FEBRUARY 2015

BRAZIL INSTITUTE SPECIAL REPORT

THE EMERGING TENSIONS OF DILMA'S SECOND TERM

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Barely forty days into her second term, President Dilma Rousseff faces a series of challenges that are likely to have significant repercussions for Brazil's development over the next decade. The expensive sectoral policies adopted during Rousseff's first term had proven increasingly untenable by late 2014, a fact the Rousseff administration acknowledged soon after winning the October elections, when Finance Minister Guido Mantega was shown the door. Meanwhile, the election results triggered important political realignments within the governing coalition, in Congress, and in Rousseff's second-term cabinet. Drawing on the reflections of participants in seminars held by the Latin American Program and the Brazil Institute at the Woodrow Wilson Center in February 2015[1], this essay points to the challenges in the political and economic environment that have emerged since the October elections, describes the tensions inherent in Dilma's new policy set, and closes by outlining four central questions about Brazil's future that emerge from this fluid policy environment.

The wake-up call of the 2014 election

On the political front, the 2014 election was hotly contested. Held against the backdrop of the tumultuous July 2013 protest marches, the contest was recognized from the outset as a "change election." Fully 70% of Brazilians polled ahead of the vote claimed to want change, a fact recognized by Rousseff's campaign, whose slogan embodied her promise: *"Governo Novo, Ideias Novas,"* or new government, new ideas. Throughout a campaign marked by tumult – the tragic death of candidate Eduardo Campos, the rapid surge and equally speedy deconstruction of candidate Marina Silva, and the rise of the social

1 This essay draws heavily on presentations offered by Paulo Sotero, Monica de Bolle, Ernesto Henrique Fraga Araújo, Otaviano Canuto, Mauricio Moura, Joel Velasco and myself at two seminars held at the Wilson Center on February 10 and 11. The opinions offered here are my own, however, and while they draw on the astute observations of all of those mentioned, the speakers do not necessarily share my perspective or even my interpretation of their comments.

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democrat Aécio Neves in the final month of the electoral cycle – the outcome was never entirely certain, even as the incumbent was heavily favored.

Rousseff's marketing team skillfully kept the campaign debate centered around the social gains achieved under the Workers' Party (PT), while also playing up the potential for a return to the dark days of the "neoliberal" 1990s. This strategy is best illustrated by a campaign ad used against then-frontrunner Marina Silva, showing food disappearing from a family table as the austere policies of a banker-friendly administration were put into place. But the opposition also made the argument, more effectively than in the past, that voters deserved better management, and less corruption, especially as scandalous new revelations emerged about Petrobras, the crown jewel of Brazil's developmental state.

Voters were clearly unhappy about the PT's continuation in power, but also wary of the opposition. Dilma, as she is widely known in Brazil, was given the benefit of the doubt in part because of the PT's ability to convince the emergent lower middle class – 55% of the electorate in the middle echelon of the income distribution known in Brazil as the "*Classe C*" that they were truly better off than they had been twelve years ago. Meanwhile, Aécio Neves, the candidate of the social democratic PSDB, polled worse than he needed to in the southeastern region his party dominates, hurt by mixed reviews of his record as governor of Minas Gerais, as well as a water shortage in São Paulo, awkwardly mismanaged by the social democrats who have governed São Paulo since 1995.

But it was a close race. Dilma Rousseff squeaked by on only three percent of valid votes in the second round, by far the lowest margin of victory since the Workers' Party (PT) was first elected to national office in 2002. The PT won some important victories, including by taking Minas Gerais – Aécio Neves' home state – from the PSDB after three terms. But the PT was overwhelmingly rejected in most of the south and southeastern states where it was born; even Dilma's Rio Grande do Sul went for Aecio by 54%. Partly as a result, the PT's congressional delegation also shrank by 18 seats in the Chamber of Deputies, falling to 70 and increasing the administration's reliance on its coalition partners.

