

WORKING P A P E R S

Privatization and the Distribution of Assets and Income in Brazil

Roberto Macedo



CARNEGIE ENDOWMENT
for International Peace

**Economic Reform
Project**

**GLOBAL POLICY
PROGRAM**

**Number 14
July 2000**

© 2000 Carnegie Endowment for International Peace

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means without permission in writing from the Carnegie Endowment.

Carnegie Endowment for International Peace
1779 Massachusetts Avenue, N.W.
Washington, D.C. 20036
Phone: (202) 483-7600
Fax: (202) 483-1840
www.ceip.org

Carnegie Endowment Working Papers

Carnegie Endowment Working Papers present new research by Endowment associates and their collaborators from other institutions. The series includes new time-sensitive research and key excerpts from larger works in progress. Comments from readers are most welcome; please reply to the authors at the address above or by e-mail to pubs@ceip.org.

* * *

About the Author

Roberto Macedo is research associate at the Foundation Institute of Economic Research of the University of São Paulo, professor of economics at Mackenzie University in São Paulo, and weekly columnist at *O Estado de S. Paulo*. From 1991–1992 he served in the Brazilian government as secretary for economic policy. His major areas of interest are macroeconomic adjustment, public sector reforms, labor markets, and social policy.

EXECUTIVE SUMMARY

This paper focuses on the Brazilian privatization program undertaken in the 1990s, one of the largest in the world, as a result of which over US\$71 billion worth of equity capital and US\$17 billion of debt owed by the former state-owned enterprises (SOEs) were transferred to private owners, both at the federal and state levels.

Various characteristics of the program are examined in the paper, such as the industries involved, the nationality of the buyers, and the form of sale and payment. Although privatization is only an exchange of assets, it brings a major gain to the new owners because they have the opportunity to increase the efficiency and the profit of the former SOEs as they become profit maximizers, are better managed, and have the prices charged or paid by them corrected after privatization, in some cases by the government itself, in the form of realistic tariffs for public services provided by some of the privatized companies.

This paper questions how open the access was to the opportunity to gain from privatization, and concludes that it was restricted to big business, both foreign and national, as the government opted to auction large and controlling blocks of shares. Although democratization of capital ownership was and still is among the objectives of the program, it was not practiced in the form of public offerings, since the government, having other and conflicting objectives, opted for getting the higher price and allegedly to use the proceeds to reduce its debt. Nor did the government exchange its SOE equity capital for liabilities it owes to citizens in general, on account of the unfunded pension liabilities of the virtually penniless Social Security system, and for deposits it received from private firms in the name of their workers as a guarantee for unemployment compensation.

The privatization program reached its peak in 1997 and 1998, when the economy was facing severe problems due to macroeconomic mismanagement, both on the fiscal side and in the external sector, in the form of large deficits and increasing debt. A major link between the twin deficits was the attempt to defend the Brazilian currency, the real, by means of very high interest rates, which was the major cause behind the large fiscal deficits and the enlarging public debt. The foreign inflow of short-term capital, stimulated by the high interest rates, plus the foreign direct investment attracted by the privatization program, were also crucial in maintaining the foreign imbalance which followed the overvalued real.

In this respect, the paper concludes that privatization contributed to softening both the fiscal and the external constraints, by allowing an enlarged public debt and aggravating foreign imbalances. It also contributed to delaying devaluation, which came only in early 1999, immediately after the privatization program came to a halt. Because of this macroeconomic mismanagement, the objective of reducing the public debt was not achieved. In spite of the size of the program, the government ended up with increased liabilities. With respect to income distribution, the paper concludes that it was also aggravated, since the poorest groups did not have access to the assets and the gains of privatization, and will in the end share in the payment of an increased public debt and of a larger interest bill. The better off, on the contrary, reaped the benefits of privatization, and of the larger interest rates practiced by the government. Some correction of these distortions might occur depending on how the government spends the higher tax receipts it is collecting from the former SOEs, as they become more efficient and profitable, a performance also supported by the evidence presented in the paper.

INTRODUCTION

This paper analyzes the privatization program undertaken in Brazil in the 1990s and focuses on its relation to asset and income distribution. Section One reviews the old and ongoing discussion of the causes of income inequality and shows that the primary focus has been on incremental and minor changes, often ignoring the high inequality itself and the role that asset distribution plays in shaping it. Against this background, a huge privatization program has been in progress since the early nineties, the result of which, until 1999, was the transfer to private groups, both Brazilian and foreign, of US\$71 billion worth of equity capital in state owned enterprises (SOEs).

The impact of this transfer on asset and income distribution is therefore an important issue, particularly since it was accompanied by trade liberalization, increasing exposure to external financing, a serious fiscal crisis, high interest rates, and an overvalued exchange rate. This complex combination has been a source of income gains and losses of various sorts, together with changes in the value and in the property of assets.

It is in this context that we shall focus on asset and income distribution, following the thread of privatization, attracted by the size of the program, and by the fact that it peaked in 1997 and 1998, when fiscal and external imbalances were at their worst in the decade. Section One also sketches an analytical framework for tackling some of the issues involved in the relation between privatization and asset and income distribution.

Section Two describes the privatization program and its outcomes. Section Three presents a picture of the fiscal side, involving deficits, debt, interest rates, and other ingredients of a problem that privatization was supposed to help, but that was mishandled in such a way as to damage the positive impacts of privatization on the fiscal crisis and harm income distribution as well. The mishandling also included the external side as shown in Section Three. Section Four relates these macroeconomic developments and the privatization process to income and asset distribution in Brazil, and presents other conclusions of the paper

1. SETTING THE ISSUES AND ANALYTICAL BACKGROUND

Income Distribution in Brazil

Studies on income distribution in Brazil are abundant, as it is one of the worst cases of inequality in the world. According to 1998 data from IBGE, the Brazilian Census Bureau, the income share of the poorest 50 percent was only 14 percent while the richest 10 percent took a hefty 46 percent of the total income.¹ Most of the analyses begin with a measure of inequality, such as the Gini coefficient, or the income of a particular group in society, and after looking at how it has changed over time, proceed to investigate the causes of the change, leaving aside or taking for granted the reasons, such as the asset distribution, that make up for the very high degree of inequality itself.

For instance, after census figures revealed a worsening of the income distribution in the 1960s, an intense debate emerged about the causes. On one side of the discussion were those who blamed the wage policies of the military government then in power, particularly the erosion of the purchasing power of the minimum wage. On the other side were those who, instead, blamed the change on the larger income gains made by educated people in short supply in relation to unskilled workers, as demand for labor expanded rapidly following a period of very high rates of economic growth.²

More recently, since the income of the poorest groups has improved a bit since the mid-nineties, explanations have emphasized the price stabilization achieved by the Real Plan, which was unveiled in 1994. Since the plan has been successful in curbing very high inflation, the fate of the poorest has been improved as they had been the major victims of the “inflationary tax” implicit in the very high rates of inflation, which reached as high as 84 percent a month in March 1990.³ An increase in the value of the minimum wage has also been appointed as a major factor, and its major impact is now on the incomes of retired people and pensioners of the INSS (National Social Security and Welfare System), where it is the floor of the monthly individual benefits.⁴

The Objectives of the Privatization Program and the Neglect of Asset and Income Distribution

It is against this background of a very high income inequality that a huge program of privatization of public assets, in the form of equity in SOEs, has been in progress since the early nineties, following earlier but weaker moves in the same direction.

Law 8031, of April 12, 1990, established the legal framework for the program.⁵ Six objectives were set in its first article:

- (1) to reestablish the strategic position of the State in the economy, by transferring to the private sector the activities unduly undertaken by the public sector;
- (2) to contribute to the reduction of the public debt, by helping in the process of adjusting the finances of the public sector;
- (3) to make room for increased investments in the companies and activities transferred to the private sector;
- (4) to contribute to the modernization of the country’s industrial sector, by improving its competitiveness and by strengthening entrepreneurial skills in the various sectors of the economy;
- (5) to allow the public administration to concentrate its efforts in the activities in which the presence of the State is fundamental for accomplishing the national priorities; and
- (6) to contribute to the strengthening of the capital markets, by increasing the supply of securities and by democratizing the capital ownership of the SOEs included in the program.

Thus, from its conception, the Brazilian privatization program has shown no explicit concern with income distribution, except in the blurred form of democratizing capital ownership. In any

case, the privatization of a SOE will cause an impact on *both* asset and income distribution, and in this respect the program raises many interesting questions, among them the following:

- Who benefited most from the previous public ownership of the SOEs that have been privatized?
- Which benefits came with privatization?
- How open was the access to privatization and who bought the SOEs?
- Was money the only asset received by the government in exchange?
- Could the government have devised alternative forms of privatization, with different impact on asset and income distribution?
- How did the government use the money from the program?
- What has been the impact on personal asset and income distribution?

These are complex questions, which will be addressed in the limited scope of this paper. It makes no claim of providing a complete and finished picture, but rather sketches the major facts and issues involved, and provides some paths upon which these questions could be further investigated. By doing this it deals with an important and neglected issue that shapes income inequality in Brazil—the distribution of assets—and brings into the discussion the impact of a major asset redistribution, namely the current privatization program.

Even within this limited scope, it is important to sketch an analytical background for the issues to be examined. When a SOE is privatized, the buyer gives the government an amount of money or other form of payment, that either was its property or was borrowed from some source. Thus, the privatization is an exchange of assets. The main interest of this paper is income distribution, and the question to be examined is whether or not this exchange of assets was *neutral* in its impact on income inequality.

Since the transaction occurred, we can assume that the sale was made at the right price or, in any case, at a price that did not preclude a gain of another type, and which we see as the major one. This gain is an expected one and will come from the buyer's belief that he will be able to better manage the company, profiting from the previous incompetence of the government managers in obtaining a higher return, or from government policies—such as wage and price policies—that precluded these managers from doing so.

The private buyer is a genuine profit maximizer, while the government and/or its managers have other conflicting objectives, such as providing products and services at subsidized prices, the welfare of the managers and workers of the SOEs, the growth of the companies for the sake of growth, overstaffing, political gains of various sorts, or the defense of vested interested groups, such as their suppliers or customers, who could benefit by the prices they received or paid as such. In addition to these distorted objectives and the inability to set or get the correct prices, a SOE can also show a pure technical inefficiency.

Implicit in the sale is an expected gain to the buyer, and thus (barring data difficulties), the efficiency and the profit rate of the privatized firms can be evaluated before and after the sale. Another testable hypothesis is that the rent gainers around the SOEs will lose from privatization, as prices of products, services, suppliers, and workers will more closely follow the market rules.

The issue of prices is of particular importance since some of the privatized companies have a monopoly of services. Others are now duopolies, such as in the operation of the regional telephone systems, or act in very concentrated markets, such as with steel and petrochemicals. Thus, there is also a major change in the exercise of economic power, from the government to private groups.⁶ Moreover, because of strategic concerns, political reasons, and the scale of capital required, the role of the state as an entrepreneur has been concentrated in the areas of public services and in the production of intermediate goods such as steel and petrochemicals. It follows that the privatization process, if left to its natural course, would attract big business, including foreign investors. Thus, if the objective of democratizing capital ownership were to be sought, the government would have to devise specific means to accomplish it.

