CHAPTER 1

Introduction

SINCE 1994, BRAZIL HAS BEEN ON A RELATIVELY VIRTUOUS PATH OF economic and political development, though there have been bumps in the road. Is twenty years long enough to conclude that Brazil is still on the road to a sustainable developmental path whose hallmarks are social inclusion with steady economic and political development? Or, were the past twenty years simply a flash in the pan similar to the short-lived Brazilian miracle of the late 1960s and early 1970s? This time, the miracle is for real because of a change in beliefs in Brazilian society and consequent changes in economic and political institutions. Today, the dominant belief held among those in power as well as the majority of the population is in "fiscally sound social inclusion." How did this belief emerge? And, moreover, what are the forces that will sustain it? To understand the changes in Brazil over the past fifty years, we wed the concepts of windows of opportunity, beliefs, dominant network, leadership, institutions, and economic and political outcomes into a framework to understand the dynamics of institutional change and the beliefs within which they are nested.[1] Development is contextual; that is, each country must find its own way. Brazil is no exception, though the concepts developed in this book have purchase in understanding institutional development or persistence elsewhere.

Economic Development and Critical Transitions

Our main theme is the process of development in the modern world. The purpose is to better understand the forces leading some contemporary societies to achieve economic and political development while most societies remain in autopilot. "Development" may seem fairly intuitive; yet, all countries manage to grow during some periods and almost all develop to

1 We build on an expanding literature on institutions, beliefs, and leadership. For books for the primarily academic audience, see Acemoglu and Robinson (2006); Eggertsson (2005); Greif (2006); North (2005); North, Wallis, and Weingast (2009); North et al. (2012); and Schofield (2006). A recent contribution reaching the general audience is Acemoglu and Robinson (2012). The list of articles dealing with the topic is voluminous and we will reference them when specifically relevant.

some extent over time. However, few countries manage to complete what we call the "critical transition," which is a more fundamental change in a country's circumstance than simply increases in GDP.

To see that the process of development entails a transition from one state to another, rather than simply an incremental change along a continuum, note that it is common for analysts—whether growth theorists, development economists, political scientists, journalists, or others—to classify countries into two broad groups. There are rich and poor countries; developed and developing; center and periphery; First World and Third World (the Second World disappeared with the fall of communism); industrialized and nonindustrialized; and open-access and limited-access orders. Although the labels and the associated theoretical approaches differ, the basic notion is that there are two categories. It is natural then for the interest to center on trying to understand the determinants of the transition from one group to the other. It turns out that recent cases of countries making the transition are quite rare. It is not simply a matter of time until most countries grow themselves from the bottom to the top category. In table 1.1, we used the Maddison Project data set to classify each of the countries for which there was GDP per capita data, as being in the high income, low income, and middle/transition categories.[2] We did this for three different years spanning the data set—1900, 1950, and 2008. In order to classify the countries, the choice of cutoff for the high group was chosen somewhat arbitrarily to include countries that are normally accepted as being "developed" at that time, and the cutoff for the low group was set at two-thirds (66.7 percent) of that level. Given the propensity to classify all countries into just two groups, the countries between the low and the high groups are considered as being in transition from one to the other. As expected, there are fewer countries in the high GDP per capita group than the low group (note that in 1900, the limited data availability biases upward the proportion of those in the high group). Strikingly, the number of countries in the transition group is always relatively small—less than 10 percent. The last row in the table names the countries in the transition group, which allows one to see that this group would be even smaller if we reassigned the special cases (Puerto Rico, Kuwait, UAE in 2008, and war-torn Europe in 1950). Furthermore, some of the transition countries are transitioning downward (such as Argentina and Uruguay in 1950), corroborating the notion that countries making the transition from the bottom to the top group is a relatively rare occurrence. Although the numbers in table 1.1 depend on the criteria used to classify the countries (see note to table), the general conclusion that there is a small high-income group and a

2 The Maddison Project data is described in Bolt and van Zanden (2013).

Table 1.1. Number and Percentage of Countries: High, Low, and Transition

	2008			1950			1900		
Stage of development	GDP/P	N	%	GDP/P	N	%	GDP/P	N	%
High	>$18K	27	17	>$5.5K	13	9	>$2.8K	13	30
Low	<$12K	121	74	<$3.7K	116	84	<$1.9K	26	60
Transition	>$12K and <$18K	13	9	>$3.7K and <$5.5K	10	7	>$2.8K and <$1.9K	4	9
Countries in transition	Greece, Portugal, Spain, Czech, Slovakia, Belarus, Latvia, Lithuania, Chile, Puerto Rico, Kuwait, UAE, Mauritius			Austria, Belgium, Finland, France, Germany, Norway, Argentina, Chile, Uruguay, Trinidad, Tobago			Norway, Sweden, Chile, Uruguay		

Source: Calculated using data from the Maddison Project (Bolt and van Zanden 2013).

Note: Data: GDP per capita in 1990 Int. GK$. Countries classified by the following criteria: 2008—High (GDP/P > $18,000), Low (GDP/P < $12,000), Transition ($12,000<GDP/P<$18,000); 1950—High (GDP/P > $5,500), Low (GDP/P < $3,666), Transition ($3,666<GDP/P<$5,500); 1900—High (GDP/P > $2,800), Low (GDP/P < $1,866), Transition ($1,866<GDP/P<$2,800). Upper bound is 1.5 times the lower bound.

large low-income group, with few transitioning countries in between, is quite robust. This flies in the face of the notion that poor countries will inexorably grow over time and catch up with richer countries, known as the convergence hypothesis, which has been a major debate in economics in the past decades.[3]

