ECLAC
Economic Commission for Latin America

"Regional Project on Proposals for Policy Reforms to Increase the Effectiveness of the State in Latin America and the Caribbean (HOL/90/S45)"

Regional Seminar on Public Policy Reforms
Santiago, Chile, 3 - 5 August 1992

THE POLITICAL ECONOMY OF TRADE AND INDUSTRIAL POLICY REFORM IN BRAZIL IN THE 1990s

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This document was prepared by Messrs. Gustavo H.B. Franco and Winston Fritsch for the Regional Project "Proposals for Policy Reforms to Increase the Effectiveness of the State in Latin America and the Caribbean (HOL/90/S45)", carried out by ECLAC with the financing of the Netherlands. The views expressed in this work are the sole responsibility of the authors and do not necessarily coincide with those of the Organization.
The political economy of trade and industrial policy reform in Brazil in the 1990s

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† A report prepared for CEPAL
1. Introduction

This paper discusses the political economy of the reform of trade and industrial policy undertaken at the onset of the 1990s. It is argued that the political drive towards reform responded to a deep crisis in old forms of public intervention - unveiled by the fiscal crisis, stagnation and hyperinflation of the 1980s - and that the resulting search for a new pattern of intervention appears to be leading, despite hesitations, ambiguities and resistences, to a far less dirigiste model of trade and industrial promotion policies.

We start by reconstructing, in section 2, the trends through which major tensions between state and society degenerated into hyperinflation and a broad regulatory crisis during the 1980s. In section 3, the main features of the traditional regulatory framework of trade and industrial policies are highlighted. Section 4 describes the ongoing reforms and discusses the political economy issues associated, more specifically to the trade liberalization programme, and more broadly to the redefinition of interfaces between the state and industry.

2) Hyperinflation and the collapse of state intervention in the 1980s

The remarkable deterioration in macroeconomic performance in the 1980s was certainly the most important single element leading the political agenda towards change. The growth machine of the 1970s, able to deliver average annual growth rates over 10%, was derailed to a point of barely maintaining income per capita constant in the 1980s, and, besides, experienced the rare disease of hyperinflation. No observer of the Brazilian economy at the end of the 1970s could possibly forecast these outcomes for the 1980s. In fact, even later, in 1984, when the first civilian government in two decades was about to take office, the economy was experiencing the early phase of a vigorous recovery, the budget deficit was under reasonable control (between a zero and 1.5% of GDP) and inflation, despite a rising trend, was still moderate, no one could possibly predict that, five years later, at the end of the Sarney's presidency, the fiscal situation would become unsustainable - with the budget deficit, in the operational concept, approaching 10% of GDP) and Brazil would
experience the seventh worst hyperinflation in history. What extraordinary chain of events could possibly produce this outcome?

The answer to this question should start by observing that the influence of external factors, particularly the debt crisis, to the generation of hyperinflation was far from being decisive. Although the fiscal counterpart of debt transfers were significant to the worsening of fiscal account in the early part of the 1980s, the opposite was true during the "New Republic", i.e. after 1985: fiscal and external burdens of debt transfers were actually reduced. This is clearly seen in Table 1 below.

Table 1: Government current account, operational concept, (% of GDP)

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<tr>
<td>. other</td>
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<td>6.0</td>
<td>6.5</td>
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</tr>
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<td>4.7</td>
<td>2.2</td>
<td>-0.4</td>
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</tr>
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</table>

Source: Ministério da Economia, National Accounts.

Note that the deterioration in public savings during 1970-1985, when they were reduced from 6.1% of GDP to minus 0.4%, is comparable to the one observed from 1985 to 1989, when they reached minus 5.8% of GDP, and the overall public deficit reached 8.9%. The early round of fiscal deterioration may rightly be associated with the domestic fiscal counterpart of the transfer problem created by external shocks and the debt crisis. But the truly puzzling aspect of the Brazilian crisis is the further deterioration occurring after 1985, which was a product of domestic factors, comprising increased public spending and reduced deficit financing capability, leading fiscal accounts to a chaotic situation in the end of 1989.

Interestingly, existing accounts of all hyperinflation cases agree that a common feature is that all result from to a perverse combination of outstanding economic policy challenges, posed by external and domestic problems, with the governments' loss of decision capacity on economic issues. No wonder major economic crisis include economic and political components,

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1 Considering the average inflation rate for the last six months of all hyperinflations known. Cf. Franco (1990b).
2 Capie (1986).
with weights that are quite variable from case to case. The interesting question to ask is how exactly political factors operate to produce a paralisis in economic policy making. A disturbing coincidence in the Brazilian crisis, is the fact that macroeconomic policy degeneration coincides with the return to democracy after two decades of authoritarian rule. In fact, this is hardly a coincidence. Democracy, with its concomitant of labor demands and political competition for public resources, is certainly a factor in Brazilian inflation, just like it was, for instance, in Weimar Germany. In the latter, the extraordinary increase in unions' affiliation and activity immediately after the 1918 revolution provoked a very strong drive towards recovering the level of real wages prevailing before the war, which was about twice the prevailing level. This was certainly an inflationary influence, and one that turned even more difficult the adjustment effort necessary to meet the reparation obligation. In the Brazilian case it is also true that union activity was considerably increased in the second half of the 1980s, and also that this increased "resistence" on the part of workers to wage cuts required by external adjustment is clearly felt.