Another issue to be analyzed is how the government spent the money it received from the sale. Finally, looking at the source of funds for privatization, since in some cases the buyers of the state enterprises have borrowed money from a government bank, we will examine if this was done at a rate below the market rate, and to whom this benefit was given.

A Major Issue: Access to the Opportunity to Profit from Privatization

The rules of privatization have excluded some groups from participating in the process. Thus, one of the major issues shaping the relation of privatization to asset and income distribution is the access to the condition of buyer and to the efficiency and profit gains provided to the new owners of the former SOEs.

Among the objectives of Law 8031, the government has emphasized the reduction of the public debt. It has also opted for auctioning its shares of the SOEs above a minimum price evaluated by outside consultants in order to get the highest value for them. The auctions have, as expected, attracted big business, both national and foreign. This course of action prevailed over democratization of capital, a component of objective (6), which would have led to another form of asset exchange and a different impact on income distribution.

Democratization of capital can be made mainly in four ways:

- (1) management-employee buyouts,
- (2) mass privatization as was undertaken in some countries of central and eastern Europe,
- (3) large scale flotations, as adopted in Great Britain, or,
- (4) recognizing unfunded pension liabilities, and other liabilities owed by the government in its social security and welfare area, as it could have been done in Brazil. That is, the government could also use the privatization process to fund liabilities in this area by transferring its equity capital in the SOEs to those entitled to these liabilities.

The manager-employee buyout, which has been partially and scarcely adopted in Brazil, deserves specific attention because the opportunity to profit is open to a particular group only. This group would be one among other buyers who benefit from the opportunity to purchase the firms, and should be analyzed along the same lines.

The type of mass privatization that took place in central and eastern Europe never received a serious thought in Brazil, since it does not have the same socialist tradition, nor did the government find it necessary to use the idea to gain political support for the privatization program.

Large-scale flotations have not yet been adopted in Brazil.⁷ According to Velasco (1997), who compared the Brazilian model with the British, a fixed price is required for the flotation; this could lead to criticism of under-evaluation, which was feared by the Brazilian authorities. On the basis of the British experience, he points out that large-scale flotations have diminishing effects over time, since thereafter buyers tend to sell their shares to large holders. He confirms that the concern with the fiscal crisis prevailed in Brazil.

The fourth way to democratize capital deserves close attention since unfunded pension liabilities and other liabilities in the social security and welfare areas are enormous in the Brazilian public sector, including the SOEs.⁸ The recognition of these liabilities, a course of action that was not followed by the government, would have led to very different results of the privatization process in terms of asset and income distribution. For later reference, we shall call this proposal the redemption of social security and welfare liabilities.

This idea has been raised by some economists, who also suggested that the equity received from the government should go into private pension funds so that it might gain from efficient management. It could also be used to start a new pension system following the capitalization rule, since the present one follows an explosive combination of the pay-as-you-go rule with schemes indigenous to Brazil—like the receive-more-than-you-pay and the don't-pay-as-you-go—and is virtually broke.

The idea, however, has never gained wide acceptance, nor is it supported by political initiatives. The idea has not been given room to prosper by the present government, which is only cosmetically social-democrat, lacks ideological consistency, suffers anxiety about getting local and foreign money from privatization to help in the fiscal crisis and for financing balance of payments, and continues to feel the pressure of big business. Notice also that Law 8031 has conflicting objectives in this respect, since democratization of capital in this or any other form, such as large-scale flotations based on a fixed price, does not maximize the reduction of public debt.

The relevant opposition, the Workers Party, on the other hand, preferred to fight privatization in the courts, in Congress, and in the streets, instead of providing an alternative way.⁹ Adherent to primitive forms of socialism, it has ruled out the idea of transforming workers into capitalists by share or fund ownership. Moreover, workers of SOEs and public servants, who have been traditionally suspicious of privatization, since they are entitled to favored pension schemes by regulations and laws, and also by the Constitution, are among the major supporters of the party. The idea of democratization of capital, whatever its form, has thus remained in a limbo.

To further clarify what we mean by the fourth way to democratize capital ownership, we shall now resort to an imaginary balance sheet of assets and liabilities of the public sector, but containing only the items relevant to the analysis. A balance of this sort is not usual in traditional analysis of public finances, but it is a key element in this kind of “Chapter 11” situation in which the government releases assets to reduce liabilities. This balance is shown in Table 1.

One of the main reasons that the government sells its equities in a SOE is to reduce debt. According to Table 1, this would mean a reduction in both A-1 and L-1 or L-2, since the government has also accepted as payment a part of its debt in the form of securities, such as those of the Agrarian Debt (issued to pay landowners who had their land used in agrarian reform projects) and Siderbrás Bonds (named for the former holding of the government steel companies).¹⁰

TABLE 1: Relevant Items of an Imaginary Balance Sheet of the Brazilian Public Sector

ASSETS		LIABILITIES	
A-1	Equity in State Enterprises	L-1	Short-term Debt (Treasury Bonds)
A-2	Loans from the Workers' Tenure Guarantee Fund (or FGTS)	L-2	Long-term Debt (such as Agrarian Debt Securities and Siderbrás Bonds)
		L-3	Unfunded Pension Liabilities
		L-3-1	Workers of SOEs
		L-3-2	Public Servants
		L-3-3	National Social Welfare and Security System (or INSS)
		L-4	Deposits in the Workers' Tenure Guarantee Fund (or FGTS)

The fourth scheme mentioned above would in effect be using the equity capital in the state enterprises, that is, A-1, to cover L-3-1, L-3-2, and L-3-3. Moreover, the government also owes a liability of another form, the deposits in the FGTS or Workers' Tenure Guarantee Fund (or FGTS), to the workers of the formal labor market. Brazilian employers are required to deposit into this fund the equivalent of one month's wages per worker per year in an account in his or her name, and the money can be drafted only if the labor contract is broken, if the money is used to buy a house, or upon retirement. FGTS is thus a funded form of unemployment compensation or social security. In the course of privatization, another idea that came into discussion from time to time, was to allow workers to use their FGTS balances to buy equity capital of the SOEs being sold.¹¹ It is important to mention that in the revised version of Law 8031, that is, Law 9491, of 1997, a provision was made to allow individuals to place 50 percent of their balances in the FGTS account into "Privatization Mutual Funds," which was designed to participate in the National Program of Privatization and in the programs at the state level. These funds, however, have not come into existence thus far.

If democratizing capital ownership and asset and income distribution were the purpose, the group best qualified for it would be the contributors and pensioners of the National System of Welfare and Social Security (the INSS), whose pension liabilities are in L-3-3 in Table 1. They comprise around 20 million workers and 18 million pensioners, the latter of whom receive pensions with the monthly minimum wage (roughly US\$70 in late 1999) as the floor, and 10 times that amount as the ceiling. Rural and informal workers, as well as the handicapped and the aged without other sources of income, are also among the pensioners. Thus, the INSS combines social security with welfare or social assistance benefits. This system covers some of the major poorest groups, while those in L-3-1 and L-3-2 are essentially middle-class or even wealthy people, with favored pension schemes that include 100 percent of active pay and no ceiling. Pensions in the value of US\$1,500 to US\$3,000 are not uncommon in this minority group and some are even higher.

TABLE 2: Privatization, Assets and Income Distribution Assumptions, Consequences and Testable Hypotheses

ASSUMPTIONS	CONSEQUENCES	TESTABLE HYPOTHESES
Unlike private firms, SOEs are not profit maximizers.	SOEs have suffered from technical and pricing inefficiencies.(*) Access to privatization represents opportunity to profit from the correction of such inefficiencies.(*)	Productivity and profit will increase after privatization. Overstaffing will be corrected.(*) Wage and price (*) policies of privatized firms will more closely follow market rules. Groups used to rents from the state enterprises will lose.(*) Privatized companies will pay more taxes after privatization. Check how the government will spend the money, for the impact on income distribution.
	State enterprises will accumulate unfunded pension liabilities.(*)	Minimum price set by evaluation will compensate for them.(*) In relation to other groups entitled to the unfunded liabilities, workers of privatized firms will gain, maintaining or worsening income inequality. (*)
Strategic concerns, political reasons, and scale of capital led the government into public services and concentrated sectors. Pressure from fiscal crisis and from external disequilibrium have been dominant in setting the rules and the timing of privatization.	No concern for democratization of capital, except in a few cases of manager-employee buyout.(*) To push privatization, money was lent to buyers.(*)	Access to privatization and its gains becomes limited to some groups.(*) Scale and expertise required will attract big business and foreign investors; income gained will flow to foreigners and the wealthy.(*) Domestic inequality will be worsened.(*) Check if this was done at favored rates and who benefited from them.(*)
	The use of “rotten money” was also allowed to pay for privatization.(*)	Owners and buyers (*) of the securities have benefited from the rule. Income inequality will worsen.
	Privatization will be followed by regulatory practices managed by government agencies.	Check for biases in regulatory practices, such as favorable prices, and groups who benefited from them.
	Revenue from privatization is to be used to reduce debt, opening room for lower interest rates.(*)	Owners of financial capital will be paid less; income inequality will be lessened.(*)

The FGTS accounts are held by formal workers, whose wages range from the lowest to the highest. As wage earners, most have an income that, on average, is likely to be well below that of the businessmen and other groups that won the privatization auctions, but above the pensioners of INSS. In any case, as far as the course adopted by the government is concerned, opening to them the opportunity to gain from privatization would be an alternative that could have contributed to a reduction of asset and income inequality.

Although not explicitly considered in the privatization process, the provision for unfunded liabilities has been made only in the case of the workers of the SOEs, by means of a reduction in the auction price to compensate for the existence of these liabilities. That is, part of A-1 has been used to cover L-3-1. This constitutes one more impact of the privatization process on asset and income distribution and on the maintenance or increase of inequality, since this group of workers is among the better off.

To summarize: if democratizing capital ownership and asset and income distribution were the purpose, the groups most qualified to participate in the privatization, by means of the redemption of social security and welfare liabilities, would be, in this order, L-3-3, L-4, L-3-1 and L-3-2, the last two having roughly the same status.

If liabilities such as short- and long-term debt were reduced, the government would no longer be required to pay interest on the amount of the reduction, thereby achieving a reduction of the fiscal deficit—one of the objectives of the program. Moreover, a sizable debt reduction could have reduced the interest rate paid, since the shaky government finances have increased the risk premium paid to buyers of government bonds. The impact on income inequality would be to lessen it, since the interest paid goes mainly to the highest income groups. This course of events can be analyzed following the usual framework of analysis of the taxation and expenditure policies. Within the same framework, we can also fit the future increase in tax receipts that will come from the larger profits of the privatized companies, as well as the expenditures that the additional revenue will finance. In this case, the impact will depend on who benefits from the expenditures.

Table 2 summarizes the assumptions, consequences, and hypotheses that have emerged from the analysis in this section. The line between consequences and hypotheses is not a strict one. The former are of a more general nature and come first in the sequence of causation, while the latter are more specific and follow upon the consequences. In the analysis of the next two sections, the evidence presented will cover only those cases marked with (*).