The evidence in table 1.1 refers solely to GDP per capita. Although higher levels of income and wealth are necessary for a critical transition, this concept requires important changes in several other dimensions as well. Many times, an increase in GDP per capita can take place in circumstances that are not sustainable or that compromise future growth, creating a middle-income trap. A critical transition, in contrast, requires not only economic improvements but also accompanying changes in social relations (e.g., greater equality) and political institutions (e.g., alterations of power and checks and balances). Therefore, a country that has achieved a critical transition has done something significantly harder and more fundamental than simply raising its GDP. Note that according to

3 See Barro and Sala-i-Martin (2004: 16–21) for a history of the literature.

the classification in table 1.1, Argentina was a high-income country in 1900 (GDP per capita $2,875), in transition in 1950 ($4,987), and in the low-income group in 2008 ($9,715), suggesting that although incomes were high at the outset, other conditions were lacking. In the opposite direction, although Austria, Belgium, France, and Germany are classified as in the transition group in 1950, this was a temporary setback due to the two world wars, suggesting that the other fundamental conditions besides GDP that had promoted the development of these countries in the nineteenth century were still in place.

The conditions besides GDP growth that are necessary for a critical transition vary from country to country. By examining those countries that have achieved sustainable development, we can see that there are many common features, such as rule of law for all, political openness and universal participation, free entry and exit for all sorts of organizations (business, political, religious, and associational), checks and balances, electoral uncertainty *ex ante*, and certainty *ex post*. No country has all these features, and each has its own set of quirks and dysfunctionalities, but by and large their institutions share a related set of such characteristics and generally lack other conflicting elements, such as authoritarianism, inequality, segregation, favoritism, and systemic violence.

Brazil is currently poised to make the critical transition. Given that only a handful of countries have managed to do this in the past decades, it is incumbent on us to back up this claim with evidence and argumentation. Furthermore, given that Brazil's performance in terms of GDP growth has been merely mediocre in past decades, we need to make a strong case that other fundamental changes are taking place that are setting the stage for economic growth to follow. In chapter 2, we present a basic framework for understanding how countries develop or fail to do so. In chapters 3–6, we provide a detailed analysis of the changes in Brazil since the 1960s. We show that the country has become economically orthodox, politically open, and socially inclusive, with all these three areas marked by a general respect for the rules. The characteristics, which are now firmly rooted and less likely to be reverted by eventual shocks, have never been aligned in such a way in Brazilian history and contrast markedly with the state of the country just a few decades ago. Previously, chronic fiscal and monetary indiscipline kept the country in a perpetual inflationary state with high internal and external indebtedness. Misguided and excessive state intervention fostered inefficiencies, distorted markets, reduced productivity, and left market failures unaddressed. Politics was at different times mired in different combinations of authoritarianism, corruption, clientelism, populism, nepotism, electoral fraud, gridlock, and exclusion. Socially, the country was highly unequal—among classes, races, regions, and sectors—with lack of opportunity for the disadvantaged and few effective policies seeking to address these imbalances through redistribution. Though some of these problems persist, there have been huge strides.

Brazil: This Time for Real?

Brazil currently boasts the world's sixth largest economy, and it has been undergoing a profound transformation toward its critical transition. At first blush, this is a bold claim because the rates of GDP growth during the past twenty years, especially at the start of its transition, have been generally unremarkable and often disappointing. But, as noted earlier, a critical transition is about more than GDP growth; it also includes economic opportunity and distribution as well as genuine political competition and democratic stability. On these scores, we demonstrate in the empirical section that Brazil is a different country now than it was twenty years ago.

We are bullish about the changes in Brazil, but the perception by much of the media inside and outside of Brazil is that the slowdown in economic growth is an indication that once again the glory years are lost. This replacement of hope and confidence with skepticism and despondency is not hard to understand. From 1975 to 1994, the country underwent two decades of unrelenting economic decline during which a crippling process of hyperinflation wreaked havoc with individuals', organizations', and governments' attempts to structure their lives and to plan for the future. To many, the repeated frustrations and failures of this period destroyed the country's self-esteem and instilled a sense that perhaps this dysfunctional state of affairs was not a phase to be overcome, but rather a natural Brazilian characteristic.

Since 1994, things have changed for the better. Inflation has been kept under control, and several economic indicators have clearly improved, some of them remarkably so. Poverty and inequality have been falling for more than ten years; the country's debt ranks as investment grade; agriculture and other exports are booming; international reserves are above US$350 billion; extensive oil reserves have been discovered; and powerful politicians involved in corruption scandals have faced tremendous reputational costs, and some have been tried and punished by the Supreme Court. Over this period, Brazil has consolidated a vibrant, competitive, and liberal democracy in a global context in which generalized elections have often not resulted in guarantees and safeguards to citizens' civil and individual rights.

And yet, there remains a nagging feeling among analysts and the Brazilian public that these achievements may merely be a temporary good spell of the sort the country has often had in the past, but which inevitably ends in tears. Perhaps the most salient argument along these lines is that all these achievements are a direct consequence of the world's commodity boom since 2003 and now that this has ended, everything will come crashing down.

Skepticism about Brazil's achievements as well as its future prospects is not gratuitous. An examination of several indicators of performance and prosperity provides sufficient ground to be suspicious of claims that the country has deeply changed. Figure 1.1 shows Brazilian GDP per capita growth rates from 1950 to 2010. For the purpose of comparison, the figure also shows the average GDP per capita among all countries as well as the boundary for the top 20 percent and bottom 20 percent countries in each year. The figure differentiates when GDP per capita in Brazil grew above and below the average. The data show that prior to 1980, Brazil performed overwhelmingly above the world average and often above the top 20 percent mark. Since then, however, its performance has been, more often than not, below average. This is not an obvious candidate for a study of a country on a successful transition to sustainable development.