The shifting terrain of Dilma's second term

The electoral season obscured a number of challenges that have now emerged in full relief. Most malodorous, and touching on all of the others, is the scandal at Petrobras, which poses enormous economic and political risks. The company's value has plummeted from its peak in 2008, when its market capitalization was US$310 billion, to around US$45 billion today. Much of this decline has occurred in the past six months, as the federal police carried out an investigation of money laundering and corruption known as Operation Car Wash (*Lava Jato*). So far, the investigation has netted several executives from Brazil's leading construction firms, but the political phase of the investigation has only just begun. By Brazilian law, national politicians have special standing for their cases in the Supreme Federal Tribunal (STF); importantly, the STF phase of the investigation is being conducted under strict secrecy protections which limit public understanding of the pace and tenor of the proceedings.

Despite these secrecy protections, the allegations that have emerged in press accounts of the scandal are astounding, even for a public long inured to corruption. One plea-bargaining witness has claimed that as much as US$200 million was paid to the PT, and estimates suggest that more than US$1bn was lost in bribes paid to political figures. The scale of the actual theft is perhaps best demonstrated by the fact that a single Petrobras executive, as part of his legal defense, *volunteered* to return US$100 million to the public coffers. After resisting for weeks, Rousseff finally accepted the resignations of the top management of Petrobras in early February. But her nominee for Petrobras CEO, Aldemir Bendine, did little to assuage investors or the public, given his reputation as an administration loyalist, as well as the allegations of improprieties that accompany him from his time as president of the Banco do Brasil. Meanwhile, the company has failed to meet its accountants' demand for a balance sheet that faithfully reports losses from corruption, and its credit rating has been docked accordingly.

The economic repercussions are significant. Petrobras lies at the center of a complex network of companies, and its collapse thus poses systemic risk, as Joel Velasco noted in his presentation at the Wilson Center's Brazil Institute. The government's ability to carry out investments via Petrobras has been significantly restricted, as the company's ability to borrow is restricted, and new equity financing is out of the question. The companies in Petrobras' supply chains are obviously hurt, but so too is the corporate finance market, which has been shuttered. As the scandal has rippled outward, all of Brazil's major construction companies have seen their own borrowing constrained, and as a result, major building projects in other sectors of the economy are on hold. Economist Samuel Pessoa estimated in the *New York Times* that Petrobras and its subsidiaries were responsible for about 10% of Brazilian GDP; their troubles are likely to reduce already anemic growth by a further 0.75% of GDP.

On the political front, the Petrobras crisis has had a direct effect on Dilma, whose public image has long been that of a serious, competent and effective public manager above personal reproach. A February 9 poll by Datafolha showed that this image has suffered considerably: 25% of those polled thought that she knew of corruption within Petrobras, but was powerless to do anything about it, while another 52% thought that she knew about corruption and *chose* not to do anything about it. Partly as a result of this dismal deterioration in her image, Dilma's personal popularity has fallen sharply since December: from 42% approval to 23%, while her disapproval has moved in the opposite direction, from 24% to 44%.

The immediate repercussions of Dilma's dwindling popularity have been quick in coming. The first is in the Chamber of Deputies, the lower house of Congress, where dissatisfaction with the PT's unwillingness to share power and pork led to revolt when the president of the Chamber was elected in January. Rousseff invested heavily in her own candidate, Arlindo Chinaglia, including by publicly announcing that she was sending her chief of staff Aloisio Mercadante to negotiate with recalcitrant allies.

Yet despite these efforts, the insurgent candidate, Eduardo Cunha of the centrist PMDB, was chosen in a landslide and the PT was shut out of the Chamber leadership team.