2. THE PRIVATIZATION PROGRAM: CHARACTERISTICS AND RESULTS

Some aspects of the Brazilian privatization program have already been advanced in the previous section, but they lack detail and evidence. This section presents data and other information on the program, as well as evidence with respect to the consequences and hypotheses that have emerged from the previous analysis.

In the process of privatization, the decision was taken by federal and state governments to sell their minority or controlling shares in various companies (some of which had private capital as well) by means of auctions in the stock exchange. In the case of roads, bridges and other public works, the privatization has been in the form of concession of public services, with the selection

of the interested parties occurring by means of competitive bidding. Due to the limits set for its scope, this paper will not deal with the case of concession of public services.

In privatizing its companies, the government has advanced by industries, starting with the steel and mining companies, then moving into the electricity, telecommunications, and other industries. In the case of electricity, where the state governments have strong participation, there have been major advances in the area of distribution. On the production side, a large part of the program remains to be completed. Major state enterprises still exist not only in the area of electricity, but also in the banking and petroleum industries.¹²

The privatization program is composed of three parts. The first is the federal National Program of Privatization (or NPD),¹³ started by President Collor in 1991. The second is a similar program at the state level. The third is the privatization in the telecommunications industry, thus far the largest in terms of value, which was initiated by the federal government in 1997, as a program separated from the NPD, but running parallel to it. We shall call it the Telecom program, for later reference. The auctions under this new program resulted in US\$ 28.7 billion in only two years (1997 and 1998), while the NPD came to a total of US\$28.9 billion in eight years (1991 to 1998).¹⁴

Table 3 shows the total proceeds of the privatization program from 1991 to 1999, and also the sum in each of its three parts. The total value, US\$88 billion, is impressive and certainly places the Brazilian program among the largest in the world. Two years, 1997 and 1998, have concentrated 74 percent of the total value of the program thus far. This will have important implications for the analysis, to be undertaken in the next section, of the impact of the program on the fiscal crisis and the external imbalances, since in these two years both were seriously aggravated.

TABLE 3: Brazilian Privatization Program, 1991–1999 By Components (in US \$million*)

YEAR	NPD	TELECOM	STATES	SUM
1991	1,988	–	–	1,988
1992	3,383	–	–	3,383
1993	4,188	–	–	4,188
1994	2,315	–	–	2,315
1995	1,628	–	–	1,628
1996	4,749	–	1,770	6,519
1997	7,824	4,734	15,116	27,674
1998	2,737	23,948	10,857	37,542
1999**	49	421	2,603	3,073
TOTAL	28,861	29,103	30,346	88,310

* Includes transferred debt

** Until July

The number of firms privatized from 1991 to 1998 was 115. As already pointed out, the whole program has been confronted by the opposition, in particular by the Workers Party. The disputes have ranged from battles in the courts, including last-minute petitions against the sales, to attempts to disrupt the scheduled auctions. In some cases, this has led to confrontation with those attending the auction and with the police.

Nevertheless, the government has showed competence in overcoming these difficulties and the program first gained speed in the early 1990s. Management of the program was a crucial issue and the task was given to the National Bank for Economic and Social Development (BNDES). Its major role is the provision of long-term financing to both the private and public sectors, such as a petrochemical plant, in the first case, or a subway line, in the second. As a rule, private banks in Brazil do not finance long-term projects, because of the risks involved, particularly in the past, when inflation was rampant, and because they get more profits with government securities and with short-term financing to private clients. The bureaucracy of BNDES is among the most efficient in the public sector and it has acted effectively in organizing the actions, in informing the interested parties, in the court battles, and also in providing assistance to the state governments in their own privatization programs.

In the Telecom auctions, however, it seems that those on the top of the process went too far and too fast, in pushing for the assembling of interested groups. A scandal emerged late in 1998 when conversations between the minister in charge of the sector and the president of BNDES, which revealed some arm-twisting in the assembling of groups for the auction, were wiretapped by their adversaries and leaked to the press. In the aftermath, both have been acquitted by the Tribunal de Contas, a court that examines the government budgets and accounts, but the program is now at a very low speed, having been damaged by the scandal and criticisms of various sorts. Table 3 highlights the lackluster results in the first half of 1999.¹⁵

In Figure 1 we present additional characteristics of the privatization program, in the form of three pie charts. The first shows the share of its three components: NPD, Telecom, and the privatization by the states; the second shows the share of the various industries; and the third shows the nationality of the buyers. All the shares are measured in terms of the total value of the program from 1991 to 1999. The first two charts put numbers to issues already raised in the previous discussion. The third chart reveals that the program has been liberal in terms of foreign participation: it reached a share (43.5 percent) not very far from the one taken by Brazilian investors (56.5 percent). This will have major implications for the discussion on asset and income distribution, as well as on the future pattern of the current account balance, and will be discussed in more detail later in this paper.

In Figure 2, composed of four charts, we present information covering the NPD only. The first chart on the upper left side shows the share of each industry. The other three charts show data that are crucial for clarifying issues under discussion. Proceeding in a clockwise fashion, the second chart shows how the NPD total of roughly US\$20 billion was paid for, a total that does not include the debt owed by the companies and assumed by the buyer. Worth mentioning is the acceptance of the “rotten money,” in the form of Agrarian Debt Securities, Privatization Certificates, and Siderbrás Bonds. Using the terms adopted in the balance sheet of Table 1, this acceptance meant a gain to the owners and buyers of L-4, and thus benefited high income groups since the poor people and even the middle classes are not among the typical holders of securities in Brazil.

FIGURE 1
Brazilian Privatization Program, 1991–1999*
Total Result: US\$88.31 billion

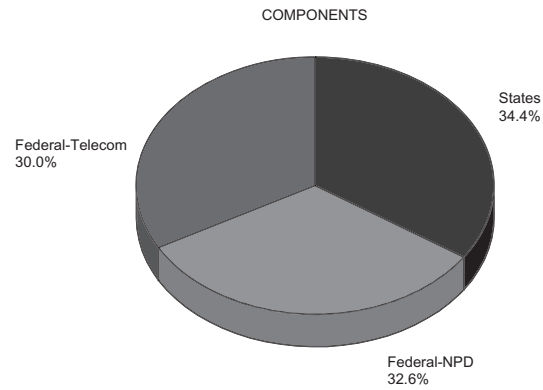


CHART 1

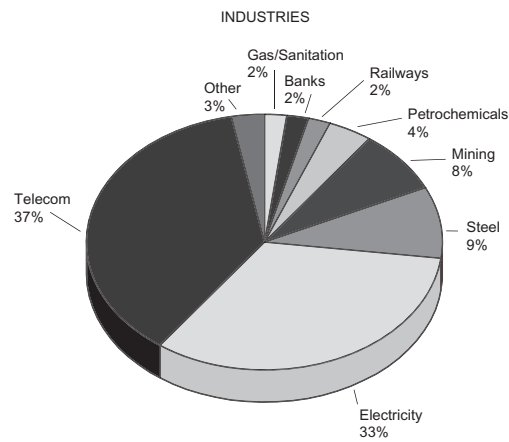


CHART 2

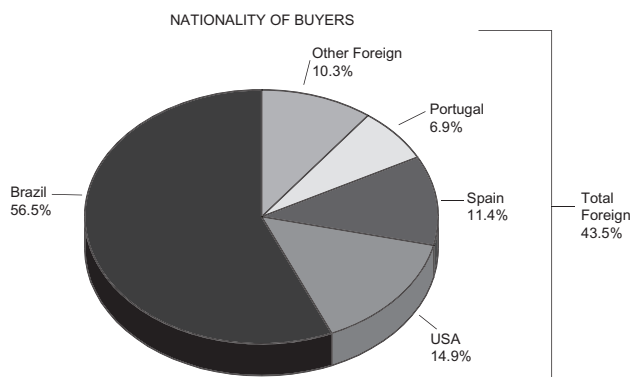
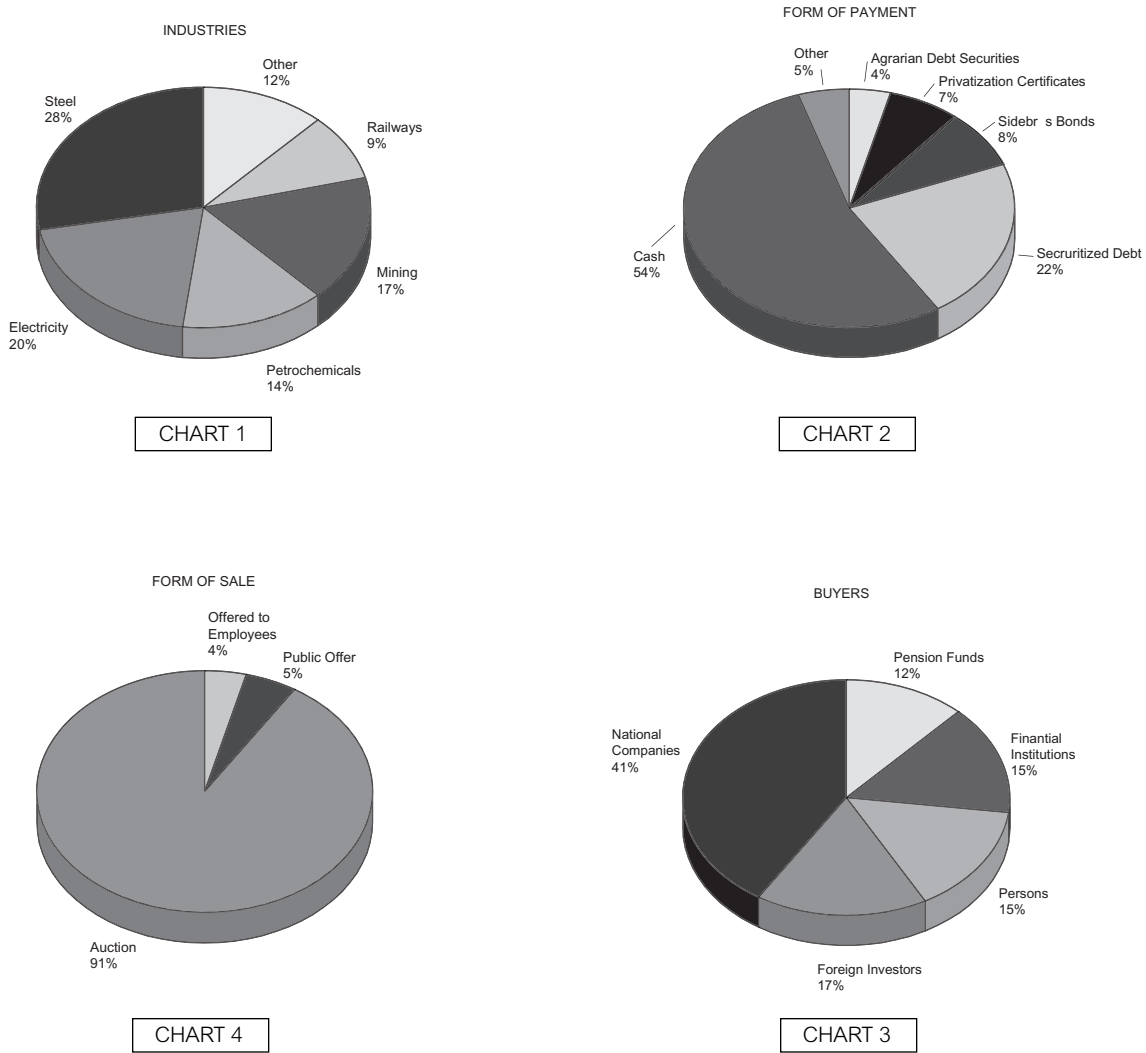


CHART 3

FIGURE 2
National Program of Desestatization, 1991–1998
Total Sales: US\$19.66 billion



With regard to the buyers, the third chart of Figure 2 (moving clockwise) shows that in the NPD, the participation of foreign investors has not been as large as in the total program, the reason being that they had taken the largest part of the Telecom program. Worth mentioning, for later reference, is that pension funds took 12 percent of the NPD. This represents democratization of capital, but its impact on income distribution is handicapped by the fact that the pension funds are mainly those of the workers of state enterprises who are privileged among other groups covered by pension schemes. In the fourth chart, the relevant information is that the public offer and the amount offered to employees have been minor initiatives, particularly since they have not been undertaken in the case of the Telecom program.