Other indicators are equally ominous. In the United Nations' Human Development Index, Brazil was only 85th out of 187 countries in 2011. In the *World Bank's 2011 Doing Business* ranking, which compares the ease of doing business across countries, Brazil was ranked 126th out of 183. The Legatum Prosperity Index puts Brazil at 42nd out of 110 in 2011. In the Heritage Foundation's 2012 Index of Economic Freedom, Brazil was in the "mostly unfree" category, ranking 99th out of 179 countries. In terms of corruption, Transparency International's Corruption Perceptions Index (CPI) places Brazil at 69 out of 174 countries in 2012. In 2012, Reporters without Borders ranked Brazil at 99 out of 179 countries in terms of the freedom of press. In the 2009 OECD PISA test for educational attainment for fifteen-year-olds, Brazil came in 50th, 55th, and 51st out of 62 countries in reading, math, and science, respectively.[4] These are clearly not the kind of rankings that would make a country stand out as an example of successful development. In most categories cited above, Brazil seems woefully distant from the leading group. How

4 The sources of the indexes cited in this paragraph are as follows: Human Development Index (http://hdr.undp.org/en/humandev/); Doing Business Index (http://www.doingbusiness.org/rankings/); Legatum Prosperity Index (http://www.prosperity.com/default.aspx); Heritage Foundation Index of Economic Freedom (http://www.heritage.org/index/default); Corruption Perceptions Index (http://cpi.transparency.org/cpi2011/); Reporters without Borders Press Freedom Index (http://en.rsf.org/press-freedom-index-2011-2012,1043.html); and OECD Programme for Student Assessment (http://www.oecd.org/pisa/46643496.pdf).

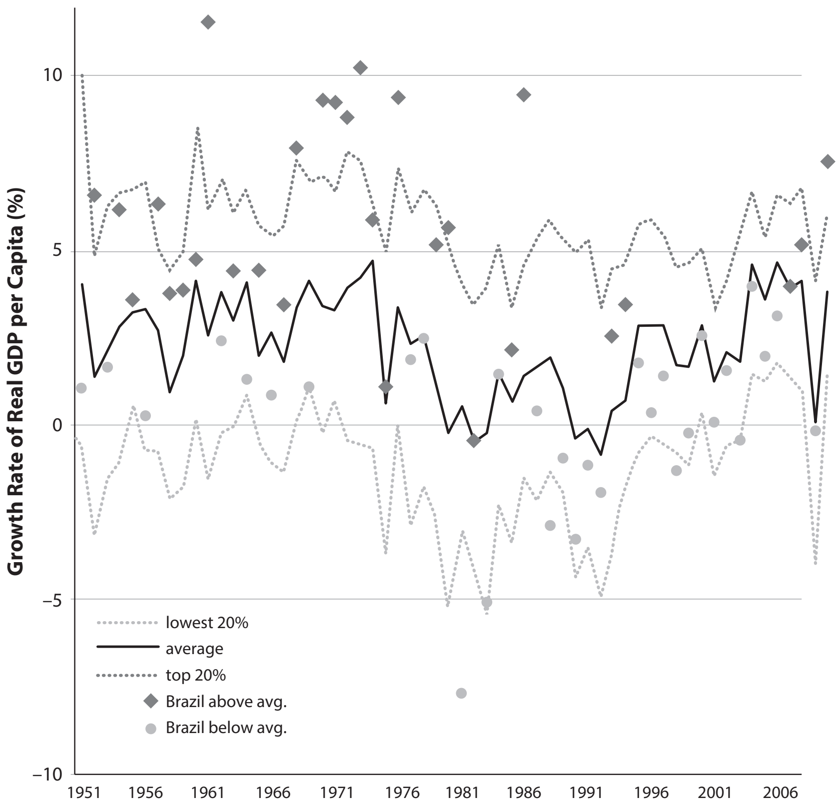

Figure 1.1. Brazilian GDP per capita growth relative to the rest of the world. Sources: Heston, Summers, and Aten (2009) data for 1950–2007 in constant 2005 prices; IMF for 2008–2010 data, http://www.imf.org/external/pubs/ft/weo/2010/02/weodata/download.aspx.

is it then that we justify our choice of Brazil as a country on the road to prosperity?

Rather than trying to discredit these indexes and the comparisons they purport to allow, we find that such attempts at measuring different dimensions of a country's performance can often be quite useful. It is naive, however, to expect a successfully developing country to simultaneously and monotonically improve all or even most of these dimensions throughout that process. The process of development is inherently messy and contextual, and no combination of indicators ever provides a sure telltale sign of whether a definitive transition is really underway. Many of the indicators measure performance variables that vary widely over time, reflecting cyclical rather than deeper determinants. Other indicators are built using perceptions by experts, businessmen, and other individuals, for example, the CPI (Transparency International) and the Worldwide Governance Indicators (World Bank). Yet, perceptions are often overly influenced by more salient current information and are often subject to herd behavior. Tetlock (2006) has shown the weakness of expert opinion at predicting issues such as which countries will thrive and which will fall. His twenty-year study with a large and varied sample of experts from various fields concluded that even those who by definition should be knowledgeable predict only marginally better than chance.

