as under this government *modus operandi*. As long as new groups appear in the political arena, claims for more equality have been met with more rent-seeking policies, which work as shortcuts to meet rapidly social demands.

National Developmentalism does not appear compatible with growing social demands, which in turn require a more efficient model. Nowadays, society claims for better quality of public services, like healthcare, education and security. Those demands challenge fiscal stability, which is additionally pressured by the necessity of public investment in infrastructure.

Rent seeking manifests in several ways. We divide them in four main groups. First, there is a very complex system of tax and transfers, characterized by several rules and exemptions that mask the beneficiaries of privileges. Second, there are mandatory tax-transfers mechanisms that do not go through government budget. Third, several cross-subsidies, via prices control and forced allocations of funds, provide specific benefits under hidden mechanisms. Lastly, trade and non-trade barriers that limit competition at the expense of consumers, impacted by higher prices and worse quality of goods. They all contradict the ideal solution of direct transfers included in government budget.

In the following sub-sections, we describe a few of these mechanisms.

5.1 Taxes and transfers

In the twentieth century there has been a sharply increase in government intervention and social spending in social policies in most developed economies. Large government does not necessarily mean inefficiency. There is a controversy in the literature concerning the extent to which such intervention may hurt incentives and result in net economic costs. Surprisingly enough, that was not the case for developed economies for most of last century. Democratic processes seem to have been successful in controlling social costs associated to these interventions, at least until the end of last century.

Furthermore, up to the 1960s, transfers were concentrated on education, which increases productivity. A rather transparent process in which tax-transfers mechanisms, their general principles and criteria are widely debated and evaluated, mostly accounted in government budget. Besides, there is a permanent concern with the monitoring of their impact, leading to frequent reforms.⁴⁰

The effectiveness of the fiscal policy in promoting long-term growth depends on the quality of spending and the complexity of the tax system, and Brazil fails in both fronts.⁴¹ Rent seeking weakens the effectiveness of fiscal policy, as it reduces the resources available for investment and social spending and produces a distortive tax system.

Standard social policies, usual in developed countries, focusing on education, healthcare and income distribution, had been rather scarce in Brazil, even in comparison to other developing countries, and not entirely subject to democratic scrutiny.⁴²

Tax burden hovered around 10% of GDP up to the 1940s and increased to 20% in the 1970s, as government widened the intervention in the economy. Once inflation stabilized and the expansion of government transfers increased, it scaled to 25% of GDP in the 1990s. Government spending in Brazil reached in 2012 as much as 40% of GDP according to the IMF, while tax burden was close to 37%, as displayed in Chart 6.⁴³

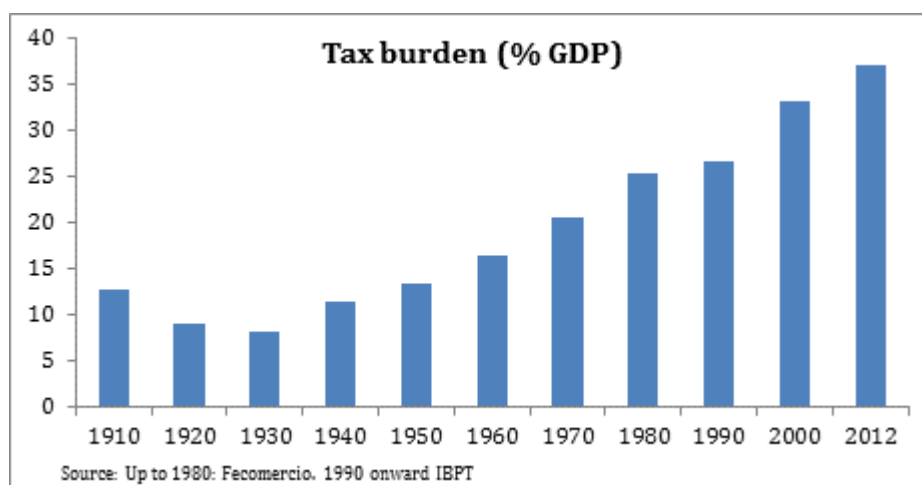
⁴⁰ Lindert (2004) provides an extensive quantitative analysis on this subject as well as the different behavior of labor market in these economies. Since 1960s, social spending has moved increasingly towards to pensions, which has led to debates of their net economic costs. For a recent analysis of tax reforms in developed countries in the last two decades and their concern on growth incentives, see Brys, Matthews and Owens (2011).

⁴¹ Lindert (2004) emphasizes the importance of transparency and democratic controls of taxes and government transfers in developed economies, where several reforms and controls were implemented in order to reduce incentives contrary to economic activity. Brys, Matthews and Owens (2011) discuss tax reforms in OECD countries in the last 30 years and their motivation.

⁴² Ministério da Fazenda (2003) compares tax and transfers to families in Brazil and other countries and shows that in the second income inequality is deeply reduced by government transfers, contrarily to the first.

⁴³ The level of complexity leads to many methodological debates in Brazil on how to evaluate the tax burden. In an impressive and complete work, Afonso, Soares e Castro (2013) describes Brazil's complex tax system.

Chart 6



Comparing these figures to countries with similar income per capita, one can see that Brazil stands on the group that spending as well as tax burden is relatively higher.

Table 1
Total Tax Revenue (% GDP) 2012

Brazil	37.2
Argentina	40.3
Chile	23.9
China	22.6
India	19.1
Israel	38.9
Korea	23.3
Mexico	23.6
Turkey	34.7
South Africa	27.9

Source: IMF.

According to the Global Competitiveness Report, 2012-2013, Brazil ranked last in a sample of 144 countries in the item Extent and Effect of Taxation, and 131th on total tax rate, an item intended to measure total taxes incident over production and labor.