The government coalition failed to hold together during the vote, demonstrating the enormous danger Rousseff faces from both the declared opposition in the DEM and PSDB, as well as from dissatisfied members of her erstwhile legislative coalition. While the traditional center-right opposition and the more pork-driven clientelist center do not share many objectives, they have shown an ability to team up to create considerable mischief. Further fuel is added to the mix by the criticisms Rousseff has received from members of her own party, including Lula's former chief of staff and former party president, José Dirceu, as well as former senator Marta Suplicy, who is rumored to be on the verge of departing the PT. The lack of support among her own base will force Rousseff to rely heavily on the more faithful elements within the PMDB, a party not known for its constancy or selflessness, as well as make efforts to compensate legislators whenever possible for their support. This political balancing act in part explains the schizophrenic cabinet announced in January, which includes representatives of almost every political force in contemporary Brazilian politics, despite the many obvious contradictions across the 39 ministries.

The rapidly deteriorating political fortunes of the Rousseff administration have been accompanied by particularly damaging acts of God, as well as a declining economic outlook. The drought in the southeast of the country has hurt the leading opposition party, the PSDB, which has been pilloried for its ineffectiveness in managing the foreseeable crisis in São Paulo state, after water levels had fallen constantly for the better part of five years. But the drought's effects are also increasingly dangerous to the president, in part because of the feed-through effects on national electricity production, nearly 70% of which is produced by hydroelectric means. The resulting energy shortfalls may chop as much as 1.0% off of GDP growth this year, according to estimates Otaviano Canuto presented at the Brazil Institute event. Meanwhile, public beliefs in the economy have deteriorated sharply, and a telephone poll conducted by Mauricio Moura of more than 75,000 citizens nationwide shows that Brazilians' outlook for 2015 is grim: 75% believe that unemployment will worsen, 70% think taxes will increase, 85% are fearful that inflation will rise, and 95% think inflation will rise more quickly than wages, a particularly perilous finding in a country long accustomed to price indexation and the inertial inflationary pressures it generates.

In addition to potential energy shortfalls and slow growth, economic policymakers are caught between two constraints: public spending and inflation. After running nominal fiscal deficits of 2.5% to 3% of GDP earlier in the decade, the nominal deficit rose sharply to 6.7% of GDP in 2014. The federal government last year ran a primary deficit for the first time in eighteen years. Meanwhile, even though the government had kept a tight lid on public prices, such as gas and electricity, inflation ended the year at 6.41%, only narrowly falling under the Central Bank's target ceiling of 6.5%. The combination of spending and recrudescent inflation threatened the survival of the successful *'tripé,'* or three-pronged economic policy set, that has guided macroeconomic policies since the traumatic 1999 devaluation of the currency: a floating exchange rate, inflation targeting, and fiscal responsibility.

Recognizing the threat, Rousseff dumped Finance Minister Guido Mantega, and nominated a "Chicago boy," Joaquim Levy, as finance minister in November. As several panelists noted, this means that for the first time under Rousseff, fiscal and monetary policy will be in sync. Levy has been doggedly making the public case that the only way to preserve the social gains of the recent past is by returning the country to a credible policy mix. But the challenge he faces is significant, as Monica de Bolle noted at the Brazil Institute seminar: Levy has committed to turning the total public sector budget from a primary deficit of 0.6% of GDP in 2014 to a surplus of 1.2% of GDP in 2015, through a mixture of tax increases, an increase in regulated prices, and budget cuts. All of this will happen in a scenario of null growth, with many private sector economists forecasting a contraction of as much as 1% this year. The political strategy appears to be to get the pain over with quickly, and to concentrate it in 2015, with the hopes of restoring credibility and regaining positive momentum later in Rousseff's second term. Together with this economic strategy, Rousseff is rumored to be planning a media campaign to restore her political credibility, including by resurrecting anti-corruption initiatives, such as a reform of the electoral system, which she originally proposed in the wake of the massive 2013 protests, and then fatefully abandoned.