Furthermore, there are several indicators in which Brazil fares remarkably well, for example, 10th out of 133 in "soundness of banks" in 2009; 15th out of 236 in number of documents published in scientific journals from 1996 to 2010; and first in a ranking of developing countries' efforts to fight hunger.[5] Another shortcoming of using any arbitrary assortment of indexes and indicators to infer the true nature of a country's process of development is that they typically measure levels when it is often more revealing to analyze how a particular society evolves over time. Indeed, a serious methodological flaw in much research in development is to infer longitudinal processes from cross-sectional data. Brazil, for example, typically scores very low in indexes of educational level or attainment. Analysts rightly hold this as one of the country's major obstacles if it is to develop. However, simply looking at the level of the country's latest PISA score masks the fact that "average PISA scores for Brazil have improved in all subjects measured over the last ten years" (OECD 2010). Despite its still low level, the quality of education has had a distinctive upward evolution over recent years in Brazil. Even in education—an area where Brazil's performance is admittedly dismal—it ranks third in a sample of 49 countries for the annual growth rates in students' achievements between 1995 and 2009 (Hanushek, Peterson, and Woessmann 2012). What has caused this change? Investigation into this issue, as done by the OECD (2010) and the World Bank (Bruns, Evans, and Luque 2012), reveals that Brazil has implemented coherent and innovative reforms that have started addressing the underlying causes of poor education in ways that promise significant long-term changes. The reforms have targeted several different dimensions of the educational system and at several different levels—federal, state, and municipal. Funding, which is constitutionally hardwired, is high by world standards, but, more importantly, the productivity of the

5 The sources of the indexes mentioned in this paragraph are: "Soundness of Banks" (World Economic Forum, Executive Opinion Survey 2008, 2009); SCImago Journal and Country Rank (http://www.scimagojr.com/countryrank.php); ActionAid (2010); and "Who's Really Fighting Hunger?" (The Hague: ActionAid International, http://www.actionaid.org.uk/doc_lib/hungerfree_scorecard.pdf).

expenditures has improved and become more equitable. The government created several new funds to assure resources for different educational purposes: they increased teacher salaries, especially in the poorer regions, and emphasized better training for teachers; government-mandated local education councils increased community participation; conditional cash transfers have been extremely successful and have been expanded to cover more than 11 million families, contributing to reduced absenteeism, repetition, and child labor; and completion rates also improved. With school attendance now nearly universal, Brazil has directed efforts to increase the length of the school day and the school year. Brazil also extended the number of years in the curriculum to twelve. This additional temporal information not only provides a much more complete and informative picture than a lone indicator but may temper or even invert an analyst's assessment of the state of education in Brazil.

The areas where improvement has been the clearest and most impressive are poverty and inequality reduction. From 1990 to 2009, approximately 60 percent of Brazilians moved to a higher economic group, and extreme poverty was practically eliminated. Only 4 percent remain in poverty in 2013 (Báez et al. 2015). The World Bank report *Shared Prosperity and Poverty Eradication in Latin America and the Caribbean* places Brazil as the country with the greatest improvement in poverty reduction in the region, home to "one in every two people who escaped poverty in the Latin America and Caribbean region during the period" (Báez et al. 2015: 65). Since the mid-1990s, the Gini coefficient of income inequality has been steadily declining, leading that index to uncharted territory in a country that has always been one of the most unequal in the world. This has taken place during a period in which, worldwide, inequality within countries has been on the rise. As a result of these improvements, the structure of society has changed with a perceptibly larger middle class and upper class, which has meant greater access to markets for goods and services, including public services such as education and health, and greater participation in national affairs, all of which should work to reinforce these trends. While the World Bank report attributes the improvements to stable growth since 2001, stronger policy focus on poverty, and the dynamics of the labor market (Báez et al. 2015: 65–66), these are merely proximate causes. The deeper determinants are the beliefs that produced the institutions that underlie those proximate causes. As with the case of education, the level of poverty and inequality in Brazil is still unsatisfactory, and much improvement is necessary in the future; nevertheless, the magnitude of change and the concerted way in which it has been achieved are highly relevant.

Still, identifying development is more difficult than simply looking at different indicators over time. A profound process of reform may have been initiated with no discernible effect yet apparent. The impact of reform may materialize with a hard-to-quantify lag during which policies, programs, and new ways of doing things have been implemented and yet no results have emerged. In some cases, things might even get worse before they get better. In other cases, some indicators might never improve or even get permanently worse, and this might still be accommodated within a successful process of development. To see this, note that even highly advanced nations fare badly along some dimensions or others: Italy was 69th out of 182 in the 2010 CPI (Transparency International); the United States had the highest prisoner population per 100,000 people in 2007 and was 29th out of 223 countries in prevalence of diabetes in 2010; the United Kingdom fared fourth lowest in a Privacy Index ranking of 48 countries in 2007; and Belgium was 57th out of 149 in the Environmental Performance Index.[6] The upshot of this discussion is that although indexes and rankings may be useful to categorize highly dysfunctional or highly successful countries, they may be less precise to distinguish between countries that are transitioning to development from those that are going through a cyclical good or a bad period.

If not indexes, what evidence can we provide to support the choice of Brazil to illustrate our approach to development? A large literature consolidated in the past two decades argues that institutions, rather than geography, culture, policies, or luck, are the fundamental cause of long-term growth (North 1990, 2005; Acemoglu and Robinson 2006, 2012; Engerman and Sokoloff 2000; Eggertsson 2005; Greif 2006; North, Wallis, and Weingast 2009; and Rodrik, Subramanian, and Trebbi 2004, among many others). If we are correct that Brazil is on the path to a more prosperous level of economic and political development, then we should be able to provide an argument where changing institutions must play a central role. It is necessary that we show that a dramatic transformation has taken place in the country's institutions between the previous history of boom and busts to the current period that we identify as a transition to a new order.

Further, we go beyond simply chronicling the change in institutions, and propose (chapter 2) a framework to understand the changes that transpired. We give a general interpretation of the changes in Brazil (chapter 2) and a detailed analysis of recent Brazilian history, also based

6 The sources of the indexes mentioned in this paragraph are: Corruption Perceptions Index (http://cpi.transparency.org/cpi2011/); Prison Population (International Center for Policy Studies, cited in http://www.allcountries.org/ranks/prison_incarceration_rates_of_countries_2007.html); Diabetes Atlas (International Diabetes Federation, http://www.idf.org/diabetesatlas/); Privacy Index (Privacy International, https://www.privacyinternational.org/); and Environmental Performance Index (Yale University, cited in http://www.photius.com/rankings/environmental_performance_index_2008.html).

on the framework (chapters 3–6). Here, our goal is to convince the reader that something truly remarkable is taking place in Brazil.