Yet, two peculiarities of the Brazilian case should be noted. One is that the order of magnitude of this "distributive conflict" effect on inflation, if we judge by the size of the external obligation, was much less important in Brazil than the one in Weimar Germany. The other is that the budget served as a buffer to distributive conflicts in a typically corporativist fashion quite different to what was seen in Germany. In fact, the crucial mechanisms by which democracy facilitated inflation in Brazil ran through the fiscal accounts given the undeveloped state of fiscal and monetary institutions, which were not designed to enhance discipline especially in a regime of open political competition for public money and regulation, an institutional weakness magnified during Sarney's term by virtue of his fragile political

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3 For an extensive comparative discussion of European and Latin American hyperinflation cases see Franco (1991).
4 This is visible in the zeal in maintaining and perfecting indexation, which is the crucial mechanism to assure stability of distributive shares under high inflation. For an extended discussion see Amadeo & Camargo (1982).
5 While debt servicing claimed an average one third of exports, and never more than 3% of GDP in Brazil, reparations paid by Germany claimed nearly 80% of exports and approximately a quarter of GDP. See Franco (1991, p. 52).
basis and authority. A very strong pro-inflation bias in fiscal institutions resulted from the combination of:

(i) the budgetary process lacking reasonable limits to the competition for public resources, or the means through which the quantity of demands could be made consistent to available resources. For this reason, budgets drafted were, and still are, invariably unrealistic, as the tendency is to accommodate all pleas.

(ii) The budget is only an "authorization", not a mandatory document; which gives the Executive great discretion in fiscal affairs and creates a "political market" for the execution of the budget or, more specifically, for the rationing of public spending.

(iii) The absolute lack of transparency in the actual management of fiscal accounts, greatly enhance the Executive's discretionary powers in this area. Inflation, in itself, is a crucial factor to obscure the management of public finances, as difficulties in indexing revenues and spending, as well as rules inappropriate to an inflationary environment regarding "excess revenues", "supplements" and budgetary guidelines, turned the budget almost into an "endogenous" operation of the political market in Congress.

In light of the above and given the circumstances surrounding Mr. Sarney's inauguration as president, the lack of political support, both in Congress and from society at large, any commitment on the part of the Executive for fiscal discipline was destroyed, and any resistance to corporatist demands was removed. The Sarney administration displayed a marked clientelistic behavior which eventually produced an uncontrolled multiplication of fiscal and regulatory favours much beyond any concept of global consistency of pleas. Given that no institutional mechanisms existed to regulate the competition for fiscal and regulatory favours, "private" arrangements proliferated, through which a remarkable decentralization of fiscal and regulatory powers took place. Spending units, as well as regulatory agencies, progressively enjoyed more autonomy and, simultaneously, a closer relation with "interested parts" in the private sector. As part of this process, a clear trend was seen towards the fiscal strengthening of local governments at

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6 This is called *contingenciamento*. It is important to note that the potential for corruption and political favouring involved in practices free of any accountability is huge. The recent wave of corruption cases and scandals in public administration is certainly related to this state of things.
the expense of the federal government. Heavy transfers of revenues to local government, with no corresponding transfer of commitments to spend, were eventually included in the new 1988 Constitution, and, simultaneously, one could see a major increase in current expenditures of states and large cities. A number of experts would claim these trends to have made the federal government fiscally bankrupt. Attempts were conducted, on the part of the Executive, to transfer spending obligation to local authorities - what was called *operação desmonte* - but with no success.

At the end of the Sarney's administration, this process of "privatization of the state" by well entrenched corporatist groups advanced to a point that Brazil faced both an unsustainable fiscal situation, with which one could associate the concrete threat of open hyperinflation, and, as seen in detail in the next section, also a major regulatory crisis stemming from the uncontrolled multiplication of regulation designed to protect established interests. Indeed, the attempts to revert these two interlocked halves of the deterioration of state intervention in Brazil constituted the major issue facing president Collor. His more specific actions regarding trade and industrial policy, and the resistences facing his "modernizing" measures will be extensively reviewed in the next sections. It is useful, however, to conclude this section with a cautious note on president Collor's initiatives on the fiscal area, depending on the success of which, on going stabilization policies may be successful and some difficulties created by continuing high inflation to trade and industrial policy reforms may be by-passed. As a matter of fact, unfortunately, the Executive's initiative on the fiscal area have been few and confuse. At least up the the constitutional revision in 1993, Brazil will most likely live in the current situation of "repressed hyperinflation". What actually distinguish the latter from an open hyperinflation is not the state of the budget but a phenomenon the finds the technical denomination of "fiscal repression"\(^7\). This meant a situation of a more or less balanced budget "on a cash basis", despite the existence of large potential deficit at an "accrual basis", thanks to the fact that a quite substantial portion of budgeted expenditures are rationed, left undone, or delayed. This paradoxical combination of actual fiscal balance, thanks to "fiscal repression", and the generalized perception that there is a large underlying fiscal disequilibrium and potential hyperinflation

\(^7\) See Tanzi (1989).
is one of the distinguishing features of the recent Brazilian inflation, and is against this background that the proposed reforms in the trade and industrial policy framework have to be seen.

3. The evolution of the regulatory framework

The evolution of the Brazilian trade and industrial policy framework obeys the major trends outlined in the last section. The corporatist appropriation of regulatory functions is perhaps the key political economy issue to be highlighted. The following two sub sections address trade policy and industrial policy separately.

3.1) The trade regime

Since the reforms of the mid-sixties the Brazilian trade regime displayed three basic features typical of trade regimes of a rapidly industrializing country: (i) a very restrictive import regime based on discretionary import licensing, which was used as a partial but crucial element of industrial policies; (ii) very active export incentive schemes including subsidies and import duty exemptions; (iii) last, but not least, a fairly well managed crawling peg which avoided, except for very brief episodes, the damaging exchange rate appreciations.