The revolt in the lower house and Dilma's low standing in Congress may throw sand in the gears of this political-economic strategy, however. Mauricio Moura expressed this most clearly in his comments at the Brazil Institute event, when he noted that the sensation in Brasília is that the PMDB is now governing Brazil, rather than Dilma or the PT. Chamber president Eduardo Cunha demonstrated his control of the political agenda most forcefully soon after his election, when he allowed the establishment of a congressional committee of inquiry (*comissão parlamentar de inquérito, CPI)* to investigate Petrobras. But Cunha has been active on a variety of other fronts. He also put forth a proposal that would implement the so-called "*orçamento impositivo,"* reducing the executive branch's discretion in budget matters by forcing it to enact whatever budget the Congress approves. Further, Cunha has pushed a PMDB proposal for political reform that contradicts many elements of Rousseff's 2013 plans, including her goal of moving toward public campaign finance. Meanwhile, some of the components of the fiscal adjustment that require congressional approval have already been subjected to heavy amendment (including by members of the PT) which will likely dilute, and could even stymie the government's proposals to restrict pensions and labor benefits.

Difficult questions moving forward

What can the government do to reverse this seemingly self-reinforcing spiral of crises? Several of the panelists at the Brazil Institute event suggested that there was room for the government to carry out a "positive agenda" that did not rely quite so heavily on Congress. Foreign policy might offer one potential venue for improvement, and Ernesto Araújo noted that there is room for trade facilitation initiatives that might yield real progress without requiring the high-level energy and political commitment of full-blown multilateral negotiations. Otaviano Canuto noted that there is considerable room for executive action, including through the review of public investment priorities that the government has already announced, as well as reevaluation of the BNDES' activities. Similarly, Monica de Bolle noted that the minister of development has been pushing forward a national plan for exports, as well as a de-bureaucratization agenda.

Two silver linings to the crisis were also noted. First, several of the panelists drew attention to the fact that the Rousseff administration had committed itself to a change of fiscal course even before the president was sworn in for her second term, demonstrating the very important corrective effect that the electoral process has had on economic policymaking, as well as the lasting salience of price stability to the Brazilian electorate.

Second, Paulo Sotero noted that the Petrobras scandal has had the positive effect of demonstrating the strength and autonomy of Brazil's accountability institutions – including the Federal Police, prosecutors and the courts. These institutions have shown that they have learned considerably from their failures in prominent past corruption cases, and are working to avoid any overstepping that might vitiate the prosecution of executives and politicians.

Going forward, four questions hang over the political economy of Rousseff's second term which will likely determine Brazil's course as it heads into its fourth decade of continuous democracy:

1. First, what will happen to Brazil's unique variant of state-led capitalism? Will the crisis at Petrobras lead to a change in the median voter's perspective on the state's role in the economy? Will fiscal constraints limit the ability of state-controlled enterprise and state banks to guide the economy? Might this lead to changes in tax policy, state regulation of the economy, and patterns of state control of business?

2. What role will the PT play in the political system after 16 years in power? Can the party preserve its unique position as the leading mass party in Brazilian politics, even as a Workers' Party president implements policies that are odds with the beliefs of the party's traditional supporters in labor and social movements? In other words, can the party straddle the apparent disconnect between its historic image and the demands of governance in challenging times?

3. Will accountability succeed? The *mensalão* trial of 2013-14 exposed the deeply corrupt nature of campaign finance and the enormous difficulties of imposing accountability within the political system, recurrent problems in the thirty years since the transition to democracy. The Petrobras scandal, which is far from over, has added an additional dimension to the corruption picture, revealing the privileged status of some companies under Brazilian state capitalism, as well as the ubiquity of "pay to play" rules that govern state-business relations. Can the alleged wrongdoers be effectively punished, without the prosecutorial overreach or judicial timidity of the recent past? Is the political system capable of reforming itself in ways that effectively address recurrent and widespread campaign finance abuses? And will legal accountability lead to lasting changes in the way state and business interact?

4. Finally, how will the newly emergent middle class, the so-called *Classe C*, react to these challenging conditions? With the economy under stress, and representative institutions in turmoil, will the new middle class demand change? Can it use traditional representative institutions to make its demands heard, or will it instead bypass the political system?

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