With respect to democratization of capital ownership, the conclusion is that the program allowed only minor room for it. When democratization of capital ownership did occur, it benefited the middle- and upper-class workers, such as those at the SOEs themselves who participated in the manager-employee buyouts and those covered by pension plans. In Brazil, sizable pension funds have emerged mainly in the realm of state enterprises, and it was the funds existing in these companies that took most of the share sold to pension funds.¹⁶

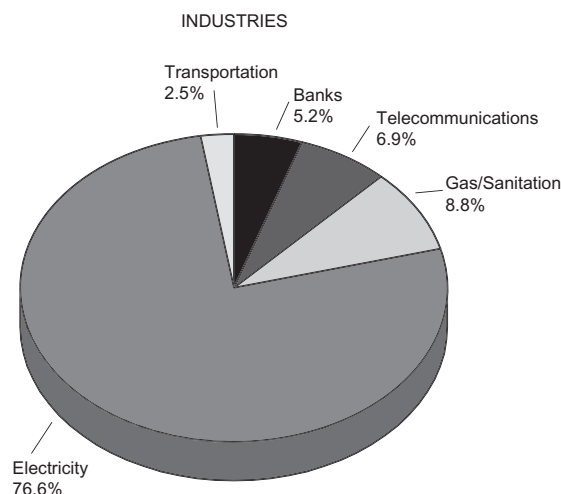
Even when privatized, these funds and their covered workers benefited from the privatization. Given the presence of unfunded pension liabilities, the value was discounted from the price for which the SOE enterprise was sold, so that in the end they moved from unfunded to funded pension plans. This is a gray side of privatization in Brazil: much is largely unknown to the public in general, and no precise account has yet been given of how much the government lost in the process of covering the funding implicit in the lower privatization price. A recent article in the press mentioned a figure around R\$10 billion in the case of the federal state enterprises which have been privatized in the last five years.¹⁷ In one of the interviews we arranged for gathering information for this paper, a fellow economist who works in the electricity industry called my attention to the case of Eletropaulo, a distributing company in the São Paulo area that was privatized in 1998. He said that the unfunded pension liabilities had cost the government around R\$2 billion. Since then, we have had the opportunity to look at data related to the auction of this company: while it had an estimated net asset value of R\$5.2 billion, it was sold for only R\$2 billion. Putting together these two pieces of information, it seems that the unfunded pension liabilities accounted for most of the difference.

This scheme of implicitly funding the pension plans of the privatized companies has another interesting aspect. Since the buyer assumes the responsibility for the funding by reducing the price offered for the company, he also has another opportunity to gain from the acquisition: he can negotiate new rules for the pension plans with the workers. These new rules are likely to go in the direction of the contention of benefits, since the new managers are profit maximizers and the workers lose political clout in the privatization. The case of CSN-Compania Siderúrgica Nacional (or National Steel Company) is illustrative of the gains obtained in restructuring the pension plan after privatization. According to its own president, after privatization the company reduced the unfunded pension liabilities (estimated at R\$450 million by the time of the privatization), by shifting 48 percent of their cost to the workers in the form of higher contributions and lower benefits.¹⁸ Thus, the privatized company also profited from the government's inability to negotiate a similar arrangement before privatization.

In sum, although the government has not shown major concern for the issue of democratization of capital ownership in the privatization process, some minor moves have occurred. These include manager-employee buyouts, the participation of pension funds in the auctions, and, implicitly, the coverage of unfunded pension liabilities since these resulted in lower prices for the enterprises sold. The benefits of this partial democratization of capital did not, however, reach the lower income groups, nor did the program open room for their participation in the process, despite their entitlements to government liabilities.

Figure 3 shows the share of each industry with respect to the privatization by the states, and reveals that electricity has by far been the dominant one.

FIGURE 3
Privatization by the States, 1996–1999
Total Sales in Auctions: US\$28.605 billion



The Impact of Privatization: Efficiency, Profitability, and Foreign Investment

There have been some major gains in efficiency and profitability. This section begins with an overall picture of the SOEs in the past, then moves to the impact of privatization, by means of some specific examples.

An overall evaluation of the performance of the federal SOEs in the period from 1981 to 1994 was done by Pinheiro and Giambiagi.¹⁹ Their findings show disappointing results by the SOEs, both in terms of profitability and of dividends received by the Treasury. Taking the whole period, the ratio of profits to net assets was, on average, a negative 2.5 percent, and the situation became worse at the end of the period, when this rate fell to minus 5.4 percent between 1988 and 1994. In the same period, taking into account only the major groups in mining, electricity, oil, and telecommunications, the ratio of profits to net assets was positive, but only 3.5 percent, although it did reach 11 percent between 1981 and 1994. Moreover, from 1988 to 1994, a period for which data on dividends are available, their total was only 0.4 percent of the total capital invested by the federal government in the SOEs.

One of the causes of this disappointing performance was the wage policies of the SOEs. We undertook a comprehensive analysis of wage differentials between private and SOEs in the mid-1980s, using surveys of wages and other characteristics of individual workers, based on forms that the Ministry of Labor requires of these firms every year.²⁰ In ten industries, we compared the wages of the workers in private and state-owned enterprises. After correcting for differences in education, age, gender, and experience, we found sizable differentials in favor of the SOE workers, reaching as high as 80 percent of the wage differential after controlling for the workers' characteristics. This occurred when the characteristics of the workers were valued according to the criteria of the private sector, as measured by the regression coefficients of the workers' characteristics in the wage equation of that sector.

Let us begin the discussion of the impact of privatization by looking at the case of CSN. This company is a landmark in the history of the Brazilian steel industry and of the state as an entrepreneur. It was the first large-scale steel mill in the country beginning its operations in 1946. It was also the first big company to be privatized, on the grounds that the government should begin the program with those enterprises that had first been brought under state ownership. As a symbol of the state intervention, its privatization also became symbolic of the new era. Its auction, in April 1993, attracted strong reaction from those opposed to privatization. Since CSN was one of the first companies to be privatized, a sufficient amount of time has passed to show results.

Table 4 shows that the trend of heavy losses and only minor investment was radically reversed after privatization. The data in Column 3 is very important, since it shows the balance of the flow of funds between the government and the state enterprise. This balance was also reversed after privatization in favor of the government.

TABLE 4: National Steel Company (CSN) Performance Before (B), During (D), and After (A) Privatization, 1985–1998 [R\$million at 1998 prices*]

YEAR	NET PROFIT	TAXES MINUS INCREASES IN CAPITAL MADE BY THE GOVERNMENT	INVESTMENTS
1985B	-2	117	0
1986B	-681	-91	149
1987B	-1,940	-480	162
1988B	-1,854	-942	91
1989B	-1,345	66	40
1990B	-2,530	66	12
1991D	46	-321	23
1992D	14	-471	43
1993A	0	84	0
1994A	279	202	138
1995A	144	242	233
1996A	298	401	394
1997A	457	346	513
1998A	464	486	513

Source: National Steel Company

Another success story is Embraer, producer of airplanes for both military and commercial use. The company started by producing light aircraft with propeller engines and has recently moved to jet models, in the 70–90 passengers range, with some international success. The company was created by technically competent people with the air force, but who lacked experience with

finance, management, and marketing. Those who bought Embraer thus profited from its technical know-how and corrected for its handicaps. Table 5 shows the company's improvements after privatization: its losses have been reversed, exports have risen, and it has an impressive amount of backlog orders for the years to come.

In a recent story aptly titled "The Beautiful Dividend of the Privatized Companies," it was reported that the ratio of dividend paid to share price (the dividend yield) of ten privatized companies in 1998 was well above 8 percent, the average paid by companies dominating the stock exchange.²¹ Moreover, the same ten companies produced the highest dividend yields among 48 companies surveyed by Economática, a consulting firm. The analysis revealed that the

TABLE 5: Embraer, Brazilian Company of Aeronautics Backlog Orders, Net Profit, and Exports after Privatization (1994) 1994–1998 (US \$million)

YEAR	BACKLOG ORDERS	NET PROFIT	EXPORTS
1994	729	-190	193
1995	647	-227	264
1996	1,227	-118	634
1997	3,011	-30	1,168
1998	4,100	109	...

Source: *Brazil Now*, May–June 1999, p. 7.

... data not available.

TABLE 6: The Highest Dividend Yields, 1998*

COMPANY (INDUSTRY)	DATE OF PRIVATIZATION	DIVIDEND YIELD** IN %
Fosfertil (fertilizers)	August, 1992	38.19
Usiminas (steel)	October, 1991	30.03
Vale do Rio Doce (mining)	May, 1997	28.02
Politeno (petrochemicals)	August, 1994	27.27
Siderúrgica Tubarão (steel)	July, 1992	26.78
Polialden	August, 1994	24.17
Copesul (petrochemicals)	May, 1992	22.75
Light (electricity)	May, 1996	22.63
Coelba (electricity)	July, 1997	20.80
CRT	June, 1998	18.94

Source: Economática, as published by *Gazeta Mercantil* (October 6th, 1999).

* Highest rates among 48 companies surveyed.

** Ratio of dividend to capital, paid in the year, taking into account the last share price in the stock exchange in the same year. Includes interest to own capital.

increase in dividends paid follows a cycle in which the company first invests resources in the privatization and then in its adjustment and growth. In this phase, the company requires a lot of capital and restricts the distribution of earnings. Only thereafter, when the results of the previous investments and of the adjustments are realized, is it able to pay larger dividends to its shareholders. Table 6 reveals the sizable dividend yields paid by the ten companies as reported by the story.