While it might seem obvious that things have improved since the 1980s in Brazil, our claim is much bolder. Not only have outcomes changed—for example, inflation is under control, and the external debt is lower than international reserves, inter alia—but more importantly, institutions, beliefs, and those in power have also changed because the process of development has changed. This is a much more controversial position. Despite occasional glowing endorsements, like pieces on Brazil in the *Economist* (2009), the *New Yorker* (Lemann 2011), and *Spiegel* (Follath and Gluesing 2012), the more typical position is of sharp skepticism about the Brazilian economy's prospects. An emblematic example of this point of view is the book *Breakout Nations: In Pursuit of the Next Economic Miracles* by Ruchir Sharma of Morgan Stanley:

> While in recent years Brazil has been widely touted as a rising regional superpower, on the relevant fundamentals Brazil is the anti-China, a nation that invested in the premature construction of a welfare state rather than the roads and wireless networks of a modern industrial economy. Nations that have grown dependent on booming prices for raw materials such as oil and precious metals—namely, Russia and Brazil—face a hard decade ahead. (Sharma 2012: 10)

Sharma (2012: 64) predicts that countries like India, South Korea, and Thailand "are the real or potential breakout nations, while Brazil is not."

Like Sharma, the *Economist* (2013) now casts a gloomier forecast consistent with our view that much of the content of the media is noise based on assessments of recent policies and outcomes rather than the deeper and more stable fundamental determinants, the changes in beliefs and institutions. Sharma (2012), for example, puts much weight on the overvalued exchange rate in Brazil and on the poor state of infrastructure as part of his argument for why Brazil will not be a "breakout nation." Admittedly, these are important variables that seriously impact Brazilian development. Yet they are outcomes that, to a large extent, are deliberate consequences of policies. Analysts frequently act as if countries did not face budget or political constraints. For example, there has been considerable criticism that Brazil neglected to sufficiently invest in infrastructure. But, what is the opportunity cost? Which will yield a higher rate of return: infrastructure or education? Brazil chose education as noted above.

Without a clear understanding of why Brazil took decisions and actions that led to outcomes, one does not have the full picture of the tradeoffs. To have this understanding, it is necessary to posit the constraints and incentives faced by all the relevant players. The major determinants of the incentives and constraints are beliefs and institutions, which is why these concepts are central to our framework in chapters 2 and 7.

This means that to show that Brazil is in the midst of a dramatic transformation, we cannot rely on a list of outcomes or policies. Instead, we need to show evidence that both institutions and beliefs have changed in such a way that the content and timing of their change coincides with the switch from dysfunctional policies and poor outcomes of the past to improved, albeit still imperfect, policies and outcomes of the present. The advantage of analyzing a single country in great detail, as opposed to a sample of countries with more generality, is that we can be very explicit about the specific institutions and beliefs and how they change. Moreover, Brazil is an important world economic and political player.

We focus on the beliefs—the mental constructs mapping institutions onto outcomes—that motivated the choice of institutions. There are two sets of beliefs that have been the driving force of the process of change in Brazil since 1985. The first is a belief in social inclusion that arose as a reaction to the oppressive experience under military dictatorship and the inequalities and injustice inherited from the country's history. The second is an aversion to inflation born from the traumatic experience under hyperinflationary years of 1985 to 1994. Together, these two separate strands form a belief in fiscally sound social inclusion that constrains and influences the choice of institutions by the dominant coalition, thereby crucially affecting the selection of policies and the incentives influencing outcomes. It might seem that the beliefs we identified for Brazil are arbitrary and unfounded. After all, many countries had traumatic experiences with authoritarianism and monetary instability, and there is no indication that such experience inevitably leads to the sort of beliefs we attribute to Brazil. These beliefs are mental models about how the world works and are not reducible to preferences or values. In chapter 2, we elaborate on the beliefs and provide evidence that there has been a sharp change in beliefs in Brazil in the past three decades.

A Sketch of the Conceptual Framework

Institutions matter for economic development. This statement has now become part of mainstream economics. Alone, understanding the importance of institutions is insufficient for understanding economic and political development because there is no recipe for institutional change. Institutional change is highly contextual to time and place. All countries have to find their own way to develop. Most countries are more or less in an autopilot mode where institutions change on the margin, but there are generally not fundamental changes in institutions followed by institutional deepening. Why? Typically, those in power structure the formal rules of the game in a manner to produce outcomes that are in their economic and political interests. For those in power, there are rents from a stable status quo where not much changes. Citizens, as well, become accustomed to the status quo, and there are few gains and, at times, high costs to rocking the boat.

Yet, there are some countries that break away from their autopilot mode and move toward a more virtuous trajectory, implementing institutional changes that lead to sustained economic and political development. We seek to better understand what undergirds institutional change. To do so, we need to better understand the role of beliefs and tie them to institutional change (Eggertsson 2005; North 2005; Greif 2006). If beliefs are the key to understanding institutional change, we need to understand what leads to changes in beliefs, especially among those in the dominant network of power that structures institutions. Beliefs are generally quite stable because most economic and political outcomes are at the margin. But, at times, economic and political outcomes diverge considerably from what those in the dominant network expected. When this happens, we call it a window of opportunity for institutional change because the powerful actors may have changed, bringing with them different beliefs, or the beliefs of those in power change. During windows of opportunity, the beliefs of those in power as well as among the citizens become malleable. "Outcomes are not normal, what is going on?"