An important change in the nature and operation of instruments of Brazilian import policy is observed during the 1970s and early 1980s namely the marked diversification and decentralization of administrative obstacles to imports. Instruments as quotas, prior permits, tariff surcharges, financing requirements, in addition to many sector specific restrictions, were superimposed on these administered by CACEX8 and on the tariff structure and managed often on an uncoordinated fashion by different government agencies following sometimes conflicting criteria. Foreign exchange rationing, evidently, pervaded the actions of all, but industrial policy conceptions, and surely sectoral rent seeking considerations, governing the use of this wide array of discretionary instruments were also present.

8 The agency responsible for the issuance of import authorizations.
Two important consequences of this process of decentralization of trade regulation should be singled out. The first is related to the tariff structure. As a consequence of the all pervasive operation of administrative import controls, the relatively high Brazilian tariff become a secondary line of defense within the Brazilian protectionist system. By generating an import structure basically formed by non-competitive goods, this system created an important distributive distortion: importing firms invariably applied for tariff exemptions, or reductions, under "special import regimes”. 42 such import regimes were in existence in 1989, when nearly 70% of all Brazilian imports entered the country with tariff reductions or exemptions. In 1989, when the average "legal" tariff was 49.4%, the average "true" tariff, i.e. revenues of import taxes as percentage of the value of imports, stood at 8.3%. Through this mechanism, import rationing is largely made by measures that do not seem to raise very significantly the cost of imports that happen to cross the barrage of administrative controls.

Another crucial by product of the decentralization of trade regulation is its subordination to sectoral concerns. This is very clearly seen in the operation of the so-called "law of similars", according to which any imported product should be subject to an exam to assess the extent to which one could find "similar" national products. If this can be proven in "similarity exams" carried out by a CACEX expert chosen in conjunction with the business associations involved, then the import is forbidden. The threat to use to procedure was often used to enforce schemes of import ceiling with domestic producers and, when large scale projects were under consideration, CACEX managed to negotiate with importers and business associations the so called "participation agreements", through which a "local content" level was agreed for the whole project.

Interestingly, the "law of similars" procedure implied a clear "delegation" to the private sectors of the discretionary power to restrict imports, which was considerably advanced over the years. This tendency reinforced the autonomy of sectoral agencies to set their own guidelines and

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9 Sometimes, when a similar product is not manufactured, the authorities may "invite" national firms to present a prototype of the product under consideration. If the prototype is deemed acceptable the import is forbidden. In the specific case of the informatics law, to be commented in detail below, often not even a prototype was necessary besides the intention of national firms to manufacture the potential import.
policies, and to experience a certain degree of symbiosis between regulators and their subjects. Most industries managed to influence regulation they were subject to, by influencing the access to public procurement and credit, local content requirements (indices de nacionalização\(^{10}\)), and the prior permits to import.

The most impressive by-product of this process of decentralization is the "market reserve" policy enforced in the informatics industry. The control over imports of loosely defined "informatics goods" by the Special Secretariat of Informatics (SEI) has given such a leverage to the latter that, in addition to usual practices such as, for example, requirements for a very high local content, it has introduced specific procedures to the regulation of the computer industry such as restrictions on technology transfer contracts and, most importantly, to foreign ownership in some segments of the industry. This has represented a major departure from Brazil's traditionally liberal stance towards foreign investment, and has raised a huge amount of controversy. Interestingly, the powers granted to SEI were regulated by a law - the famous Lei da Informática passed in Congress in 1984, - that, in fact, had only general provisions. The thrust of the "market reserve" was given by the guidelines imposed to SEI by a Council - CONIN (Conselho Nacional de Informática e Automação) - formed by industry representatives and bureaucrats. The corporatist pattern was no different from what could be seen in other sectors.

3.2) The industrial promotion schemes

During the formative years of Brazilian industry, the classical interaction between inward looking policies and small market size relative to best-practice optimum scales led to high levels of concentration in almost all the new sectors from the outset\(^{11}\). The creation of a relatively stable oligopolistic structures was reinforced by the combination of (i) a high level of multinational penetration in response to restrictive import barriers coupled with relatively little interference in the foreign investment process; (ii) the creation of "national champions" by the special protection-cum-domestic subsidies treatment given to domestic firms in some import substitution

\(^{10}\) Defined as the ratio between local cost components and total cost of a given product.

\(^{11}\) For a discussion of the dynamics of such a process, see Merhav (1971).
projects and stimulated by the concern with the creation of industrial "enclaves" that could be formed by vertically integrated MNCs affiliates; (iii) state ownership in sectors requiring large initial investment outlays, which created in fact monopolistic public enterprises\textsuperscript{12}.

The basic features of the framework of incentives and regulations were refined and consolidated during the very active policies followed from the late 1960s and, especially, in the 1970s, as a response to the perceived structural balance of payments problems created by the oil price rise, giving an impressive boost to investment in heavy intermediate and capital goods industries, and in the 1980s, as a response to challenge of adjustment to the debt crisis. Among these features it is apt to emphasize: (i) the pervasiveness of fiscal incentives granted in credits by the state development bank BNDES and directly by some government bodies; (ii) regulation enhancing non-contestability of markets, particularly the investment licensing limitations imposed by sectoral or regional bodies or by the mechanism of "sectoral agreements" coordinated by the price control authority (CIP-\textit{Conselho Interministerial de Preços})\textsuperscript{13}; and (iii) most importantly, the imposition of \textit{indices de nacionalização} by BNDES as a requirement for investment financing at large and, particularly, to the access to its FINAME line of subsidized credits for acquisition of capital goods, and by other government bodies and state enterprises especially in the context of public procurement contracts. A 1988 decree would actually turn local content requirements enforceable in the production of all goods receiving any form of subsidy, purchased by any public body or receiving any sort of financing from official institutions\textsuperscript{14}.