What we have presented thus far have been random success stories. The conclusions cannot be generalized for the large number of SOEs already privatized, except to point out that failures did not come out in our random sampling. One significant study by Pinheiro, concluded in late 1996, which is the most technically solid and comprehensive produced thus far, analyzes the performance of 50 former SOEs before and after privatization. It uses a methodology that has been adopted by other studies directed at evaluating the change in performance of the firms following privatization.²² For the large number of firms in his sample, Pinheiro obtained data for periods covering one to four years before and after privatization and did not take into account the data of the year when the sale became effective, as the change of control occurred within that year.

The study covered eight variables: net sales, net profit, net assets, investment, fixed investment, number of employees, debt, and an index of liquidity. From these variables, six others were derived to measure efficiency (sales and profit by employee), the rate of return (profit to sales and to net assets), and the propensity to invest (investment to sales and to assets). Pinheiro separated the companies that were privatized in the 1980s from those sold thereafter, and the number of observations ranged from 29 to 46, depending on the variable (14 to 19 in the first period, and 11 to 27 in the second).²³

The conclusion was that:

in general, the obtained results confirm that privatization brings a significant improvement . . . of the performance of the firms. Thus, for most of the variables, the null hypothesis of no change in behavior is rejected in favor of the alternative hypotheses that privatization increases the production, the efficiency, the profitability and the propensity to invest, reduces employment and improve the financial indicators of the firms.

A number of conclusions reached by Pinheiro should be noted. First, the improvements are stronger when there is a change of control than when only a minority participation was sold, thus confirming that the change in property brings more incentives to managers and workers. Second, the improvements are also stronger for the companies that have been privatized more recently, thus showing that the results are better when combined with other policies, such as liberalization of the economy, positive interest rates, and reduced access to Treasury resources. Third, the reduction in employment was sizable (particularly for the privatization of the nineties): 48 percent, on the average; 27 percent in the case of production workers. This confirms the hypothesized practice of overstaffing presented in Section Two. Finally, some of the improvements occurred when the firms were prepared for privatization, thus showing that when there is political will the management of the SOEs can be improved. The problem was that this political will was not present in the past, nor could it be guaranteed for the future, or under other governments.

Thus, from the point of view of bringing more efficiency, profitability, and better financial indicators to the privatized firms, the program has been a success. Of course, an analysis such as

the one developed by Pinheiro is needed for the privatization of the late 1990s, as well as continued monitoring of the former SOEs to follow their future developments.

Higher profitability could have been achieved alone by higher prices at the expense of the consumer in concentrated markets, without an increase in efficiency in the managerial and technical sense. However, as a rule this has not been the case. Companies such as CSN, Embraer, Usiminas, Siderúrgica Tubarão, and Vale do Rio Doce also operate in international markets where they have no role as price setters. Moreover, the country has been opened to import competition, which was particularly enhanced by an overvalued exchange rate from 1994 to early 1999.

Foreign investors are a major part of the new owners of the privatized companies. As far as asset distribution is concerned, this means that a larger part of the capital stock of the economy now belongs to foreigners. As for income distribution, now there must be greater attention to foreign investors, since they will get a larger share of income. An alternative procedure would be to limit the discussion to the national income alone.

Table 7 shows that foreign direct investment increased sharply in 1997 and 1998, in large part as the result of the privatization program. As we have seen, it was in these two years that a major component of the program, the telecommunications sector, was pushed ahead, and it was in this program that there was strong foreign participation. The table also shows that the share of foreign direct investment that was used to buy existing firms (as in the case of the privatization program) sharply increased in 1997 and 1998. The result of the larger investments has been the sharp growth of the remittances abroad (as profits and dividends) by foreign investors, as revealed in the last column of the table.

These remittances are placing the disequilibrium in the external accounts under further strain, as measured by the current account balance. It is also likely that they will increase further in the future as foreign investors follow the above mentioned cycle in which a period of capitalization of the companies is followed by another in which the emphasis is on receiving earnings. Since it is companies that produce non-tradable services, such as energy and telecommunications, that have attracted the greatest investment, the tradables sector will suffer more strain.

TABLE 7: Foreign Investments in Brazil
Total, for the Acquisition of Existing Firms, and Remittances Abroad, 1993–1997

Year	Total US\$ billion (A)	For Acquisition of Existing Firms (US\$ billion) (B)	[(B)/(A)]%	Remittances Abroad (US\$ billion)
1994	2.1	0.008	0.38	2.5
1995	5.5	1.5	27.3	2.6
1996	10.5	3.1	29.5	2.4
1997	18.7	10.4	55.5	5.6
1998	28.7	21.3	74.1	7.2

Source: SOBEET (Brazilian Society for the Study of Transnational Companies), Central Bank and *Conjuntura Econômica*, as published by *Folha de São Paulo* (October 3, 1999).

Financing

One criticism that has been directed at the financing of the program is that in some cases the buyers of a SOE have received loans from BNDES at favored rates. This has occurred in the case of the electric companies auctioned by state governments and also in the federal area when some groups interested in the Telecom program had access to the BNDES resources. The government has denied the allegations that a subsidy is implicit in the lower-than-market interest rates charged by the bank, on the grounds that the BNDES is the only domestic source of long-term financing, and cannot be compared to external markets offering short-term financing. The government argues, moreover, that the BNDES resources come mainly from marked funds, such as those whose interest costs are below the lending rate for all borrowers, not just participants in the privatization program. Regardless of whether this fits a strict definition of subsidy, it is clearly a favored scheme. Again, as in the access to the efficiency gains that come with privatization, there is the question of access to the opportunity of profiting from a scheme of this sort, one which is not open to everyone, in general, and to the poorest groups, in particular. The conclusion is that these loans at favored rates also aggravate inequality.

In this section we have discussed some of the hypotheses presented in Table 2: the main point is that privatization made the companies more efficient and that their higher profits are bringing more tax revenues to the government. The privatization program can thus be rated a success in terms of gains in efficiency and profits. The same cannot be said, however, of its impact on income distribution, since this opportunity to gain has been limited to Brazilian and foreign capitalists. Even when democratization of capital ownership was found in the process, it has been a minor component and, again, to the benefit of those already relatively well off. Alternatives that could have improved asset and income inequality, such as the funding of the pension liabilities of workers linked to the National Social Security and Welfare System (INSS) and the use of the deposits of the Workers' Tenure Guarantee Fund (FGTS), in forming funds for the privatization process, have not been adopted. Other income and asset gains, such as those in the trade of the "rotten money" used in the process and the loans at favored rates, have also gone to the wealthy. Thus, the privatization process has led to increased asset and income inequality.

In the medium and long term, there is room for some alleviation of this problem. This depends on how the government uses the increases in tax collections brought about by privatization to expand social expenditures targeted to the poorest groups.²⁴ Moreover, there are still some companies to be privatized and they could be used to redeem social security and welfare liabilities in such a way as to reduce asset and income inequality.

We will now turn to examining another objective of the program: the use of revenue from privatization to reduce debt. This had the potential to lower interest rates, with a favorable impact on income distribution.

3. THE FISCAL CRISIS AND THE EXTERNAL DISEQUILIBRIUM

The Political Background

The Brazilian economy entered the 1990s with serious macroeconomic problems. Inflation was aggravated in the second half of the 1980s following the erratic policies of the Sarney

government (1985–1990), the first civilian administration after two decades of military rule. The 1980s have been named the “lost decade,” with no significant growth in GDP per capita, as the country found no substitute for the import substitution and government-led growth model that collapsed in the mid-1970s. There was a reoccurrence of large deficits in public finances, financed in part by printing money and exacerbated by populist and corporatist policies that resurfaced with the redemocratization of the country. Inflation, compounded by a widespread system of indexation, skyrocketed and peaked at 84 percent in March 1990, when the Collor government (1990–1992) was inaugurated. Collor’s administration also inherited a serious deadlock in the area of external financing, with roots in the “debt crisis” of the early 1980s, as Sarney had resorted to a debt-repayment moratorium at the end of his term.

Faced with an almost chaotic situation, Collor resorted to harsh measures. Inflation was forcefully reduced by a price freeze, and the deficit and the money supply by a confiscation of financial assets tantamount to compulsory lending to the government for an extended term (18 months) at an interest rate of 6 percent, much lower than the 20 percent previously offered by the Treasury on short-term loans.²⁵ Collor also introduced the liberalization policies which have been in practice until today, particularly in the trade area, by reducing tariffs and eliminating other trade barriers, and by starting in 1991 the already mentioned NPD.

Collor was impeached in 1992 for personal wrongdoing, not for his policies. When he left, his liberalization advances were firmly entrenched and had been pushed forward by unfreezing prices and by the elimination of most price controls, including the dismantling of most of the bureaucracy in charge of them. President Itamar Franco (1992–1995) benefited from the adjustments made by Collor, who had also renewed debt service and negotiations with foreign creditors, and by a recovery of the economy following these and other adjustments. Franco was never fond of liberal policies in general, nor of privatization, in particular, and now, as the governor of the state of Minas Gerais, is trying to push back the partial privatization of his state electric company. During his term, the NPD lost speed, but not direction.

As president, Franco’s major concern was inflation, which had been fueled again by fiscal and monetary factors, and by the indexation system. Its monthly rate had reached the two digit level, coming close to 40 percent a month in early 1994, and had to be attacked again, this time by the Real Plan, which was and still is a success in bringing stabilization. It was followed by a consumption boom that lasted until 1997 and that made the government and Finance Minister Cardoso so popular that the latter was elected president in 1994, for a four-year term. Under Cardoso, liberal ideas reigned again and privatization was loudly announced as a means of contributing to the adjustment of the fiscal crisis. High deficits resurfaced again in 1995, following the high interest rates that were supporting the new currency and a spending spree by Franco at the end of his term. Moreover, the government had to deal with chronic deficits in the social security system and the disarray of public finances in the state and local governments as well. Although not an explicit objective, the privatization program was also assigned the role of financing a major part of the external disequilibrium, by means of the foreign direct investment it was to attract.

The good intentions did not pay off. Privatization was intended to help the fiscal crisis and the external imbalance. But the government (for other reasons) lost its direction and the intended positive impact disappeared in the middle of major negative moves. First, it played the

game of reelection, and pushed a constitutional amendment in Congress to allow President Cardoso to be reelected, a move that harmed the fiscal adjustment in 1996 and 1997 since the government had to engage in pork-barrel politics to approve it. Second, since its prestige was linked to price stabilization, the government was afraid of the impact of devaluation on prices and started to defend the real, which became overvalued immediately after its release. It was initially set equal to US\$1.00, but soon came down close to R\$0.80 to the dollar.²⁶ The setting of a very high interest rate was the major tool used to defend the real.

These developments had the effect of aggravating both the fiscal crisis and the external imbalance. In fiscal accounts, the impact was manifested by deficits in the so-called primary result (which excludes the payment of interest and therefore reflects more genuinely the fiscal policy of the government), and also in the nominal result (which includes interest on the debt). In the external sector, the overvalued exchange rate led both to a deteriorating trade balance and to the worsening of the current account balance, in this case due to the higher interest payments and to the sharp expansion of foreign travel, among other major items.