The complexity of Brazilian tax rules is overwhelming. The tax system embeds a myriad of rules, exceptions and exemptions, which cause excessive

bureaucracy and distortions that hurt growth.⁴⁴ From 1988, when Brazil promulgated its new constitution, to 2011, there were close to 156000 new norms - including 6 constitutional amendments, more than 4700 new laws, 1162 provisional measures - and more than 130000 complementary norms, adding up to more than 5 new tax measures per day. These numbers refer to federal government only.⁴⁵

Re-democratization was followed by a larger allocation of tax revenues to local governments, which suffered a setback during the military dictatorship, when the share of the federal government reached 70%, falling to 55% after 1994.⁴⁶

Democracy also increased meaningfully monetary transfers to low-income people, like pensions to agricultural workers and other informal workers, and several cash transfers programs to low-income families in the second half of the 1990s. Later, in the first half of 2000s, some of those programs were unified and extended under the “Bolsa-Família”⁴⁷, a successful program that amounted to 0.5% of GDP in 2012 and helped to reduce income inequality.

Despite the success of targeted social policies, total social spending still fails to improve income distribution in comparison to other countries. According to Immervoll et al (2009), Brazilian government spends more than two thirds of tax revenue on social programs, which compares to OECD averages. Nevertheless, Brazil still fails significantly to reduce income inequality and poverty as observed in more developed countries. The main reason for that is the public social security system, due to its high concentration on a relatively small group of beneficiaries.⁴⁸ Pensions account for 85% of total cash transfers to households (about 11% of GDP), which in turn represent almost one quarter of household disposable income. This percentage is above the OECD average,

⁴⁴ For a complete, and for that matter, impressive description of Brazilian complex tax rules, see Afonso, Soares and Castro (2013).

⁴⁵ Amaral et al. (2012).

⁴⁶ See Afonso, Soares and Castro (2013, pp. 77).

⁴⁷ For a government discussion of income inequality and the benefits of such policies, see Ministério da Fazenda (2003).

⁴⁸ Non-pension benefits display concentration indices comparable to those of some EU countries. Nevertheless, they represent only 1.5% of household disposable income versus around 15% in EU countries, so that their equalizing power is limited and far from enough to compensate pension benefits.

despite Brazil's much younger population, while benefits are too concentrated, with ratios far above the EU countries.⁴⁹

Souza (2012) reached a more pessimistic result when analyzing the net impact of government actions in income distribution, regardless their nature. Using 2008-09 data, the study includes public workers wage and pension differentials to private sector workers. He shows that government contributes to worsen income distribution, as public servants belongs to the higher end of income distribution and are beneficiary of a more generous social security. Whereas government action explains one third of disposable income inequality in Brazil, one fifth stems from pensions. The author mentions that this magnitude could be underestimated as it includes the progressivity⁵⁰ of direct taxes and contributions, but it does not include indirect taxes, which are regressive.

In line with those findings, Afonso, Soares and Castro (2013) compare the Index of Human Development (IHD) of several countries against their respective tax burden and show that Brazil lags behind.

Another important example of rent seeking is the economic area of Manaus (Zona Franca de Manaus, ZFM).⁵¹ ZFM concentrates about 600 industries mainly in the electronics and chemical segments and employ 400 thousand workers. ZFM was formally created in 1967, with a broad set of tax breaks aiming at promoting regional development by compensating location disadvantages. Initially, incentives were supposed to end by 1997. Nevertheless, they have been continuously renewed since then, and in 2003 government postponed their end to 2023.

Fiscal incentives are estimated in at least R\$24 billion for 2011 or 0.6% of GDP, as this amount does not comprise other municipal (lower property tax) and

⁴⁹ For similar results and a further analysis of the Brazilian pension system design and its impact on government transfers, see Rocha and Caetano (2008).

⁵⁰ "Tax progressivity" describes the way rate progresses from low to high income or expenditure, where the average tax rate is less than the marginal tax rate. Progressive taxes attempt to reduce the tax incidence of people with a lower ability-to-pay, as they shift the incidence increasingly to those with a higher ability-to-pay.

⁵¹ This session is based on Miranda (2013).

state incentives (lower value added tax on goods produced in other regions and sold at ZFM).

Companies are quite similar to "maquiladoras", basically assembling and packaging products, generating little value added and requiring imports of inputs far above country's average. Furthermore, ZFM looks like an enclave without strong ties with country's production chain. ZFM survives based upon captive domestic demand as trade barriers protect local production. The outcome in terms of exports disappoints, contrasting to the Mexican experience. Exports stand for less than 3% of companies' turnover.

Companies at ZFM have no incentives to invest and depend on permanent government protection. ZFM have persisted without efforts to restructure its model, despite the failure to promote regional development and reduce social inequality, at the expense of the society.

5.2 Compulsory money transfers outside government budget

A remarkable feature of Brazil rent-seeking model is the ability to create tax-like contributions on individuals and firms, and to transfer resources directly to special interest groups. These mechanisms do not go through government budget and are not subject to yearly congress discussion or society scrutiny.

An example is "Sistema S", which is based on a compulsory contribution on the firms' payroll that is directly transferred to 11 private institutions. The main objectives of those institutions are to improve labor force education and training and promote cultural events, among others. In 2010, funds allocated to "Sistema S" amounted at least to 0.3% of GDP, according to Afonso, Soares e Castro (2013).

Another example is workers' mandatory savings, called FGTS, which collected close to 1.7% of GDP in 2010, according to the same authors. Registered workers must collect per year an amount equivalent to a monthly wage, as compulsory saving, which is kept in a fund managed by a government agency. These resources are used as funding for investments in several areas. Workers can only dispose their resources when retiring or under specific

circumstances, like termination of employment and for financing housing acquisition. This fund pays interest below market rate.

It is interesting to notice that as informality has been historically high in Brazil, most individuals are not under government supposed protection. Therefore, FGTS as well as “Sistema S” are usually seen as benefits to formal workers and an advantage over informal jobs rather than a burden on wages. There is no transparent mechanism to evaluate the cost-benefit of those instruments and their opportunity cost in alternative use or a real wage increase.