Regulation is generally light in traditional industries, except for price controls in sensitive products and on specific segments. Wheat milling, for example, was subject to capacity regulation enforced through the rationing of imported wheat. Intermediaries were largely subject to price controls, given their weight in wholesale price indexes, there resulting high entry barriers and constant complaints as regard anti-competitive practices, as in the archetypal case of the cement industry. "Modern" segments of manufacturing

\textsuperscript{12} For a more detailed discussion see Fristch & Franco (1991).
\textsuperscript{13} On price control as a device to enforce entry barriers see Fritsch & Franco (1991).
\textsuperscript{14} Art. 16, Decree 2433, May 19, 1988.
were, by and large, subject to high degrees of regulation, i.e. fairly stringent local content requirements, investment authorizations, and a variety of sectoral entry restrictions. The importance of these mechanisms, as regards the conduct of trade policy and more particularly as regards the process of liberalization and deregulation to be implemented in the 1990s, is crucial, and two important and interrelated issues can be raised in this connection. The first is the fact that the rather extensive industrial regulation enhances the non-contestability of markets, establishes a clear pro-incumbent bias, reinforces natural entry barriers, prevents exit by distressed firms and crystallizes market positions. This very large degree of trade and industrial regulation and government interference with the competitive process maintained for so long in Brazil seems to have had a fundamental negative impact on entrepreneurial behaviour and industry efficiency, as it rewarded rent seeking and inhibited managerial awareness of the strategic importance of the acquisition of technological capability. It is for no other reason that anti-trust or competition policies could never be actually implemented in Brazil: the government is the first and foremost intervenent in the market process. This is particularly dramatic at a time when there are very rapid changes in the post-war technological paradigm upon which Brazilian industrial capability was built, and when continued manufactured export dynamism rests fundamentally on technological upgrading. For this reason the reforms to be undertaken in trade and industrial policies in the 1990s seem to place industrial deregulation and competition policy in a privileged place.

A second important issue is that the weight of regulation has been such that several coordination instances developed over the years. Typically, as import substitution in one sector was about to start an agency designed to coordinate all industrial policy instruments affecting the new industry was established. Many such agencies were created over the years, and it is interesting to note that, once the industries targeted were established, such agencies, instead of being demobilized, experienced a change in its functions, becoming, by and large, a regulatory body committed, to a varying degree, to the established interest in the industry. Many such agencies, and similar

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15 As forcefully argued in The World Bank (1990) passim. Non-contestability is used here in the usual sense, namely, as an attribute of markets in which incumbents are not threatened by entry of potential competitors.

16 For a more extensive discussion see Fritsch & Franco (1991)
functions exercised by other government bodies, were encompassed in the CDI (*Conselho de Desenvolvimento Industrial*), which was created in 1969 and extinct in 1988. CDI played an important role in coordinating the actions of other key bodies such as the BNDES, some large industrial public enterprises and the Tariffs Commission (*CPA-Conselho de Política Aduaneira*), which decided about the concession of trade-related tax exemptions on imported inputs. CDI gave great impetus to the organization of "sectoral chambers", uniting producers of a given "productive chain" around joint investment plans, pricing policies and local content targets. After 1988, CDI functions were dispersed in other agencies, but the culture of "sectoral chambers" advanced somewhat with the 1988 decrees known as "The New Industrial Policy", that attempted to create a system of joint planning for vertically integrated sectors (industrial complexes) managed such chambers with powers to establish investment plans (*PSI-Programas Setoriais Integrados*) that would be liable to a number of fiscal and regulatory incentives. These proposed reforms can be thought as an attempt to advance the symbiosis between bureaucracy and regulated firms which would actually magnify distortions deriving from spurious regulation discussed above. Interestingly, the coordination difficulties existing within sectoral chambers precluded the constitution of any but one sectoral PSI (in the textile industry) up to 1990.

4. The reforms

The end of the eighties witnessed a growing concern with the existing trade and industrial policy regime. The distortions created by state intervention were no longer a matter of static allocative inefficiencies, as usually argued by neo-classic critics of interventionist policies, and played down by local policy-makers and academia as unimportant to growth and development. The process of privatization of the state had advanced to a point that a strong consensus emerged on that the multiplication of fiscal and regulatory favours could not be justified by any rational criteria, and it was a product of the disproportionate influence of special interest groups. Popular

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17 This assessment emerged from a meeting of experts in 1988, see Matesco (1988, p. 14).
18 For a broader discussion of the changing attitudes of academia and policy makers in Latin America towards trade reform see Franco (1991).
disenchantment with the nature of state intervention in Brazil signalled that society has come to a point of "rent saturation", and this has become instrumental to strengthen the political drive towards a more market oriented economy. As argued in more detail below, this should not be seen as a late recognition of the virtues of liberalism, but a plain acknowledgement of the excesses of corporativism.

The Collor administration did incorporate these concerns and was committed to effect a discontinuity regarding trade and industrial policies. Yet, practical questions regarding the reforms faced profound divisions of opinion, even among allies of the new president, and a delicate political economy. Indeed, an important point on the reforms undertaken by the Collor government is that discourse and actual measures should be clearly separated. Advances were somewhat tentative, given the uncertainties on the effects of a greater integration into the world industrial economy for a country so underinvolved in international trade for so many years, and also, and more importantly, the influence of political forces contrary to a number of specific aspects of the reform. Implementation has been often plagued by ambiguities, contradictions and the endeavour to find lines of least resistance. Care should be taken, therefore, in assessing the consequences of the reform as a test of a well defined diagnosis and of a programme designed accordingly. In fact, the programme actually implemented is a result of a number of often contradictory influences on the policy making process and the coherence with the diagnosis is not always to be found.