During windows of opportunity, beliefs are up for grabs to some extent, but often not much happens because no one seizes the opportunity. During these times, we see leadership playing a role to circumvent the free-rider problem. We are not proposing a "great men make history" view of beliefs and institutional change but, rather, that leaders are shaped by the context of the situation. A leader senses and acts on the major anxiety facing a society. Leaders take the pulse of citizens and act on it. Leadership entails cognition (understanding the problem facing society), coordination (getting others in power to "give it a go"), and moral authority (citizens trusting in leaders' motives to try to do the right thing).[7] In Brazil, President Fernando Henrique Cardoso came to power with some moral authority because of his political exile during the military regime in Brazil. In addition, Cardoso, both as an academic professor as well as a political figure (he was a former senator and played a key role during the Constituent Assembly), developed a reputation for knowledge and leadership. Naturally, leaders can and do act selfishly, but we are interested in leaders who act for the betterment of society and how they will be viewed historically.

7 See Riker (1996) on leadership and coordination, and Greif (2012) on moral authority.

Windows of opportunity are seemingly quite frequent, but the combination of windows of opportunity with the right leaders with beliefs that foster institutions that increase economic and political development is rare. This is why most countries remain in a cycle of more or less the status quo, where people see only marginal changes during their lifetimes. Our framework—only sketched out here in general terms, but developed more thoroughly in chapters 2 and 7—helps us to better understand both institutional persistence and institutional change. It allows us to better understand transitions from one relatively stable process of institutional change on the margin to a new set of beliefs with a similar dynamic, but with a significantly different set of institutions and outcomes. Understanding the concepts behind transitions is the key to understanding why some countries make the "critical transition." In our analysis, we stress the *process* of economic and political development more so than the short-run variations in economic growth or seemingly political competition. Achieving a truly open society takes decades (North, Wallis, and Weingast 2009).

Analytical Narratives and Economic Development

This book is about understanding the developmental path of Brazil, which we hold up as a country that has embarked toward a critical transition. This claim derives not from a mechanical extrapolation of the past but rather is based on a framework that stresses windows of opportunity, beliefs, and leadership. This section discusses some epistemological issues related to the kind of evidence that we present. Because there will always be ambiguities whether a given country is making a transition or is merely experiencing a transient period of growth, no use of the data can make a definitive case one way or the other. Any judgment will necessarily be inductive rather than deductive.

This difficulty of judging the evidence is not exclusive to the setting being considered here; rather, it is common to a broad set of scientific inquiries. Whenever direct evidence is not available to test a given hypothesis, it is still possible to rely on circumstantial evidence. This involves showing that certain events or circumstances that are often associated with that hypothesis have taken place so that one can then infer, with a given probability, that the hypothesis should not be rejected. The quality of that inference will depend of course on the strength of the link between the circumstantial evidence and the hypothesis. The greater the amount of circumstantial evidence and the stronger the link between each strand of that evidence and the hypothesis, the stronger will be the case that is being made. Fogel (1982) argues that areas like economic history, like many court cases, often have no choice but to rely on circumstantial evidence.

Brazil has been going through a remarkable transformation in which the fundamental roles of windows of opportunity, beliefs, institutions, and leadership can be clearly identified. The transformation will eventually lead to a critical transition for Brazil across the gap to join the select group of developed nations. It is important to make it as clear as possible what we are and what we are not saying. In particular, it is important to distinguish what we claim from what we predict. The claims involve things that have already happened, can be expressed in greater detail, and can be confronted with evidence. The predictions, on the other hand, are of a very different nature. Inevitably, they are a guess of what we think will happen in the future. All predictions have an element of hubris, yet the level of epistemological arrogance depends on various elements of the prediction (Taleb 2010). The first is the time span and the level of detail of the prediction. The further into the future and the more specific the prediction, the less reliable it will be. The second is the underlying *process* on which the prediction was based.

So, what exactly are our claims and predictions about Brazilian development, and how can they be assessed? Consider first the claims. In the last three decades, new beliefs have taken hold that wed social inclusion to fiscal and monetary orthodoxy. The beliefs affected formal and informal institutions that in turn have led to many positive outcomes. We are not saying that the transformation is all encompassing, that it is complete, or that it has not in the process also produced distortions and waste. It is not enough to produce evidence of inefficiencies and dysfunctional behavior to refute our claims. The access to economic and political markets has made Brazil a fundamentally more inclusive society than it has ever been. The unprecedented recent fall in inequality and poverty and the growth of the middle class are evidence for our claims. The changes are also extending to more inclusion in education, less tolerance for corruption, and greater respect for the rule of law.

Simply put, we predict that Brazil will establish institutions that lead to stable economic rates of growth and increasingly less dysfunctional politics and corruption. Sustaining this path will enable Brazil to transition from the lower-growth to the higher-growth groups of countries in the world. This prediction is based on the framework we present in chapters 2 and 7. The framework emphasizes the role of beliefs and institutions in determining economic and political outcomes (as well as the role of windows of opportunity and leadership in determining which beliefs and institutions emerge). The beliefs foster institutions pushing Brazil in the direction of outcomes such as lower inequality, lower poverty, a bigger middle class, more competitive economic and political markets, impersonality, and rule of law. Myriad distortions, inequalities, and inefficiencies accompany the process of what we term "dissipative inclusion." But, dissipation does not cancel out the transformative nature of the changes.

Much of the recent literature on redistribution and growth has come to accept that redistribution, and thus inclusion, often have a positive effect on growth (P. Lindert 2003; Perotti 1995; Bénabou 2002; Easterly and Rebelo 1993; Sala-i-Martin 1997; Saint Paul and Verdier 1996; Aghion and Bolton 1997; Galor, Moav, and Vollrath 2009; Engerman and Sokoloff 2000; Galor 2011; Acemoglu and Robinson 2006, 2012; North, Wallis, and Weingast 2009). If the predictions fail to materialize, we can then assess whether they failed because the inclusion did not really take place in Brazil or because the notion that inclusion translates into growth is wrong.