5.3 Cross-subsidies

The phenomena of cross-subsidy are widespread. From the regulation of health insurance market to the supply of infrastructure services, and even access to cultural goods, there are several examples of legally introduced distortions that provide specific groups’ benefits, without transparency, at the expense of society. In several cases, relative prices are moved away from their efficient level and negative incentives are introduced.

The most peculiar one are discounts on prices of cultural events. Prices vary according to age and occupation. Students and elderly are entitled to half price at the expense of other individuals who pay higher prices. Half tickets have been increasingly allowed to a large number of groups, including people who donate blood transfusions, to illustrate the extension of the benefit.

Government intervention is particularly relevant in Brazil financial markets. Since independence, there have been many public banks, federal and state ones. It has not been a successful history. State owned banks have gone bankrupted a few times, as in the severe crisis of local states public banks in late 1990s, which resulted in losses close to 6% of GDP, according to Lundberg (2011). The arbitrary use of public banks, their social costs and macroeconomic impacts are subjects yet to be detailed in Brazil economic history.

Financial market is also affected by cross-subsidies in private sector loans.⁵² Regulations severely restrict the amount of deposits available for funding non-earmarked credit operations. Reserve requirements on demand deposits are close to 50% against less than 10% in most countries. Besides, there are several earmarked loans, charging interest rate below the market, which, excluding BNDES loans, stand for 20% of credit outstanding (as of 2012).

Non-earmarked loans charge much higher interest rates to consumers, in part for compensating the subsidy embedded on earmarked operations. In 2012, spreads on the former reached 20% versus 3.5% of the latter.

The state bank BNDES is included in the set of distortions in the financial market. It is also an example of how institutions survive, adapting to new circumstances, and in this case, reinforcing the rent-seeking scheme.

Brazil relied heavily on its development bank, established in 1952. In its early years, BNDE (BNDES since 1982) focused on developing infrastructure. Later, in the 1960s and 1970s, BNDE widened its role by becoming a majority shareholder in many companies.

Over the 1970s, BNDE shifted to financing private companies, counting on new instruments, such as financing of machinery acquisitions, serving as guarantor in credit operations abroad and investing directly in the equity of domestic companies. In 1982, it created BNDESPAR, a private investment arm, to manage those holdings.

In the 1990s privatization program, BNDES played a central role. Aside from being an operational agent, it provided financing for the buyers in some of the transactions and purchased minority stakes through BNDESPAR, aiming at attracting private players to the auctions.

BNDES remained strategically important even after the liberalization and privatization wave of the 1990s. During Lula's government, BNDES was involved in several large-scale operations aiming at building "national champions", large Brazilian companies that were build up to compete against international

⁵² Private loans in Brazil have always been subject to several mechanism and price interventions. In late 1980s, for example, inflation correction of mortgage loans was limited to wage increases, which resulted in losses above 4% of GDP (Lundberg, 2011).

companies in world market.

Time has passed, capital markets in Brazil have developed significantly, but BNDES has persisted and it has become even larger. It has changed its role over time, adapting finance mechanisms and its funding sources as well. BNDES has clearly deviated from its role to finance projects with high social return that would not be funded otherwise.

Since the disruption of the global crisis in 2008, BNDES loans have been a supposedly anti-cyclical tool. Loans increased dramatically reaching 11% of GDP in the end of 2012 from around 6% prior to the crisis, counting on enhanced cash by the treasury. According to the federal court of auditors (“Tribunal de Contas da União”), implicit subsidy of to the BNDES would have totaled BRL22.8 billion in 2011 (around USD10 billion). Additionally, BNDES has been lately a source of resources to the treasury via anticipation of dividends payment. As a result, Basel index has been decreasing, reaching 14.5% in March 2013 from 20.6% in the end of 2011.

The BNDES System amounts to USD333 billion of assets versus USD338 billion of the World Bank. BNDES is the third largest development bank in the world, following China Development Bank (USD751 billion) and Germany’s Kreditaltamt für Weidaruftan (USD596 billion).

BNDES does not comply with the key design attributes for a successful industrial policy defended by Rodrick (2007), which are “embeddedness”, carrots-and-sticks, and accountability. Government makes top-down decisions on sectors to be protected with no adequate involvement of the private sector. BNDES encourages investments in nontraditional areas (the carrot), but fails to weed out unsuccessful projects (the stick); and public does not have access to operations’ performance. There is no transparency on BNDES operations. No available data on total subsidies provided, benefited companies or sectors and the cost-benefit of policies. Furthermore, the evaluation of the outcome of BNDES investment decisions is also unavailable.

When it comes to assess the impact of BNDES in the economy, conclusions are disappointing, to say the least. According to Musacchio and Lazzarini

findings, BNDES has been picking up “winners” that neither invests in capital-intensive projects nor in projects that improve their performance. Regarding loans, the only significant impact is the reduction on firms’ financial expenses, without any consistent effect in terms of investment or performance. Moreover, the authors point that firms benefited by BNDES and firms donors to elected political candidates are correlated.

Another criticism is the distortions generated by the bank’s funding model. As discussed by Musacchio and Lazzarini (2013), BNDES funding changed over time. From government transfers and monetary deposits, with inflationary implications, in the very beginning, to payroll taxes intended to finance unemployment insurance program (FAT), consolidated in 1990, whereas BNDES would pay in return the so-called federal long-term interest rate (TJLP), below central bank’s interest rate. From the 1980s to 2008, BNDES relied significantly on retained earnings, basically the return on investments in securities using BNDESPAR. More recently, since 2009, a huge amount of funding has been coming from Treasury transfers via public debt issuance.

Lastly, BNDES role changed over time without society participation on this decision, even indirectly via congress, because BNDES does not enter in the government budget. Society has no clarity on cost-benefit of BNDES policies, because there is no transparency on its policy. Society acquaintance of BNDES activities remains basically restricted to its support to cultural activities, disclosed via institutional marketing, which in the end masks its impact in the economy.