Two important groups of issues should be distinguished: (i) those related to the trade liberalization programme, including the classic ones, such as speed, sequencing and industrial restructuring, which were given specific contours by the simultaneity between liberalization and stabilization policies; and also some peculiar problems such as the "re-centralization" of trade related measures, the "tariffication" or demobilization of sectoral NTBs and the removal of the "regulatory junk" affecting foreign trade; and (ii) those related to the reform of industrial promotion policies, such as the extent and nature of industrial targeting and, more generally, the distortions created by corporative interests acting in the decision-making interfaces between the private sector and the government. These two groups of issues are discussed in the subsections 4.1 and 4.2.
4.2) Implementing the reforms: trade liberalization

The reforms started in March 1990 announced a shift of emphasis to productivity growth as the prime objective of policy, and this, as the first government document outlining the reforms stated, "requires the radical reform of the scope and of the traditional instruments of the country's industrial policy in which the concern with promoting efficiency gains was, at most secondary ... To overcome this deficiency - the document continues - requires defining a new style of industrial policy geared at stimulating competition as the rule of the game and the quest for competitiveness as the prime entrepreneurial objective." To fulfill these objectives, the new industrial policy would contemplate, on the one hand, a "competition policy" creating "stable and transparent rules for industrial competition" and chiefly based on import liberalization and the enactment of an effective anti-trust policy and, on the other, a "competitiveness policy", which would define "a set of instruments destined to support the growth of competitiveness of national firms", starting with a thorough revision of the current maze of fiscal and credit incentives to industrial production, investment and exports, with a view to narrowing them down to a few selective incentives to investment, and attacking market failures inhibiting technological efforts, through the provision of fiscal subsidies or risk sharing in financing of R & D projects, and creating positive externalities through massive expenditures in technical training.

The implementation of trade liberalization was conceived to take place in a phased way, following a seemingly rather conventional path. First, a rationalization of the import regime would take place, whereby most "special regimes" would be abolished. Then, the actual liberalization process would begin with the abolition of QRs and its replacement by tariffs, conceived to be "the only instrument of import policy," and that would be progressively brought down. The implicit purpose is to replace the discretionary allocation of import protection by price measures, which seems rather appropriate for the Brazilian system. The conventional sequence includes a real devaluation, which the authorities explicitly avoided given its likely inflationary impact. Some appreciation was even allowed,

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in the first few months of the new administration, but levels seen as adequate were enforced since\textsuperscript{21}.

The first step in this sequence was made together with the vast array of measures issued in the first day after the new president's inauguration, mostly aimed at inflation fighting, commonly known in Brazil as the Collor Plan 1. It proposed the end of some import duty exemptions under special regimes, a cut in surtaxes on freight revenues earmarked to finance shipper's purchases from Brazilian shipyards and investments in Brazilian ports, the nullification of the decree authorizing the formation of new export processing zones (besides the existing Manaos Free Zone), and the abolition of the list of forbidden imports\textsuperscript{22}, established by CACEX and known as Anexo C.

Although regional and sectoral lobbies succeeded in making Congress to soften the decision on export processing zones and on subsidies to shippers and shipbuilders, the rest was carried out quite rapidly. The abolition of the Anexo C was in effect in May, curiously because the government wanted to install greater price discipline in some important sectors with previously forbidden competing imports - notably automobile producers - by using the threat of lowering tariffs. For this reason, import prohibition under the Anexo C were subject to "tariffication". In July, the long-standing quantitative controls administered by CACEX were relaxed, as the government announced that the issuance of import licenses by CACEX would become automatic. Shortly after, financing requirements affecting high valued and capital goods imports were eliminated and important definitions were made to dismantle the special regime enjoyed by domestic producers of the open-ended spectrum of "informatics goods".

An interesting feature of the early phases of the Brazilian program refers to sequencing. Given the decentralized, diversified and sector specific nature of NTBs in Brazil, the sequential removal of NTBs necessarily conferred a targeted character to the Brazilian liberalization. Indeed, the elimination of the Anexo C liberalized mostly consumer goods, while the maintenance of local content requirements (only with a slight reduction in levels practiced by BNDES\textsuperscript{23}), of some

\textsuperscript{21} The purpose of devaluations is to prevent balance of payments difficulties, which, however, for a number of reasons, was not seen as a problem in the early 1990s in Brazil.

\textsuperscript{22} Although the previous government had began reducing the items on the list under US pressure, the list still comprised over one thousand items out of the 13,500 in the Brazilian tariff schedule.

\textsuperscript{23} Local content requirements were first reduced in the financing of the acquisition of domestically produced capital goods through the FINAME program, and in February 1991 it
temporary restrictions on a list of "informatics goods" and, at least initially, of external financing requirements, kept the large Brazilian capital goods and the informatics industries in a protected regime. Moreover, with the suspension of new BEFIEX contracts, an important mechanism firms could use to gain access to imported capital goods was eliminated, so that some segments of the capital goods and parts industry were even more protected than before. By and large, therefore, non border NTBs mostly of sectoral character remained unchanged and largely unnoticed.

Another odd feature of the early phase of the Brazilian liberalization program is the anti-export attitude visible in the suspension of new contracts in the BEFIEX program, the elimination of some export incentives and financing mechanisms and the slow speed, by the Central Bank, in reversing the marked exchange rate appreciation observed during the last few months of the Sarney administration. Although the appreciation would be reversed some time after, that illustrates the lack of commitment with an aggressive export policy as far as the exchange rate is concerned. This orientation stands at variance with the recent liberalization experience of other Latin American countries, who very explicitly targeted exports liberalizing inputs used therein either through import-to-export schemes or through export processing zones.