Impact on the Fiscal Crisis

Let us now show data that illustrate these points. Table 8, which covers the public sector finances, and Table 9, which shows data on the external accounts, reveal several aspects of the worsening of the macroeconomic scenario, which became particularly serious in 1997 and 1998. As is shown, the aggravation coincided with the peak of privatization program.

TABLE 8: Public Sector Results, Interest Paid and Debt, 1991–1998

YEAR	PRIMARY RESULT AS % OF GDP	OPERATIONAL RESULT AS % OF GDP	INTEREST ON DEBT (IN R\$ BILLION)	INTEREST ON DEBT AS % OF GDP	NET PUBLIC DEBT (IN R\$ BILLION)	NET PUBLIC DEBT AS % OF GDP
1991	2.8	-1.4	...	...	...	37.9
1992	2.3	-2.2	...	...	...	37.2
1993	2.7	0.3	...	...	...	33.0
1994	5.3	1.4	...	...	...	29.2
1995	0.4	-4.9	...	...	...	30.5
1996	-0.1	-3.8	46.4	5.8	269.2	33.3
1997	-1.0	-4.3	45.6	5.1	308.4	34.5
1998	0.0	-7.5	73.1	8.1	385.9	42.4
1999*	3.2	-9.4	89.8	18.4	495.3	49.5

Source: Secretary of National Treasury, Minister of Finance.

* Until June.

... Data not relevant to the arguments developed in the paper and whose inclusion would require correction for inflation of the figures in R\$, not important from 1996 to 1998.

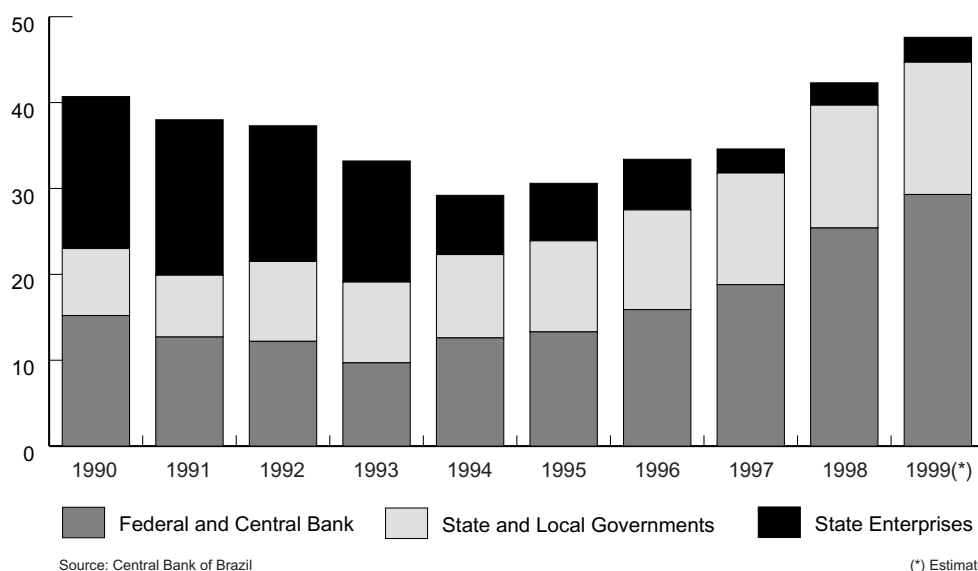
Table 8 shows that the fiscal side had improved from 1991 until 1994, when there was a large primary surplus as well as an operational surplus, the latter concept reflecting the nominal deficit, inclusive of interest paid, but net of the effect of indexation. Notice that the primary surplus practically disappeared in 1995: this led to a serious reversal of the operational result. The net public debt as share of GDP also came down in the early 1990s. From 1995 to 1997, the fiscal result became negative and the operational deficit remained high, being seriously aggravated in 1998 and 1999 because of higher interest on a growing debt. From 1994 to 1999, the net public debt as percentage of GDP increased sharply—from around 30 percent to close to 50 percent, with most of the increase occurring in the last two years. The very high values of the debt and interest in the first semester of 1999 occurred because of the devaluation, since part of the debt is in dollars and the devaluation is counted as nominal interest.

Notice, in particular, that the increase in debt from 1997 to 1998, that is, R\$77.5 billion, or roughly US\$65 billion at the prevailing exchange rate is equal to 73 percent of the total value obtained from the privatization (US\$88 billion). Looking also at the growth of the debt before and after, the unfortunate and inescapable conclusion is that the contribution of the whole program to the adjustment of the public sector finances was lost since their conditions were seriously aggravated by higher deficits and debt. To put it simply: the money from privatization went down the drain in the disarray of public finances.

A counter argument that could be raised is that without the privatization the fiscal crisis would be even worse. To this, we can respond by saying that the privatization has somehow relieved the hard budget constraint of the government. As the budget constraint became the sum of tax receipts plus debt plus privatization resources, there was more room to expand expenditures, including interest, and the government has shown its adherence to Kornai's concept of soft budget constraints, typical of centralized governments whose budgets are only vaguely, if at all, monitored or controlled by Congress and society.²⁷ Without privatization, the debt would have increased even more and in the end would have faced restrictions from the financial markets. It does not follow, therefore, that without privatization the fiscal crisis would be even worse.

Our argument can be further explained with the help of Figure 4. It shows the public sector net debt as a percentage of GDP (from 1990 to 1999), broken down by the shares of the federal government inclusive of Central Bank, the state and local governments, and the state enterprises. Notice, in particular, the reduction in the share of the state enterprises following the adjustments of the SOEs for privatization and the program itself, and the increase of the total debt and the growth of the shares of the federal and state and local governments. In the chart, the reduction of the black part of the columns (state enterprises) opens the way for the increase of the gray parts (federal, state and local governments). Without privatization, including restructuring of the SOEs, and assuming a constant share of GDP for the debt owed by them, total debt would have reached not 49.5 percent but 66.5 percent of GDP at the end of the period, plus the reduction in the government debt achieved by the program. This would have been unsustainable given the conditions of the financial markets. Thus, privatization really did relax the hard budget constraint of the government, or at least made it softer by reducing the SOEs' debt, since otherwise the other part of the total debt owed by the government could not have increased as it did.

FIGURE 4
Public Sector Net Debt as % of GDP
 December Balances, 1990–1999



The External Imbalance

The external imbalance is related to the fiscal disequilibrium since the high interest rates to defend the real compounded the fiscal deficit and debt. Table 9 reveals a dramatic worsening of the picture from 1994 to 1998 for all variables except international reserves, which increased between 1994 and 1996 and decreased thereafter. With the 1999 devaluation, the disequilibrium was reduced, except in the case of interest payments. (Note that the 1999 figures cover the first semester only. The higher interest payments in this semester reflect the higher debt and the reduction in interest receipts due to the loss of reserves).

That the interest rate was used to defend the real is clear from Figure 5, which covers the period September 1997 to September 1999. As international reserves began to fall at the end of 1997 due to the “speculative attack” that followed the crisis in the countries of Southeast Asia, the government raised the basic interest rate from around 20 percent to about 45 percent, as shown in the bottom part of the chart. The result was a recovery of reserves which came to renewed pressure in the third quarter of 1998, this time due to the crisis in Russia. The government tried again to reduce the loss of reserves by increasing the interest rate, this time without success. Devaluation became inevitable, but the interest rate increased anyway to contain the overshooting of the exchange rate, which reached R\$2.14 in February. The increase in reserves in April 1999 reflects the effect of the IMF rescue package.

Figure 6, which covers the flow of foreign resources 1994 to 1999, also demonstrates the increased exposure of Brazil to financial globalization. As expected, foreign direct investment came to stay, with repatriation representing less than 10 percent of the total inflow. Short-run money, in the form of financial investments, came only to profit from the high interest rates and

TABLE 9: External Accounts, 1990–1999 (US \$million)

YEAR	TRADE BALANCE	CURRENT ACCOUNT BALANCE	NET EXTERNAL DEBT	INTERNATIONAL RESERVES	NET INTEREST PAYMENTS
1990	10,753	-3,782	86,753	9,973	-9,748
1991	10,579	-1,407	83,590	9,406	-8,621
1992	15,308	6,144	87,081	23,754	-7,253
1993	12,938	-592	82,059	32,211	-8,280
1994	10,440	-1,689	80,862	38,806	-6,338
1995	-3,158	-17,972	77,473	51,840	-8,158
1996	-5,554	-24,347	83,982	60,110	-9,840
1997	-8,357	-33,054	115,587	52,173	-10,391
1998	-6,484	-34,981	166,096	44,556	-11,947
1999*	-524	-13,830	...	42,156	-8,644

Source: Central Bank.

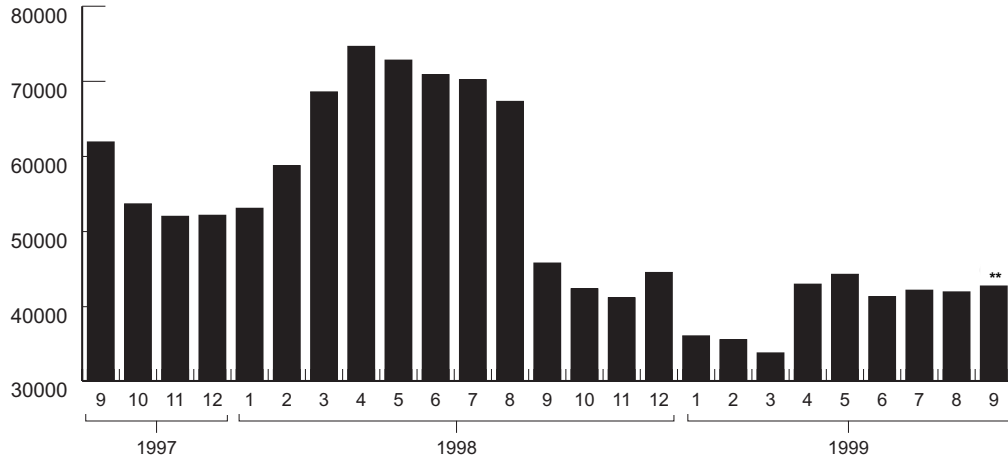
* Until July.

only roughly 10 percent of the total inflows remained at the end of the period. External debt increased by R\$84 billion and, together with foreign direct investment, actually financed the external disequilibrium. Privatization brought foreign direct investment as expected, but as in the case of the fiscal crisis, its contribution was overshadowed by the misguided macroeconomic policies of the period.

In the same way that privatization softened the hard fiscal budget constraint, the foreign direct investment that followed privatization also relieved the external constraint, as it allowed the financing of higher current account deficits. Although this is usually considered a positive consequence, it can also be viewed as negative, in the sense that it postponed adjustment in the form of devaluation. Interestingly enough, the devaluation of early 1999 came after the wave of the Telecom privatization program in 1998, in which the presence of foreign direct investments was stronger. These investments were seen by the market as a sign that the government could hold on to the overvalued real. Thus, if the privatization program had proceeded with full force, a likely outcome is that overvaluation could have been further extended; since the program came to a halt, devaluation came sooner.