5.4 Trade protectionism

There is an additional mechanism of rent-seeking: trade protectionism to specific sectors, characterized by unusual higher import tariffs and non-tariffs barriers in comparison to other countries, which are also complex and, in several cases, severely limit foreign products access to the Brazilian market.⁵³

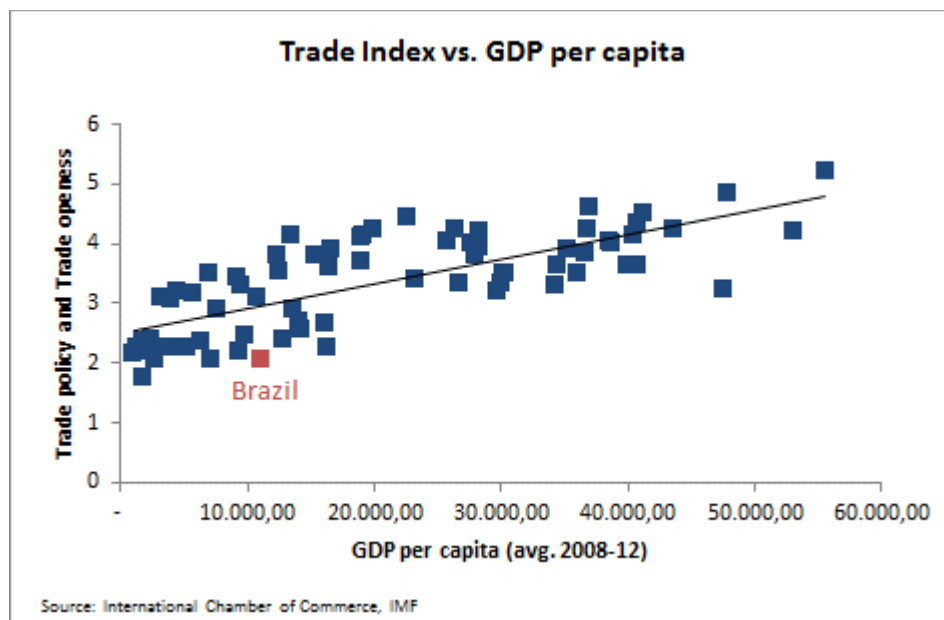
⁵³ For an example, see Carrasco and Mello (2013).

After World War II, Brazil development project has resulted in a reduction in trade flows. Local production in substitution to foreign trade was part of the strategy. Decades of protectionism took its toll in terms of low productivity gains and the low competitiveness of Brazilian manufacturing, which in turn has been frequently used as an excuse for keeping barriers to external trade.

The collapse of this growth model in the 1980s resulted in efforts to open the economy to trade, under democracy. Nevertheless, Brazil remains a very closed economy, with a complex structure of tariffs and non-tariffs barriers, which produces income transfers from buyers, consumers or other firms, to the protected sectors.⁵⁴ Consumers are penalized by more expensive and with lower quality domestic products.

Brazil stands at the group of the most closed economies in the global ranking in terms of trade openness and trade policy, measured by the level and complexity of tariffs, non-tariffs barriers, and efficiency of import procedures, as shown in Chart 7.

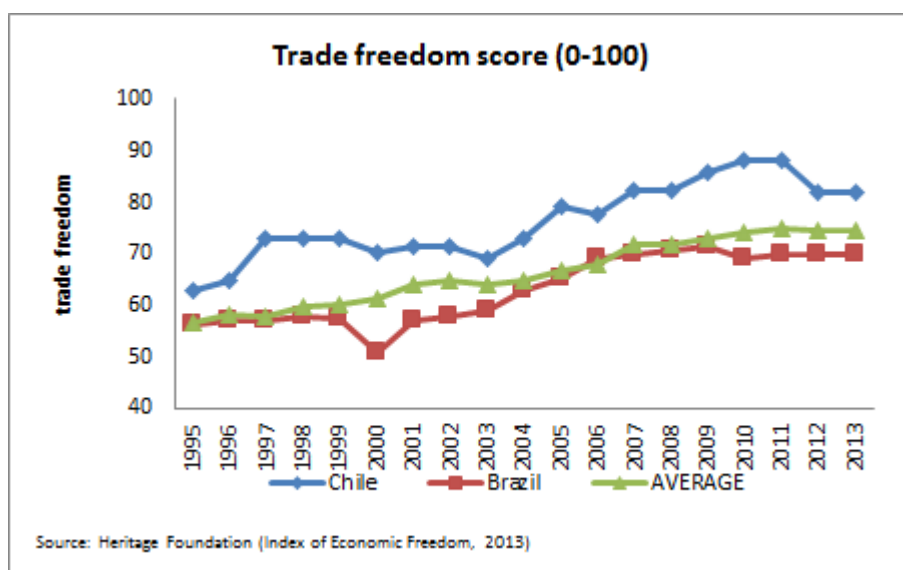
Chart 7



⁵⁴ Brazil relies on many technical requirements to restrict competition from abroad. Technical norms that are very distinct from the ones used in other countries and bureaucratic maneuvers that make it impossible to import some goods. Those barriers end up with higher costs for local consumers. For an example of such procedures and their costs, see Bacha (2012).

Moreover, as displayed in Chart 8, the country has apparently worsened trading conditions lately, in the aftermath of the global crisis disrupted in 2008, with deterioration in the Index of Economic Freedom, after important improvement last decade, even in comparison to Chile, an economy far more dependent on trade than Brazil.

Chart 8



Protectionism has been defended in Brazil as a component of the development strategy, in order to provide protection from external competition and foster local production. O'Rourke and Taylor (2006) showed that in poorer regions such as Latin America, low capital-labor ratios along with high-land-labor ratios has led to raised tariffs, contrasting to the US experience.⁵⁵

6 – Democracy indicators: Where does Brazil stand?