Finally, a new tariff schedule, with the projected yearly variations until 1994, was announced on January 1st, 1991 to be in force in February 15th was designed to follow a rule of concentrating the heavier reductions during the first two years on intermediate and capital goods, thus enhancing effective protection and competitiveness of consumer goods sectors. The aggregate result is shown in Table 2.

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<td>Mode</td>
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<td>20.0</td>
<td>20.0</td>
<td>20.0</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Table 2: The new Brazilian tariff, 1991-94 (%)

Source: Coordenadoria Técnica de Tarifas, Ministério da Economia.

was further reduced to a maximum of 60%. Note, however, that a 1988 law still in force establishes that all firms receiving any kind of fiscal subsidy and financing from official banks and involved in government procurement should be subject to a local content requirement.

It can be seen that the new tariff falls rather gradually over time and protection becomes more homogeneous among goods, witness the fall in the standard deviation of the rates. Nevertheless, if one takes into consideration that the tariff in force after the 1990 round of abolition of QRs had a maximum of 105%, the extent of the projected liberalization looks quite impressive. More recently, the government speeded up the fall in tariffs to reach the maximum level of 35% in mid 1993.

The reform of the trade regime also comprised changes in the extensive gamut of export promotion instruments. The first attack came in March 1990, within the Collor Plan: fiscal incentives conceded as income tax exemptions for export earnings, were abolished together with several other subsidies and tax expenditures, including those liable to be conceded in new BEFIEX contracts, as part of a comprehensive fiscal package. The second turn came in the June guidelines (Diretrizes) document, when the government announced a new export policy. According to the stated aims of this policy, the mainstay of export incentives would be export credit, and while the traditional FINEX credit lines provided by the Banco do Brasil were frozen, it was announced that a new Brazilian Eximbank would be founded under private control. However, there were non-negligible difficulties with this private Eximbank initiative, mostly derived from the lack of interest of the part of the private financial sector in providing export finance in internationally competitive terms even with the public backing of export guarantees. Thus, to reduce the plight of some segments of the capital goods sector hard hit by the collapse in domestic demand following the early stabilization measures, the BNDES eventually stepped in, creating a special line for finance of equipment exports (Finamex). Finally, in early 1992, a major attempt at restoring traditional credit incentives was made with the restoration of "interest rate equalization" financing and improved conditions for draw-back operations.

A difficult problem to be faced by the Brazilian authorities since inflation begun to pick up again in 1991 was that of implementing a major trade liberalization program in the context of a highly inflationary economy, that is, the problem of the optimum timing between the stabilization and liberalization programmes. In the Brazilian case, the government strategy was designed with the intention of first stabilizing the economy and then, launching the trade liberalization. Indeed, while the stabilization program was launched in the day following President Collor's inauguration in March 1990, the decisive phase of
the trade liberalization program, as described above, was scheduled for the period 1991-94. The expectations at that time were that when tariffs would begin to fall, the worst phase of the stabilization program would already be over. The fact that things did not happen according to plan in the stabilization front means that, in practice, Brazil is launching a liberalization program at a time when a major stabilization effort is still needed. This poses some important difficulties for the management of economic policy which, if not properly addressed, may generate macroeconomic disequilibria which will substantially increase the costs of the trade liberalization program.

The most usual political difficulty in trade liberalization programmes stem from employment problems in industries deemed to shrink after the programme is put into effect. Even though these problems may quite localized, they may be important given that the political requirement to block policy reforms tend to be much softer than the one for push reforms ahead. This is precisely the reason why, ideally, liberalization should be made in a growing economy: expanding sectors may absorb labor expelled from declining industries. In the Brazilian case, in which import penetration at the onset of reforms is very low (industrial imports barely over 5% of total industrial supply) and liberalization is very gradual one, may hardly forecast, in normal conditions, employment problems to become very important. During 1989-90, the average share of domestic demand in total manufacturing output was around 95%, against 9.5% for exports and only 4.5% for imports. In an economy such as this, the impact of a 20% rise in real imports on domestic output and employment can be countervailed by an increase of less than 1% in domestic demand.

However, when stabilization is to be undertaken simultaneously with liberalization, one superimposes the fall in aggregate domestic demand caused by the stabilisation programme to the sectoral adjustment strains accompanying trade liberalization. The difficulties involved in this could be clearly seen when, in late 1991, the new economic team headed by Mr. Marcilio M. Moreira implemented a policy mix based on very strict "fiscal repression" and very high interest rates following the end of the price freeze imposed earlier in that year. The success in the stabilization front was quite modest -inflation stabilized on levels slightly above 20% - and the same is true for advances in the fiscal area, considered essential to the success of stabilization. The recession, on the other hand, was quite dramatic as clearly seen in Graphs 1 and 2. An important feature of this recession, however, is that the reduction in levels of employment is much
more significant than the one for output levels. The improvement in labor productivity, shown in graph 3, is quite impressive. This behavior stands in sharp variance with the experience of other previous recessions in which productivity displayed a procyclical behaviour. Apparently, efforts of adjustment to higher levels of import penetration yet to take place, would be commanding these efforts. Indeed, it is a crucial feature of the Brazilian liberalization program that the level of imports behaved quite uneventfully since March 1990 .... This performance, when compared to benchmark cases, such as Mexico and Turkey, is somewhat puzzling. The recession certainly plays a significant role in explaining this poor import record, but one may surely suspect that non-border NTBs still in place may be preventing a significant change in import penetration. In one way or another, the effect of the recession has been, from the point of view of many domestic producers, similar to what would happen in a liberalization program in normal conditions, though the importance of the domestic market is such that a 10% decrease in domestic demand has the same effect of a tripling of import penetration. The efforts of adjustment undertaken in the last two years seem to respond to this idealized outcome.
The political complaints centered on the consequences of the recession were mostly voiced by state governors with strong interests in the municipal elections taking place later this year. Interestingly, however, these political leaders voiced their discontent against trade liberalization even though falling orders and rising unemployment results quite clearly from falling domestic demand induced by the orthodox stabilization policies and not from increased import penetration. Indeed, the true vilain, as far electoral politics is concerned, is Mr. Moreira, the responsible for "fiscal repression" - from which state governors suffer quite directly - and high interest rates, but his political strength is such that most politicians prefer not to confront him directly attacking what is seen as his most important virtue: his commitment to orthodoxy or, at least, to avoid heterodox experimentation in stabilization policies. In this connection, it was preferable to attack what was seen as a secondary policy commitment, the liberalization programme, that is not seen as having the same political weight as the anti-inflation effort.