FIGURE 5

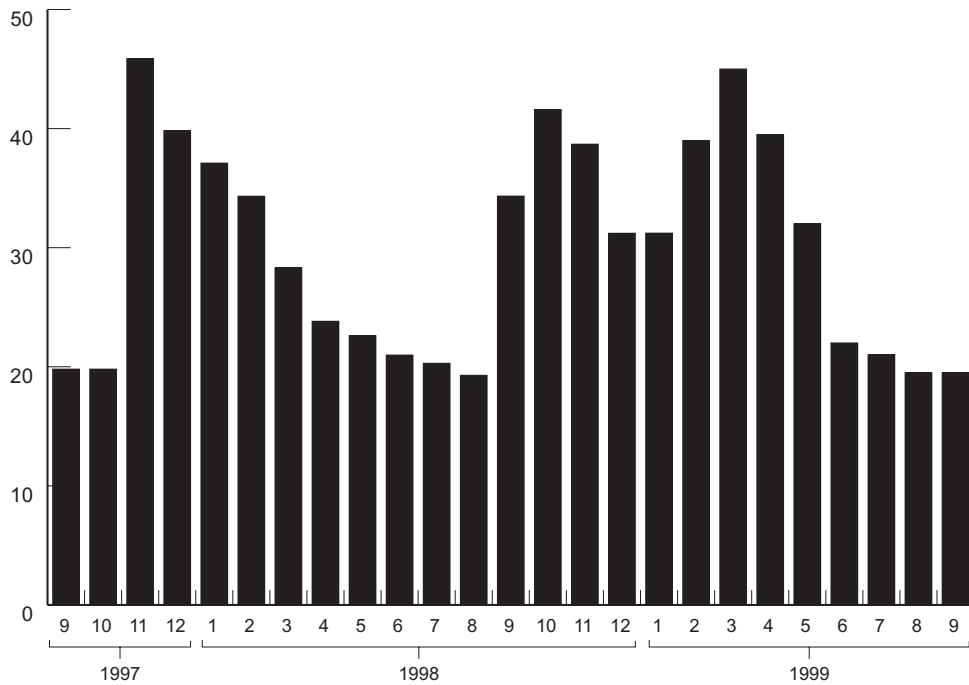
**International Reserves,* 1997–1999
(US\$ million)**



* International liquidity concept
** Estimate

CHART 1

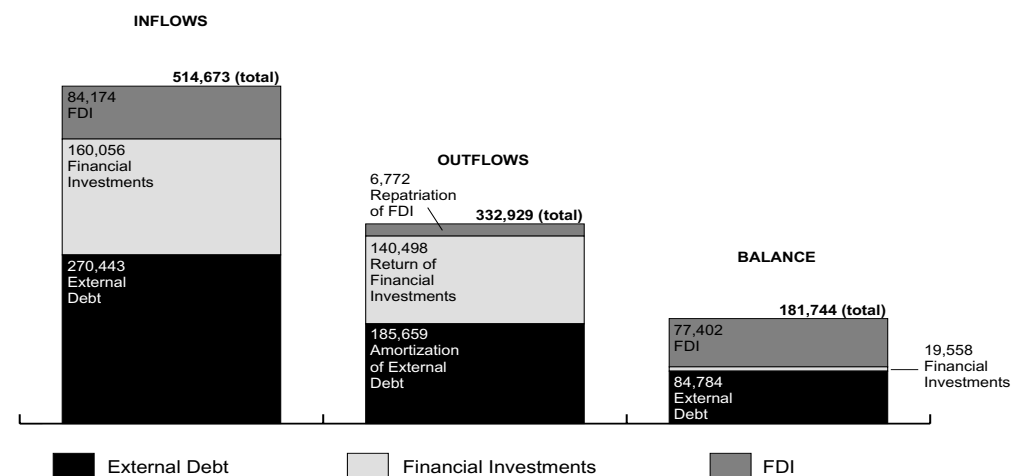
**Interest Rate,* 1997–1999
(% per annum)**



Source: Central Bank of Brazil
* SELIC rate per annum at the beginning of each month based on daily rate and 252 days.

CHART 2

FIGURE 6
Flow of Foreign Resources, 1994–1999 (until July)
 (US\$ million)



Source: Banco Bilbao Vizcaya, Working Paper by Octavio de Barros, Folha de S. Paulo (8-22-99)

4. THE IMPACT ON ASSET AND INCOME DISTRIBUTION AND OTHER CONCLUSIONS

With one exception, the consequences and hypothesis listed in the analytical framework of Table 2 and marked with an (*) have been confirmed by the characteristics of the Brazilian privatization program, as presented in this paper. The exception occurred in the case of the last hypothesis listed in the table, namely, that the program would reduce debt, opening room for lower interest rates which would have a positive impact on income distribution. Because the program has been developed in a context of macroeconomic policies that have aggravated fiscal crisis and external disequilibrium, this has not occurred. Worse yet, by providing additional resources for the government, the program has contributed to softening the hard fiscal budget constraint and to delaying the adjustment of the external sector as it brought inflows of foreign resources that helped in defending the real.

However complex this combination of privatization, fiscal crisis, and external imbalance might be, the conclusion with regard to income distribution is straightforward. The poorest people did not have access to the immediate gains from privatization, did not see their pension and welfare liabilities covered in the process, and have not gained from the high interest rates that came in the wave of the fiscal crisis-cum-overvaluation. The government has shown no firm

commitment to democratizing capital ownership, an objective that was initially set for the privatization program, but that was never forcefully pursued.

The unraveling of this complex combination of events goes well beyond this. At the start of this paper, we were primarily concerned with the impact of the changes in asset and income distribution that follow a privatization process. But when privatization is carried out in a context of aggravated fiscal crisis and external disequilibrium, a major consequence of which is a sharp increase in the public debt, the intended positive impact of the privatization on the fiscal side is nullified. Public assets have, as a result, been sacrificed in the privatization process, and in the end the liabilities of the society in general have sharply increased. Returning to our “Chapter 11” metaphor, the situation can be compared to a firm that sells assets to cover liabilities, but rather than the liabilities being diminished, they are instead increased. These increased liabilities, with the interest that accrue to them, constitute an enormous, serious, and lasting problem.

Since the budget is now showing again a primary result, taxes are being used to pay at least a part of the interest bill. Moreover, as tax receipts have increased and indirect taxes respond for the largest share of taxes in Brazil, the poorest will bear a relatively high share of the burden. In any case, the largest part of the increased liabilities, plus interest, on income distribution, will not be felt immediately, since the government debt and interest simply piles up. Thus, except for part of the interest bill, the burden of the enlarged debt is not distributed and will be left for generations to come.

We can speculate about who will more likely suffer the burden in the future. If the larger debt is to be serviced by taxes and if the regressive tax system is maintained, the poorest will bear a disproportionate share. In the short run, the effects of the larger liabilities, even of the interest bill actually paid, might not appear or will come up only marginally in the income distribution statistics of the Census Bureau. Foreign capitalists do not fill out the Brazilian census questionnaires, and domestic owners of government debt might hide or understate the increase in their interest income, given that compounded interest on their government securities is not necessarily viewed as disposable income. Many people confuse compounded interest with indexation, since in the past it was difficult to separate one thing from another. Moreover, since part of the gains accrue to banks and companies, the profits might not be distributed, and therefore would not reveal themselves as personal income. Thus, asset and income distribution is being aggravated, but it will not necessarily be revealed by the collected income data and the inequality indices based on them.

In contrast with the poorest groups, some middle-class groups and rich Brazilians, together with foreigners, have reaped most of the gains that have emerged from the opportunities opened by privatization; they have also gained from the disarray in public finances and in the external sector that led to advantages for the owners of financial capital. However minor, some alleviation of these distortions can be made if the resources raised by the government (by taxing the increased profits of the privatized companies) are used in social expenditures targeted to the poorest groups. These groups will also benefit by the increased efficiency of the former SOEs, if this leads to lower prices and increased investment. Since most of them operate in concentrated markets, their efficiency and their prices should be closely monitored, together with their ability to promote investment, all of which contribute to the growth of the economy. With privatization, Brazil is seeking a new engine of growth, and the work of it will be crucial for

generating employment and income for the poorest groups. Moreover, since there are still some firms to be privatized, the government will have another opportunity to use these assets to democratize capital ownership and to improve asset and income distribution.

The need for resources that has arisen from the fiscal crisis and from the external imbalance has been used by government officers to neglect democratization of capital, in general, and asset and income redistribution, in particular. Other excuses have also been presented, such as the fact that the redemption of social security and welfare liabilities would have required time-consuming and politically difficult changes in legislation, even in the Constitution.

Changes would have included: a new social security system parallel to INSS, in the form of private pension funds covering formal-sector workers and public servants; the transfer of liabilities from one system to another; an end to the existing guarantee of fixed benefits; and a reform of the legislation of capital markets, in the areas of corporate governance, in general, and rights of minority shareholders, in particular. Another difficulty would have been to calculate the balances owed individually to those entitled to the social security and welfare liabilities. This would have required the action of other ministries not linked to the privatization program, such as the Ministry of Welfare and Social Security, as well as a coordination among the various branches of the government that has not yet taken place. These obstacles are impressive, but the major reason that a different course of action was not taken is that a genuine concern with the idea of democratizing capital ownership has not existed either at the bottom or at the top of the government hierarchy. The privatization program has had many other obstacles, but they have been overcome because there was, at least until 1998, a strong commitment to the idea. Only now, that most of the major SOEs have undergone privatization, is the idea of democratizing capital ownership resurfacing again in some areas of the government, in the weaker form of large scale flotations.

One cannot underestimate the major difficulties that lie ahead if another course of action were to be taken, as suggested by this paper. These difficulties could involve the problems of large-scale flotations of the British type and of the mass privatization efforts undertaken in transition economies, as well as those typical of the Brazilian institutions and of the expectations of the country's citizens. Many Brazilians are not familiar with the institutions of modern capitalism, such as shareholding, pension funds, and capital markets, and have shown an enormous resistance to moving from state-guaranteed fixed benefits to variable ones, either in social security and welfare or financial markets, which have been indexed because of high inflation.

Both the pensions of the INSS and the FGTS deposits have been accordingly indexed, the latter plus interest. Would the citizens be willing to move into the riskier realm of share or fund holdings, voluntarily buying shares in large-scale flotations? Would they accept politically the exchange of the liabilities that the INSS and the FGTS owe to them for shareholding or fund participation? Would efficient management of the former SOEs be guaranteed? How to avoid having the control of these enterprises fall into the hands of the groups referred to by Nellis (1999) as the "resourceful, agile and well-connected," as was typical of the privatization in many transition economies?

In spite of all these difficulties, we insist that the alternative route suggested in this paper, or others along the same line, should have been tried and must be given a chance for what remains to be privatized in Brazil. This would create a new model—to compete with the one developed

thus far in a dispute that is stimulating to both and that is healthy for the economy. It would bring to the forefront a discussion of neglected issues, such as democratizing capital ownership, reform of capital markets, and popularization of pension funds, which we see as crucial for changing the asset distribution that is at the root of high income inequality.