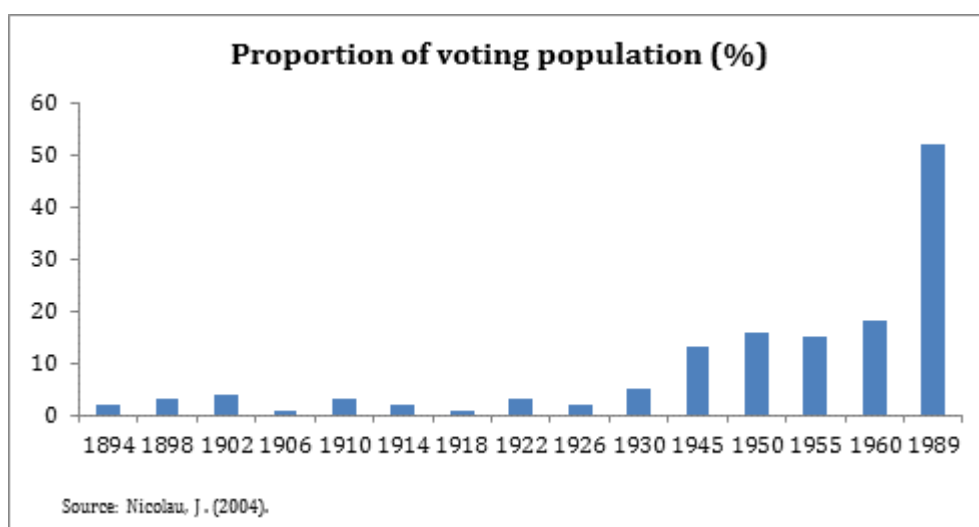
In 1824, the first Brazilian constitution established censitary suffrage. Votes were restricted by wealth and literacy requirements. This backdrop changed slowly under Republic. Mandatory and secret vote was established only

⁵⁵ According to the authors, countries in the New World with high land-labor ratios, democratization should have been associated to higher tariffs, except those richer, such as the United States, with high capital-labor ratios muting this effect significantly.

in 1934 amid significant political pressure and female vote dates back to 1932. Illiterate vote appeared only in 1988, under full or mass democracy, as opposed to previous elite democracy.

The proportion of voting population was negligible, around 2% up to 1934, climbing to only 18% in the 60s. Under the re-democratization, it crossed 50% of the population (Chart 9). On contrast, in the US and Canada, the proportion of the population voting was around 16% in 1880 and 40% already in 1940.

Chart 9



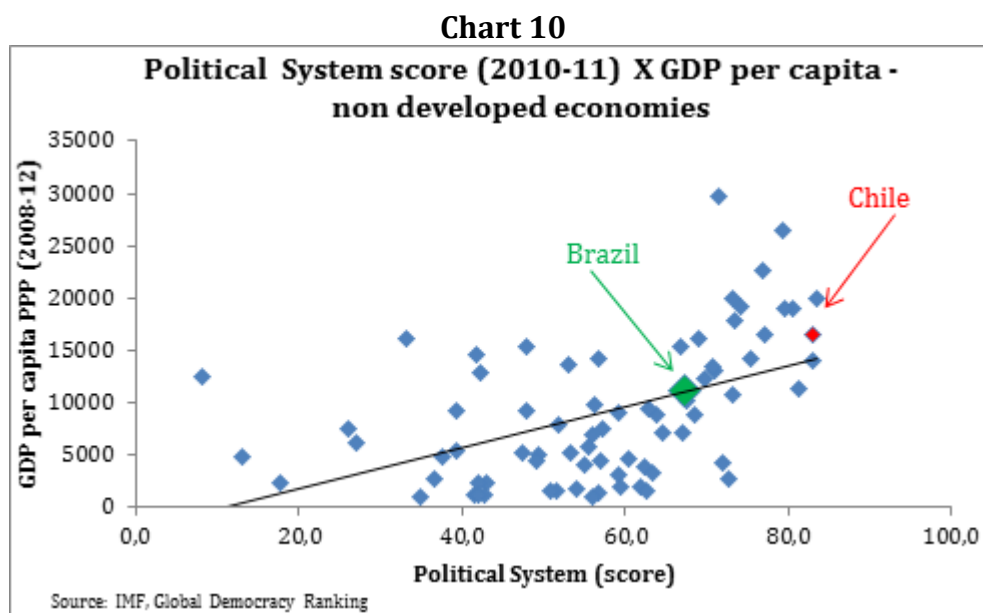
Democracy, however, should not be only measured by the proportion of the voting population. There are several other relevant variables to evaluate the quality of democratic institutions, such as social participation, civil rights and freedom of expression.

The construction of democracy rankings is significantly complex, especially because it should encompass several institutional aspects. The next step, as difficult as the first one, is to identify possible indicators to compose the index. That being said, conclusions from those indicators should be taken with a grain of salt.

There are few democracy ratings indices available and the range is not large. The Global Democracy Ranking tries to measure the quality of democracy via the degree of freedom and some other characteristics of the political system, and the performance of non-political dimensions. We focus here on the political

system, which would be the closest gauge for democratic institutions, leaving aside other indicators, because they are more linked to economic and social indicators, in our opinion. The sub-index called Political System comprises: political rights (25%), civil liberties (25%), gender gap (25%), press freedom (10%), corruption perceptions (10%), change of the head of government in the last 13 years (2.5%) and political party change of the head of government in the last 13 years (2.5%).

Brazil's Political System score against its GDP per capita can be considered today an intermediary position when compared to other non-developed countries (Chart 10). In other words, both variables look consistent to each other. Nevertheless, Brazil is far away from Chile, which stands at the "top one" position in the ranking in terms of political system. This striking gap highlights the necessity to pursue the improvement of democratic and pro-growth institutions in Brazil.