4.3) Implementing the reforms 2: issues in industrial policy

The reversal of the process of decentralization of industrial policy management and generalization of incentives documented in section 3 seems to be essential for the state to regain the capacity to undertake industrial targeting. An "active" industrial policy, as Brazil has indeed conducted since the formative years of Brazilian industry, consists in creating "special conditions" for certain sectors or firms considered as priorities\(^{25}\). When, however, such "special conditions" are extended to nearly all producers, the targeting component is lost and the inefficiency and fiscal costs of industrial targeting became paramount. In order to avoid this degeneration of industrial targeting, surely a feature of the last years of the New Republic, "active" policies have to be limited, according to some criteria, to a few industries and/or firms. An useful principle in this connection is the one that any benefit accruing to "special" sectors, firms or regions of a given country, should be liable to be generalized to all "special" sectors, firms or regions without cancelling the benefit. If they are not, this means that benefits are granted on clientelistic grounds. Examples of violations of this principle in past

\(^{25}\) Industrial targeting is defined here on the lines of Krugman (1987), as the effort to change the allocation of investment among industries so as to favour industries in which the market is believed to underinvest.
industrial policies, as seen in section 3, are so abundant that one may consider Brazilian industrial policies to have fallen into something we may term "generalization trap", i.e. the incapacity of defining exclusion criteria for selective actions given the clientelistic nature of the government.

It is interesting to see how this same trap made itself present in the Collor administration. The new industrial policy, as defined in the basic guidelines document (Diretrizes Gerais) published in June 1990, explicitly mentioned that "strategic choices" would be made regarding industrial targeting, and even advanced some criteria for that. Two groups of sectors should be distinguished: high tech industries - informatics, fine chemicals, precision mechanics, new materials and biotechnology - to benefit from infant industry promotion on a traditional import substitution basis, and industries "in need of restructuring". Broad as they are, these guidelines seem to be made not to exclude any one from targeting, and thus made likely the reproduction of the "generalization trap" mentioned above. In fact, given the still prevailing clientelistic and corporatist nature of relations between the state and the private sector in the area of industrial policy, it is difficult to prevent industrial targeting to fall into the same old pattern of generalized distribution of benefits. The only obstacle to this, at this moment, is the fiscal crisis, that reduced very considerably the scope for fiscal incentives.

The corporatist nature of relations between industry and the state was also seen in a rather clear fashion in the Executive's initiative, in the early months of the Collor government, of creating the GEPS (Grupos Executivos de Política Setorial), sectoral groups formed by bureaucrats and business associations, inspired on the experience of sectoral chambers under the 1988 decree. Some GEPS, as the one for the auto industry, were formed right in the midst of the liquidity crisis following the Collor Plan 1, and served as an active lobbying channel for sectoral demands during these troubled months. Shortly after, in the June Diretrizes, the initiative was extended, as the stated government's intention was enforcing a system of "consensual planning" through the interaction of government officials and the private sector within the GEPS. Of course, this was a serious blow on the idea of having a less personal and market based relationship between the government and the private sector, and a very clear return to the old corporatist culture. Government officials justified this departure of from deregulation in trade and industrial policy making by arguing that business associations should be co-opted to the modernization project and that there was
no danger of granting benefits on a clientelistic basis since the GEPS were only "consultive" (though their denomination did include the word "executive") and that commanded no discretionary benefits to be allocated.

The consolidation of GEPS was blocked by two circumstances, one, already mentioned, the all pervasive fiscal crisis and the government's unwillingness to sustain regulatory benefits such as market reserves. The second was the failure of the March 1990 stabilization plan. The relations between the economic team and industry turned sour as inflation slowly accelerated in the second semester on 1990 and the Executive blamed quite loudly "oligopolies" for irresponsible pricing practices and overindexation. Conflicts were explicit as the Executive did use the threat of anti-trust sanctions to punish sectors seen as conducting irresponsible pricing practices, notably pharmaceuticals and the auto industry.

In February 1991 the government launched another stabilization plan, this one similar to "heterodox shocks" implemented during the New Republic. A price freeze was enforced and a gradual defreeze predicted. While being voted in Congress, the new plan incorporated a number of suggestions, important among which the creation of "sectoral chambers", initially designed to help the "flexibilization" of the price freeze. Interestingly, the inclusion of sectoral chambers in the Collor Plan 2 was a demand of the Partido dos Trabalhadores - PT as part of negotiations with the opposition towards the congressional approval of the Plan. The key novelty was the inclusion of unions within the chambers. Vocal representatives of PT claimed the sectoral chambers to offer a mechanism for a "broader policy based on negotiations" of all aspects of economic policy: prices, incomes policies, trade liberalization and even the "coordination of inflationary expectations".