Our prediction has relatively large confidence intervals (low epistemological arrogance), as we are vague on timing and details. We are not venturing to predict exactly how the transition will happen, except that it will be driven by the *beliefs in fiscally sound social inclusion*. We are not predicting which sectors/areas/domains will improve and which will remain mired in inefficiencies, nor how fast or smoothly the transition proceeds. We do not predict these details because neither the framework nor the literature provides a basis for making such inferences. The lack of detail does not make the prediction less striking or controversial.

Finally, our analysis is in no way an endorsement of whatever party or president was, is, or may come to be in power. Similarly, we do not endorse or criticize any specific current policy or program, as our justification for expecting Brazil to thrive is not based on the analysis at this level. Instead, in our framework the main determinant of outcomes are institutions, which in turn are determined by beliefs. Although we are very explicit about which beliefs and institutions are responsible for the fundamental changes in Brazil, we understand that there is an infinite number of specific policies, programs, and other manifestations through which these beliefs and institutions can lead to change. We have no way of telling whether the specific set of government efforts that have materialized are the best path to economic growth. In fact, given the messy nature of politics and the complexity of the task, it is quite likely that the observed policies are probably not the best that could be done and may often be counterproductive. What we do expect, however, is that the beliefs and institutions are such that there will be forces that push for those policies and programs to be eventually revised as they prove to be mistaken. Whereas in many countries institutions are such that inefficiencies may be there by design, as they suit the ruling elite, we see Brazilian institutions as providing the incentives and the means for the inefficiencies to be continually, though imperfectly, transacted away in political markets. Like cointegrated variables that may stray apart but are always eventually pulled back together, our view does not require that government policy be always efficient and in line with the beliefs in fiscally sound inclusion. We do expect, however, that there will be forces to pull them back toward those beliefs.

A careful reading of our application of the framework makes it clear that our analysis is not a stamp of approval (or disapproval) of current governments or policies. We identify the period during and closely after the *Real Plan* in 1994 as a window of opportunity in which a crucial role was played by leadership, which initiated institutional changes and sustained institutional deepening, moving Brazil toward a critical transition. This was an occasion where individuals mattered. But since then—including the second term of Cardoso, the two terms of Luiz Inácio "Lula" da Silva, and the first term of Dilma Rousseff—we see less of a role for leadership. The framework is such that except during windows of opportunity, there is little scope for leadership, and the country is on autopilot. Of course, each specific dominant network is able to affect the details and imprint its own style, but the essence and general direction are ultimately determined by beliefs and institutions.

Road Map for the Book

A large part of the evidence consists of analytical narratives in which we use both quantitative and qualitative evidence to provide support for the application of our concepts to historical periods in the last fifty years of Brazilian history. Analytical narratives are much more nuanced than running a regression from which the scholar interprets causation because of a "significant" coefficient.[8] With analytical narratives, there are not significant coefficients, but there is considerable evidence, much of which is independent and as a result can be very convincing. As in courts of law or in medical diagnoses, the plethora of circumstantial evidence can make a compelling case for guilt or innocence, or for the course of medical treatments. In chapter 2, we lay out a brief conceptual dynamic to interpret the past fifty years in Brazil. We developed the framework to understand Brazilian development, though we believe it can also aid the understanding of development elsewhere, particularly in Latin America. Our framework rests on tying together the key concepts of windows of opportunity,

8 We recognize that not all scholars use regression analysis so naively, and indeed, regression results are useful evidence when viewed along with qualitative evidence, making the results more convincing.

beliefs, dominant network, leadership, institutions, and outcomes. It is the dynamics of the concepts that led to institutional change in Brazil and in turn a new trajectory. We then discuss the important dominant networks in power, along with their beliefs, in four periods: 1964–1984 (the military years); 1985–1993 (the early years back to democracy); 1993–2002 (Cardoso years); and 2002–2014 (the Lula and Dilma years). Here we give an overview of the fifty years.

We delve into the details of the development of Brazil over fifty years starting, in chapter 3, with the military government. The belief in "developmentalism" motivated the institutions put in place by the military regime. Developmentalism rested on top-down technocratic planning and was a coalition between the military and the business community, both domestic and foreign. Import substitution policies along with state-led industrialization brought economic growth in the late 1960s and into the mid-1970s. Economic growth resulted essentially because the military regime solved a coordination problem for business. Given the low level of GDP in Brazil at the time, there was low-hanging fruit to be reaped with planning. But, the Brazilian miracle of the late 1960s and early 1970s began to sputter out, and, moreover, political rights became more constrained. The threat of torture was present; censorship was dominant; and a considerable number of people left the country. The years of censorship and a closed political system sowed the seeds for a more open political order. Above all, the failure of the expansionist strategy of growth through import substitution accompanied by inflation and external debt became self-evident. Citizens also began to blame the government for not reducing economic and social inequality. The dominant belief that economic growth should precede social inclusion started losing political support.

In chapter 4, we discuss the factors, especially changing beliefs, that led to redemocratization and the subsequent institutional changes during the years 1985–1993. After the military government, the middle class demanded more inclusion in the political arena. To a certain extent, this happened with multiple parties, and only one claiming to be a right-wing party. Unexpectedly, the franchise was given to illiterates seemingly because the belief in social inclusion warranted it; the illiterates were not in the streets clamoring for the vote. The granting of the franchise to illiterates had few short-term, but many long-run, consequences. The business sector was less open than the political sector, with the initial maintenance of import substitution programs. Business was still in the hands of elites with lots of regulations as well as ways to avoid regulations—for a price.