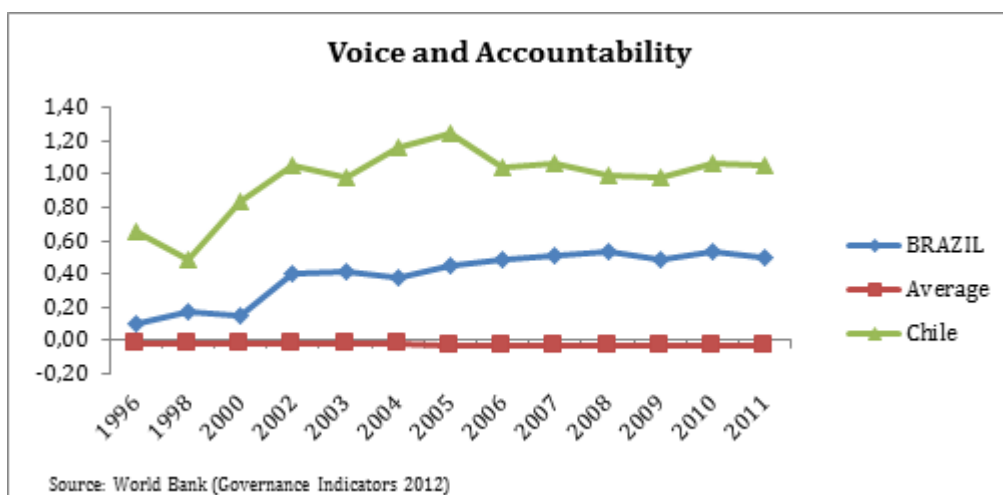
The World Bank Governance Indicators helps to shed a light on this subject. The indicator comprises six dimensions: Voice and Accountability,

Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption.⁵⁶

Brazil performance has not changed meaningfully since 1996, when the study starts. One can see no striking improvement in all dimensions, except for some upgrade in “Voice and Accountability”, which measures citizens’ ability to participate in selecting their government, as well as freedom of expression (Chart 11).

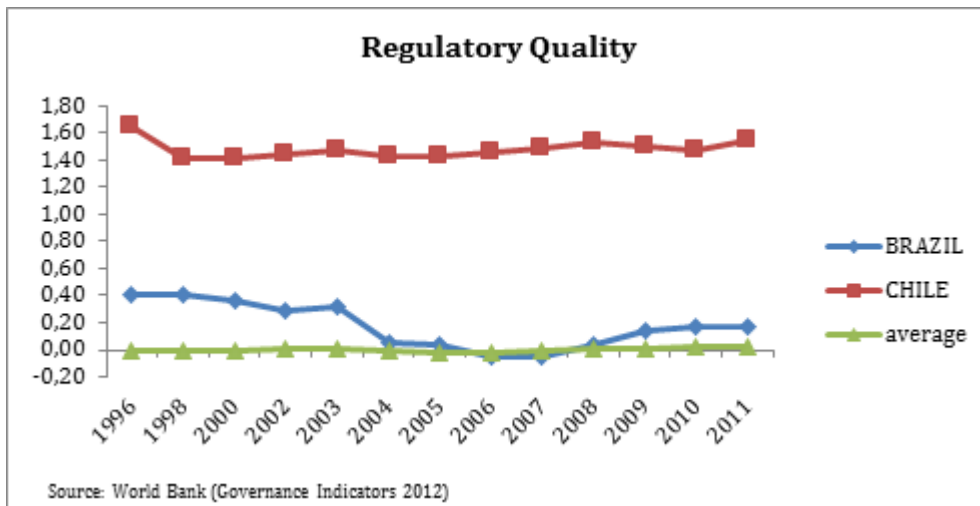
On the bleak side, “Regulatory Quality”, which measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development, has worsened since then (Chart 12).

Chart 11



⁵⁶ The six aggregate indicators are based on 30 underlying data sources’ reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide.

Chart 12



“Government Effectiveness”, which measures the quality of public services and the degree of its independence from political pressures, has remained on sidelines (Chart 13). The dimension “Rule of Law”, which measures the quality of contract enforcement and property rights, has improved lately, but failing to cross the global average (Chart 14). However, Brazil differential to Chile, which is considered the benchmark for Latin American countries, has not diminished since re-democratization.

The main conclusion is that both countries look more democratic today, in terms of social participation in the political system (“Voice and Accountability”), but Brazil remains sliding in terms of governance indicators, which are related to pro-growth institutions.