The essence of the new sectoral chambers is very much an old story. Business associations of vertically related sectors coordinate their actions towards prices (passively passing way cost increases) and competitors (establishing agreements of "local content" and barriers to entry) so as to act as an unified vertically integrated firm. It was meant to be a "mega combine", now incorporating unions, designed to prevent rent dissipation in the sector affected by the arrangement and assure a more "democratic" sharing of privileges.

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26 See Serra & Franco (1991)
produced by government regulation. It is an essentially corporatist arrangement through which active minorities, labor and capital, exploit unorganized majorities, consumers and taxpayers.

Quite surprisingly, in light of his very clear liberal orientation, Mr. Marcilio M. Moreira not only maintained the sectoral chambers but also extended quite considerably their coverage and number. Fifty one sectoral chambers are in existence at the moment, and it is quite paradoxical that the main enthusiasts of this new wave of corporatist institutions are large firms, foremost among which the auto manufacturers, and large unions notably those associated with the Partido dos Trabalhadores. One may legitimate ask what do the sectoral chambers of this new vintage do, given that there are no longer fiscal incentives to be granted on a discretionary basis as in the past. The answer is perhaps the key to the compatibilization of the new priorities of trade and industrial policy for the 1990s and the inherited culture in this area that is not likely to disappear very fast. Corporativism is certainly to suffer adaptations to the priorities of the time and some interesting indications in this connection is provided by the recently drawn tri-partite agreement in the auto industry. The terms of the agreement have been under heavy fire as of late and involved several issues. Manufactures would agree on lower margins, federal and state governments would reduce value added and sales taxation, workers would agree on not going on strike in exchange for a halt in lay-offs, all of which composing a 22% reduction on final list prices. Industry representatives claimed sales to increase nearly 130% in response to the price reduction, which generated some debate. In fact, it is not clear whether (i) a price reduction could actually be seen, given that auto prices overshot inflation quite markedly before the agreement; (ii) that sales did increase this much; and (iii) the sales increase happened because of price decrease. The gains accruing to each of the parties involved may not be very clear in this price agreement, though it is significant to note that auto manufactures managed to obtained a long sought goal, the tax reduction on cars.

However, the price agreement is only one of the issues under negotiation in the auto industry sectoral chamber. A proposal is also under discussion of exchanging export commitments for a import quota on finished cars plus a import monopoly granted to auto makers plus import tax exemptions for parts. It is very

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28 See Miguel Jorge "O fim do acordo" Folha de São Paulo 3/7/92; Gustavo H. B. Franco "Maravilhas do acordo automobilístico" Folha de São Paulo 14/7/92; and Paul Singer "ganhos e perdas do acordo automobilístico" Folha de São Paulo 20/7/92.
much like a revival of BEFIX scheme though now, what was seen as the raison d'etre of this type of agreements, i.e. a very heavy structure of protection, is no longer there. Access to imported inputs is surely a condition to make exports viable, at least as long as the domestic industry complies with indices de nacionalização of nearly 80%. In fact the only reason for such high local content requirements to be obeyed is the long standing alliance between auto manufacturers and auto parts industries which, now, is even stronger given that the presence of unions in sectoral chambers reinforces the concern with a reversal in vertical integration in the sector. Yet, as long as exported cars are concerned, access to imported inputs at world prices may surely be made through now improved draw-back facilities, so this is not really the issue. Domestic producers have been induced to export as the domestic market is very weak, and it is interesting that producers demand from the government, as a reward to their export performance, a "market reserve" in the domestic market. Although, the Ministério da Economia, through its Secretaria Nacional de Economia, was sympathetic to the idea, objections from other segments of the Executive, including the president himself, prevented the arrangement to be turned into law.

5. Some conclusions

This essay sought to characterize the inheritance of the 1980s, in terms of trade and industrial policy framework, and to show that the accumulation of distortions was such that a major effort of reform was to be necessarily undertaken at the onset of the 1990s. The key conclusion is that the political drive towards reform has little to do with liberal conceptions, except at a very superficial level or as way to co-opt foreign creditors or multilateral institutions, but mostly with a domestic urge to revert a process of predatory privatization of the state. Liberalism appears though as a circumstantial alliance needed to destroy some of the more damaging "conquests" of corporativism. The evolution of trade and industrial policy reforms has been, therefore, a struggle to remove corporatist arrangements assuring privileges to interest groups that has, sometimes, mixed results. The very decentralized nature of regulatory arrangements turn this

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29 Interestingly, the proposed agreement is very similar to the one made in Mexico, an example often quoted in the Brazilian debate. A comparative analysis is certainly interesting, though somewhat beyond the scope of this essay.
struggle into a long succession of small battles, each one fought in very specific
grounds. The deregulation of ports, the Manaos Free Zone, export processing
zones, sectoral and regional bodies interfering with import authorizations, as well
as issue like intelectual property, foreign investment taxation, privatization "at
the margin" in public utilities, all such issues involve long and difficult
negotiation processes within which coalitions have to be formed to defeat entrenched interests. There is no other antidote to the "generalization trap" that a
case by case work.

A distinguished feature of the trade and industrial policy reform in Brazil
has been the tension between the political will, on the part of the Executive, to
built a market oriented system and a long established, very strong and organized,
corporatist culture involving the relations between government and industry. The
crisis of the late 1980s introduced an urge to change that placed the Brazilian
development model before a serious identity crisis has been only now producing
new models of policy and sectoral and regional coalitions likely to be generalized
in the future. In any event, the most extraordinary feature of this all is the
velocity with which things are changing, though towards models yet to be clearly
declared. If this is very much what has always been refered to as "modern", in art,
politics and economics, no doubt, president Collor was a major success in
advancing the "modernization" process.

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