We explore the role of the Constitution of 1988 in the critical transition process. We make four points about what we call a decade-long "constitutional moment." The first is that the constitution embraced the set of beliefs in Brazilian democracy, which evolved out of the fight against military rule. We view the constitution as both a crystallization of beliefs and a focal point for policy. By playing these roles, it legitimized procedure over substance, which is an essential part of democratic life. The "constitutional moment" created a consensus by Brazilian "elites" on the importance of social inclusion with fiscal sustainability, on the one hand, and powerful presidents operating in a constrained institutional environment, on the other.

Second, the Constitution of 1988 redesigned in fundamental ways the country's social contract. Reflecting the change in beliefs, the constitution stipulated new foundations for public policies to incorporate inclusion and redistribution. Third, the constitution vested the presidency with great powers while also strengthening the judicial and the legislative branches. Fortifying the presidency reflected a deep-rooted concern of the elites; these enhanced executive powers, in turn, were to operate in a constrained institutional space. The constitutional process was markedly erratic, underscoring the uncertainties surrounding a transition period. The consensus around the rights constitution—the provisions pertaining to social rights, individual liberties, and rule of law—persisted throughout the constitutional process. Nonetheless, the economic and fiscal constitution was subsequently extensively amended. A core set of beliefs, however, has not changed, and they relate to rights, checks and balances, and a powerful presidency. It took years of experimentation for the recognition that changes to the constitution and policy had to be made, but ultimately it became apparent that unbounded inclusion was not fiscally sustainable.

The period 1985–1993 witnessed several hyperinflations akin to those in Germany during the 1920s. It presented the right leader with a window of opportunity to put Brazil on a new trajectory, at least fiscally. Cardoso seized the window of opportunity (chapter 5), first as the finance minister and later as president. His leadership was not solely top-down; rather, the Cardoso team coordinated other organizations and citizens to buy into the *Plano Real*. In chapter 5, we make three fundamental points. First, Brazil entered into a virtuous path toward a critical transition, which was not inevitable. The outcome was a contingent process shaped by an array of factors. Many alternative coalitions could have emerged with very different outcomes. Actors faced high uncertainty and looked backward in a problem-solving fashion, but also looked forward toward the necessary institutional deepening.

Second, to quell inflation entailed up-front costs and coordination problems that required leadership. Later, at the end of the second term of President Cardoso, Brazilian society had adopted a belief in strong inflation aversion, maintaining the belief in inclusion. That is, social inclusion would still be given priority as long as it was fiscally sound. Once society internalized the new beliefs, leadership was no longer critical, and the institutional dynamics and deepening entered an autopilot mode. Third, new economic and political actors developed a stake in the reform process and formed a constituency that did not exist before: firms redeployed their assets in new profitable ways (as opposed to rent seeking) and politicians increasingly voted for public goods. In addition, citizens as consumers updated their beliefs in the benefits of liberalization and price stability.

In chapter 6, we discuss institutional deepening and the subsequent economic and political outcomes in the two terms of Lula and first term of Dilma. We also advance three main arguments. First, markets, as evidenced by exchange rate movements, did not anticipate the smooth political transition process from Cardoso to Lula. High uncertainty about a Lula presidency was the norm. After the initial shock resulting from the electoral results, Lula drastically reduced uncertainty by providing credible evidence that his administration would not abandon fiscal and monetary orthodoxy. Second, the new beliefs and institutions (e.g., constitutional constraints that emerged in the 1980s and 1990s) effectively constrained political and economic elites in their interaction, thereby enabling competitive processes in the political and economic arenas. The established political institutions locked-in and reinforced the direction of change by affecting the incentives facing individuals, organizations, and politicians.

The functioning of these economic and political institutions largely explains policy continuity in key areas such as macroeconomic management. But they ultimately reflected the new beliefs emerging out of the transition process and the Cardoso era. Unlike the Cardoso years, however, developments in the economic and social realms entered an autopilot mode. Indeed, there was no necessity for the exercise of leadership: institutional change took place essentially at the margin and within the prevailing bands of the new status quo of beliefs. In other words, outcomes matched expectations, and rents started to move toward a "normal" form—that is, away from the prevailing mechanisms based on control of political property-rights mechanisms.

Lula was a highly charismatic figure who exercised strong personal leadership in the conventional meaning of the expression, but not a leader as defined in chapter 2. Not only did he come from the largest opposition party—the Workers' Party (PT)—he was also the first nonelite politician to hold the chief executive post in the country, and one of the few ever to do so in Latin America. At the most general level, this was highly significant for the new era of inclusive politics.

Third, social redistribution was intensified in the wake of the new social contract that emerged from the change in beliefs in the 1980s and

1990s. However, there was no discontinuity in social policy: old programs were scaled up rather than dismantled or created ex nihilo. Unlike the 1985–1993 period of populist inclusion, the new redistribution was to occur within the constraints of macroeconomic policy.

The continuity of beliefs, institutions, and even policies does not mean that the process was smooth nor that the new government did not seek to imprint its own vision of where the country should go. Rather, the extant beliefs and institutions contain forces that pull policies and behaviors back to a set of bounds compatible with beliefs. Although Lula and Dilma continually tested the bounds and even crossed them on occasions, the country stayed on track. It makes development markedly messy and often disordered. We call the process "dissipative inclusion." Because inclusionary policies naturally redistribute, there will almost always be losers who will resist and oppose those policies. This resistance may or may not be sufficient to stop the redistribution, but in either case, it means that many of the rents dissipate and obvious inefficiencies emerge. The upshot is that the push for greater social inclusion is full of distortions.

In chapter 7, we flesh out an inductive framework for understanding stasis and critical transitions. We developed the framework with a lens on Brazil, but it has more general applicability that we illustrate with a brief application to Argentina. In the final concluding chapter, we offer some conjectures about the future of Brazil, especially in light of recent declarations that the Brazilian miracle has vanished once again.