Chart 13

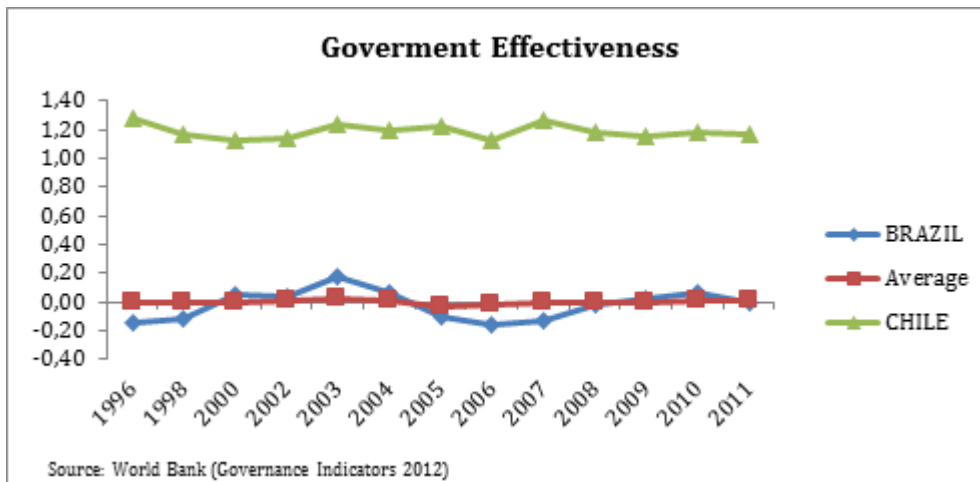
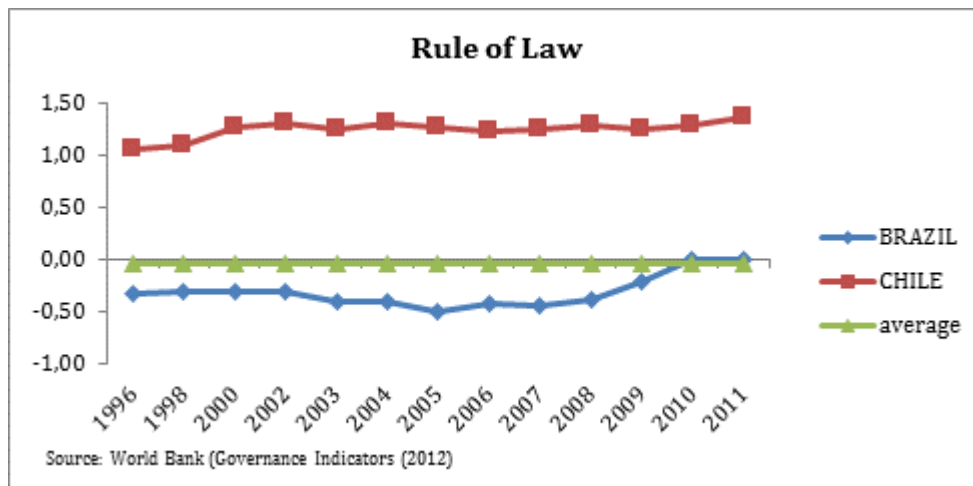


Chart 14



One possible interpretation for these figures is that Brazilian democracy is still recent and young and it is yet to be seen whether it could derive into the development and improvement of pro-growth institutions. From this perspective, closing the gap to Chile indicators could be only a matter of time, whereas the seeds for improvement would have been already sowed.

Alternatively, and possibly a more realistic view, is that democracy improved, but it still has a long way to go once a broader concept of democracy is taken into account. Morlino (2011) considers not only (almost) universal adult suffrage, civil rights and civil liberty, but also the absence of political actors able to block or control the arena of political decisions.

Aside from that, judging by Brazil experience, the presence of political actors with veto power might not be the only threat to democratic institutions. The lack of transparency of government policies contributes significantly to weaken democracy, not only due to risks of higher corruption and low government alternation, but also because widespread and opaque rent-seeking policies mean undemocratic economic decisions. Society does not effectively participate on economic decisions and does not count with full accountability of policies' costs and impacts, though they pressure the government for benefits. By their own nature, rent seeking policies lack an adequate governance and does not lead to transparent social costs, weakening public policy effectiveness.

Groups benefited by government rent seeking policies have incentives for their adoption. The rest of society, however, as in Olson's original argument, pays a very small price for each measure independently and is not mobilized into the debate. The combined sum of all distortions, however, is impressively high, as exemplifies by the high tax burden in Brazil compared to the public policies that are provided.

Reducing specific benefits face the opposition of beneficiary groups, while diffused costs leads to poor mobilization for changes. By its own nature, rent-seeking institutions are preserved from an encompassing political debate. And democratic institutions are away from relevant deliberations.

7 - Concluding remarks

A large government, with several agencies and intervention mechanisms, that mediates and regulates economic and social relations to an extent rarely observed in developed countries, seems to be a distinctive feature of Brazil's economic and political development. We propose the term rent seeking to summarize society interaction with government agencies in which public policies are supposed to provide specific privileges and benefits, frequently by unusual mechanisms when compared to other countries. It also results in a peculiar political process in which social demands are often decentralized, and in many cases addressed without going through government budget, and their social costs are diffused over society.

This paper addresses four main issues, trying to answer the following questionings.

First, why has a broad system of rent-seeking policies appeared? Extractive institutions and limited political participation seems to be the outcome of colonization period in most of Latin American countries. It resulted, for a large part of Brazil history, in a politically authoritarian regime and an economically interventionist government. The rules of the game in such a society rewards political access to government policies.

Second, why have rent seeking persisted after independence and enlarged significantly during last century? The dominant belief in Brazil held that government economic intervention was essential to overcome underdevelopment. It was its role to coordinate private investment decisions, to provide funds for several projects as well as protections and benefits for selected sectors in order to foster growth. For many years, the project was successful in promoting robust rates of growth and it was progressively enlarged. However, it was also an unstable process in the long run. It led to macroeconomic imbalances and ultimately low productivity growth. After a while, excessive protections and the dissemination of benefits resulted in high social costs, either in the form of inflation, high tax burden and economic distortions eroding efficiency.

Third, why has mass democracy been unable to change this modus operandi of the economic system? Rent seeking policies are opaque to society. Benefits from government interventions are tangible and result in political vocal groups that oppose withdrawing the benefits and protections. The diffused nature of their costs, however, leads to a fragile opposition to their maintenance. Some of those interventions are present in most developed countries. What distinguishes Brazil is the extension they have assumed.

Brazil have been experiencing a “democratization of privileges.” On the one hand, income distribution has been improving, but on the other, distortions have been increasing.

An aggravating factor is that the interests of small groups and popular groups look aligned, though artificially, in many situations, which increases the

opposition to reforms. This is the case of public pension reform. Any reform proposal faces significant resistance from all society, indistinctly, though they do not affect popular groups. Unions and other organized groups manage coopt the public opinion, and obstruct changes. The same happens to proposals to eliminate public universities.⁵⁷

How does democracy could help to promote reforms? In the democratic period, there have been demands to extend benefits for social groups long seen as underrepresented in the political arena. More recently, there has been also demands for improving the quality of public policies. Social movements have been challenging current policies and they have started to question some concession of privileges and benefits to specific sectors. It is still a young movement but a surprisingly strong one that, for the first time in many decades, claims for changes in government policies.