This alternative course is full of obstacles, but if bold measures are not undertaken now no relevant changes will be made, and in the future we will continue to discuss marginal changes in the Gini coefficient when the relevant issue is its shameful size. Governments are judged not only for what they accomplish, but also for what they attempt, since this allows them at least a face-saving alternative. At this moment, the government has no alternative to offer, not even one to save its blushing face.

NOTES

- ¹ PNAD (National Household Survey), 1998. Cited in *Folha de São Paulo*, December 1, 1999.
- ² For a review of this debate, see Macedo 1977.
- ³ As a rule, the poorest groups in Brazil have no access to the mechanisms available to the middle class and the wealthy to protect the purchasing power of money holdings, such as indexed checking and savings accounts.
- ⁴ Inequality was slightly reduced from 1993 to 1998, as the Gini coefficient fell from 0.60 to 0.575.
- ⁵ Law 9491, of September 9, 1997, is the most recent version.
- ⁶ To countervail this power, the government created national regulatory agencies: ANP-Agência Nacional do Petróleo, in the petroleum industry, ANEL-Agência Nacional de Energia Elétrica, in the case of electricity, and ANATEL-Agência Nacional de Telecomunicações, in the area of telecommunications. They are still in their early stages, but a traditional question in industrial organization is to check for biases in their regulatory practices.
- ⁷ At the moment, however, it seems that the government is considering this alternative, since the press has repeatedly reported on the idea of “pulverização,” or scattering of property that is being discussed in government circles. See, for instance, *Veja*, November 3, 1999).
- ⁸ As will be detailed in the next section, the pension liabilities of the state-owned enterprises have had an impact on the privatization process, by reducing the sale price of the privatized companies, as the buyers have assumed the responsibility for their funding. This can be considered a bonus for the workers of these companies, an issue largely ignored in the process. The existence of these unfunded pension liabilities in the SOEs can also be viewed as a result of their lack of adherence to the profit maximization rule, since the private sector has avoided them.
- ⁹ In a recent interview, José Genoíno, the Congressman who received more votes in the last election, and a major figure of the Worker’s Party, recognized this. See *Jornal do Economista*, January, 2000.
- ¹⁰ Both are long-term securities sold at below par values in the market and which became known in the privatization process as “rotten money.” As demand for these securities increased, their owners had a capital gain or a recovery of capital loss. Those who bought these securities to be used in the privatization process at a par value, have had a capital gain. These are changes in property of assets followed by capital gains or losses, and therefore also have an impact on asset and income distribution.
- ¹¹ The FGTS balances have been used by the government’s CEF, a savings and loan bank, to finance public sector projects in areas such as sanitation, on a long-term basis. Thus, the FGTS deposits are not an unfunded liability, but the loans are long term and difficult to recover.
- ¹² Some major state banks, such as those of the states of Minas and Rio de Janeiro, have already been privatized. The largest one, Banespa, formerly owned by the state of São Paulo, has been federalized and its privatization is scheduled for the year 2000. The federal government has a commercial bank, Banco do Brasil, and a savings and loans institution, CEF, which are at the end of the line, if they will ever be privatized. The government participation in the petroleum industry includes production, importing, and refining and it is dominated by a monopoly (Petrobrás), with a minority participation of private shareholders. It will also be at the end of the program, at a date not yet established, since even the decision to privatize it has not yet been taken. In any case, the monopoly rule has been broken recently and Petrobrás is likely to be exposed to increasing competition in the years to come.
- ¹³ In Portuguese, the name is Programa Nacional de Desestatização. This last word is more general than privatization, as, in principle, any non-governmental entity can qualify as buyer.
- ¹⁴ Unless otherwise stated, the BNDES (National Bank for Economic and Social Development) is the source of all data presented in this paper on the privatization program, including the part developed at the state level. The reports and other documents used as references in this paper are listed in the references as BNDES 1999a and 1999b.

- ¹⁵ Another reason for the current stalemate is that the program was supposed to make further advances in the electricity industry, but this is a very complicated industry from the institutional point of view, as it involves producers and distributors in various companies, some of them owned by state governments. Moreover, to further advance the program would also involve moving into industries such as oil and federal banks, where the opposition is fierce, as it includes strongholds such as Petrobrás and Banco do Brasil.
- ¹⁶ For instance, a major player among pension funds which have participated in the process has been PREVI, the pension fund of Banco do Brasil. It is also the largest pension fund in the country.
- ¹⁷ Suely Caldas, "Fundos de pensão dão prejuízo bilionário ao País," *O Estado de São Paulo*, October 11, 1999. In dollars, this total would be roughly equivalent to US\$8 billion, using the average exchange rate in the same period.
- ¹⁸ Also noted by Suely Caldas, see n. 16.
- ¹⁹ Pinheiro and Giambiagi 1997.
- ²⁰ Macedo 1985.
- ²¹ Gazeta Mercantil on 8 October 1999
- ²² See Pinheiro 1996. Cited is Meggison et al. 1994, which makes use of a methodology that includes the sign test and the Wilcoxon Signed Rank Test. According to Pinheiro, "the first measures the proportion of firms that have shown changes in the expected direction, while the second adjusts this measure taking into account the size of the change. ... In both cases, what is being tested is whether there has been a change in performance by comparing the arithmetic average of the variables before and after privatization" (p. 365).
- ²³ Pinheiro's analysis did not address the effects on top executives, but taking into account that 115 SOEs were privatized from 1991 to 1998, with an average of 10 directors per company, this means that 1150 directors ceased to be appointed largely by political criteria, not to mention managers, secretaries, and others chosen in the same fashion. Another important area offering room for increased efficiency by the private sector is the management of advertising expenditures. These expenditures in the SOEs have been an important source of political patronage, as in the cases of careless support of cultural events and sports competitions and teams. Moreover, the patronage often goes directly into the political process, such as when an advertising firm that gets a SOE account provides expertise and resources for candidates favored by the government.
- ²⁴ Interestingly enough, the recently elected President of Argentina, Fernando de la Rúa, said immediately after election said that he plans to increase taxation of the privatized companies (*Folha de São Paulo*, October 26, 1999).
- ²⁵ A squeeze of salaries and pensions in the federal government was also adopted, by not giving them the usual full indexation on account of past inflation.
- ²⁶ Overvaluation became the rule for four and one-half additional years. By the time the real was finally devalued, in January 1999, the exchange rate was only R\$ 1.20 to the dollar, against an inflation which then reached an accumulated rate around 70 percent since the real had started at parity level in July 1994.
- ²⁷ For the concept of soft budget constraints, see Kornai (1979).

REFERENCES

- BNDES (Banco Nacional de Desenvolvimento Econômico e Social). 1999a. *Privatizações no Brasil – 1991/99*. Rio de Janeiro: BNDES, Secretaria Geral de Apoio à Desestatização.
- BNDES, 1999b. *Sistema de Informações*. Rio de Janeiro: BNDES.
- Kornai, J. 1979. "Resource vs. Demand-Oriented Systems." *Econometrica* v. 47.
- Macedo, Roberto B. M. 1977. "A Critical Review of the Relation Between the Post-1964 Wage Policy and the Worsening of the Brazilian Income Distribution in the Sixties," *Explorations in Economic Research*, no.1.
- Macedo, Roberto B. M. 1985. *Os Salários nas Empresas Estatais*. São Paulo: Nobel.
- Meggison, W.L., R.C. Nash, and M. van Randenborgh. 1994. "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis." *Journal of Finance* vol. 49, no. 2: 403–52.
- Nellis, John. 1999. "Time to Rethink Privatization in Transition Economies." *International Finance Corporation, Discussion Paper* 38.
- Pinheiro, Armando Castelar. 1996. "Impactos microeconômicos da Privatização no Brasil," *Pesquisa e Planejamento Econômico* vol. 26, no. 3 (December): 357–98.
- Pinheiro, Armando Castelar, and Fabio Giambiagi. 1997. "Lucratividade, dividendos e investimentos das empresas estatais: uma contribuição para o debate sobre privatização no Brasil." *Revista Brasileira de Economia* 51 (January–March).
- Velasco, Jr., Licínio. 1997. "A Economia Política das Políticas Públicas: Fatores que Favoreceram as Privatizações no Período 1985/94." BNDES, *Textos para Discussão* 54 (April).

About the Carnegie Endowment

THE CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE is a private, nonprofit organization dedicated to advancing cooperation between nations and promoting active international engagement by the United States. Founded in 1910, its work is nonpartisan and dedicated to achieving practical results. Through research, publishing, convening and, on occasion, creating new institutions and international networks, Endowment associates shape fresh policy approaches. Their interests span geographic regions and the relations between governments, business, international organizations, and civil society, focusing on the economic, political, and technological forces driving global change. Through its Carnegie Moscow Center, the Endowment helps to develop a tradition of public policy analysis in the states of the former Soviet Union and to improve relations between Russia and the United States. The Endowment publishes *Foreign Policy*, one of the world's leading journals of international politics and economics, which reaches readers in more than 120 countries and in several languages.

The Global Policy Program addresses the policy challenges arising from the globalizing processes of economic, political, and technological change. Research projects span many areas, including the proliferation of weapons of mass destruction, the increased international movement of people, the consequences of the information revolution, democracy building and the rule of law, inequality and economic reform, and the changing international role of private business.

The program recognizes that globalization, though by nature a universalizing phenomenon, extends around the world unevenly, producing sharply varied effects, both positive and negative. The program focuses on integrating the emerging global policy agenda with traditional security concerns, and also seeks to increase public understanding of globalization.

Carnegie Working Papers

2000

- 14 *Privatization and the Distribution of Assets and Income in Brazil*, Roberto Macedo
- 13 *Democratization and Globalization: The Case of Russia*, Yuri Fedorov
- 12 *Party Formation and Non-Formation in Russia*, Michael McFaul
- 11 *Drug Trafficking on the Great Silk Road: The Security Environment in Central Asia*, Martha Brill Olcott and Natalia Udalova
- 10 *Naturalization in the Wake of Anti-Immigrant Legislation: Dominicans in New York City*, Audrey Singer and Greta Gilbertson
- 09 *Natural Resources, Human Capital, and Growth*, Nancy Birdsall, Thomas Pinckney, and Richard Sabot
- 08 *Democracy Assistance and NGO Strategies in Post-Communist Societies*, Sarah E. Mendelson and John K. Glenn

1999

- 07 *The Challenge of Semi-Authoritarianism*, Marina Ottaway and Martha Brill Olcott
- 06 *The Rise and Fall of START II: The Russian View*, Alexander A. Pikayev
- 05 *Putting Education to Work in Egypt*, Nancy Birdsall and Lesley O'Connell
- 04 *The Campaign for the Unpaid Wages Prohibition Act: Latino Immigrants Change New York Wage Law*, Jennifer Gordon
- 03 *Intergenerational Mobility in Latin America: Deeper Markets and Better Schools Make a Difference*, Jere R. Behrman, Nancy Birdsall, and Miguel Székely
- 02 *Politics at the Heart: The Architecture of Humanitarian Assistance to Afghanistan*, Paula R. Newberg
- 01 *No More Secrets? Policy Implications of Commercial Remote Sensing Satellites*, Ann M. Florini and Yahya A. Dehqanzada