Re-democratization has been a game changer. The serious economic crises of the eighties, characterized by severe public deficits, hyperinflation and external crisis, led a decade of low growth and several failed stabilization policies. The severe crisis resulted in several institutional reforms beyond stabilization. Trade barriers were reduced, state owned companies were privatized and quite a few market-oriented reforms were implemented, not without fierce resistance. Ending special privileges and benefits affected several economic sectors and special groups. However, in the end, the reform agenda managed to balanced government budget and to provide the necessary controls to ensure fiscal discipline.

Furthermore, re-democratization also led to an important shift in the social policies and, for the first time in Brazil history, it became the center of government policy debate. Access to public education has been widely enlarged, and several social programs focused on the lower income families have been introduced.

Brazil experience suggests that democracy might have contributed to the construction of more solid institutions, contrasting to those undertaken during

⁵⁷ We thank to Marcos José Mendes for this contribution.

the dictatorship, albeit the pace of adjustments looks slower. Reforms in democratic regimes may be more difficult to negotiate, but they have proved to be more resilient.

Demand for public intervention, in an age of low tolerance for inflation and fiscal discipline, has led to a rising tax burden, which reached the impressive mark of 37% of GDP in 2012. Furthermore, reforms were partial and several government intervention mechanisms persisted, such as federal state-owned banks, large trade protections and subsidized loans that are over 30% of the country total credit.

As economic growth resumed in the last decade, the reformist impetus faded and the political pressure for government intervention was reinstated. Public agencies were provided additional resources and instruments to induce specific sectors development. Progressively, government has started a large development plan, ranging from naval industry to oil and gas, aside from several specific sectors. This plan was enlarged after the global crisis of 2008.

There has been a new wave of expansion of old-style mechanisms to expand protection and transfers, especially for the industry. BNDES loans have increased significantly, reaching 11% of GDP. It has also increased its minority equity allocations. Tax breaks have been provided to selected sectors along with growing complexity of the tax system. Tariffs and non-tariffs barriers have been raised to protect selected sectors.

Current excessive intervention of the government in the economy has been taking its toll. Growth has been disappointing, decoupling from peer countries in Latin America and even world growth, and inflation has become stickier.

The disappointing economic behavior and a widespread dissatisfaction with government concession of privileges have led to social unrest. Paradoxically, at the same time, political movements claim for specific benefits. Apparently, what is in dispute is not the nature of a strong government intervention, but the ones that should be the beneficiary. Several new groups have introduced new demands.

Overcoming rent-seeking mechanisms is essential for increasing investment and growth potential. Local provision of specific privileges and benefits has introduced economic distortions and reduced productivity growth. Transparency seems to be essential to allow democratic institutions to discuss and deliberate over government policies and evaluate their outcome.⁵⁸

This paper, hopefully the beginning of a larger research project, summarizes a historical interpretation of Brazilian institutional development and its impacts on several aspects our political and economic model. At this stage of our research, we have provided some evidence that support and exemplified our main argument.

There is still a lot of work to be done, such as collecting all the evidence on the rent-seeking mechanisms, their economic effect and distortions, and assessing the role played by the political process on the development and accountability of the rent-seeking mechanisms.

Systematizing all tax-transfers mechanisms is a crucial first step to a full comprehension of the rent seeking structure, in order to reassess government policies. This is particularly important taking into account the opacity of government policies. This effort will require estimation of non-monetary transfers policies such as subsidized credit loans and trade protections, including non-tariffs ones. This is a large task, though a necessary one.

These data could provide inputs for researches on the evolution of policies over time, shifts in their focus as democracy evolved, their outcomes in terms of growth and equality and lessons to be learned.

Several questions regarding the cost-benefit analysis remain unanswered whereas they should be part of democratic deliberations. Social costs and benefits of public policies should be transparent and subject to questioning. The same must be said about distortions caused by public policies that hurt productivity and economic growth. Confrontation of results and expectations is the best way out to economic reforms and evolution.

⁵⁸ For a discussion on some recent setbacks in the institutional framework, see Pessoa (2013).

This is particularly relevant for Brazil at this moment, when fiscal constraints and growing social demands need to be met, requiring reassessment of policies and priorities, according to democratic choices.

Transparency requires institutions that disclose costs and benefits, allowing social accountability. A contribution in that direction would be an independent and well-equipped agency responsible for monitoring public policies. Its objective would be to record policies targets and monitor their implementation, rather than approving projects and discussing their merits.

Each new project would have to be submitted to the agency, with clear indication of purposes, expected outcomes and costs. The agency research department could also compare government proposal policies to equivalent ones undertaken abroad. It could summarize best public policies practices in other countries and contribute to policy discussions in Brazil. The agency would be requested to provide information on policies' targets and actual results annually, and the information, available to the budget commission in the Congress, would be publically disclosed. Society must be able to evaluate whether the benefit worth the cost.

A second proposal is that all concession of benefits and privileges must be identified as public transfers and be accounted for in government budget, including all subsidized loans, transfer to "Sistema S", ZFM and FGTS. Implicit subsidies must be made explicit to society. Those receiving protections and privileges from government must have their accounts disclosed. Society must know the beneficiaries and the results of such policies. This proposal would lead to a full accountability of government concession of privileges and benefits.

Privileges, protections and transfers are always desirable by the ones who receive them. Rent seeking creates by itself incentives of self-preservation by interest groups. If individual social cost of each policy is small, while decisions are taken independently, society may not account for the total social costs, especially if they were hidden under market distortions. The myriad of government agencies and instruments available allow benefits to be conceded independently and in many cases secretly. If there is no social accountability of costs and benefits, old privileges may persist, and new ones are likely to appear.

Feeding a small termite may be a generous act at a negligible cost. If the termites are many, and society only decides the survival of one at time, in the end, it may feed many. And many termites may erode a house.

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