BRAZIL IS WITNESSING one of the most competitive and thrilling presidential elections in nearly a quarter of a century. In the last three months, polls had the three candidates alternating in the lead. Now, with the second-round runoff between President Dilma Rousseff (Workers’ Party, PT) and Senator Aécio Neves (Brazilian Social Democratic Party, PSDB) close to a toss-up, it’s useful to take a step back to get some perspective on the challenges for the next administration. No matter who wins on October 26, the post-election landscape will be as difficult for the next president as the election is electrifying for the candidates.

The Brazilian economy is clearly suffering from low growth and high inflation. Part of the problem stems from the end of a commodity super-cycle and the Chinese slowdown. But a big part is self-inflicted. For the past three years the government has been creating a crisis of investor confidence in its macroeconomic management. For a country that needs a potentially painful rebalancing of its economy away from consumption-driven to investment-led growth, the draining of confidence is a serious problem.

While investors have been resting their hopes on the potential for an opposition victory, which could usher in the return of sound macroeconomic management and much-needed reforms to heighten Brazil’s growth potential, no matter who wins in October, changes are likely to be more moderate—particularly for those needed reforms. In other words, whoever assumes the presidency in January is not likely to be in a position to push through economic reforms in fiscal, tax, or labor policy at least in the first two years.

The macroeconomic policy tradeoffs will be difficult given low growth, high inflation, and a tough fiscal adjustment—a combination that will quickly erode the next president’s political capital. While either candidate is likely to push for tax reform in 2015, the odds of success are low. State governments will want compensation

castroneves@eurasiagroup.net
for any change in the state-based value-added tax (ICMS), and Congress will be calling for more spending, even though spending has been growing since last year.

Moreover, even though coalitions in the next Congress will not differ dramatically from today’s coalitions, fragmentation will worsen since in the first round major parties lost ground to smaller ones. Presidents are usually able to balance these forces and build a majority with relative ease, but a tougher economic environment and potentially low approval ratings are likely to make it harder to get legislation through.

Rousseff’s coalition, for example, will retain control of 64% of the senate and 59% of the seats in the lower house, down from the current 66%. Numerical majority aside, the election also produced a rebalancing of power within the ruling coalition. In the lower house, major parties like the PT and PMDB, the largest and second-largest caucuses, will lose clout to smaller centrist parties. In practice, this means that a second Rousseff administration will have more difficulty dealing with Congress. In her first term, Rousseff’s ability to negotiate with Congress was heavily predicated on the cooperation of large centrist parties like the PMDB. Now, however, she will have to deal with a far greater number of smaller, centrist parties with diffuse interests.

As for the opposition, led by the PSDB, no major changes will ensue. They lose a few seats in the senate (from 28% to 23% control) and gain some ground in the lower house (from 29% to 41%). However, one fourth of the new opposition seats in the lower house were won by Marina Silva’s PSB. It remains to be seen how the PSB will operate after Silva’s defeat, especially since she is likely to attempt to create her own party next year. Moreover, Neves would face heavy opposition from the left, led by the PT and organized labor. This means that even if Neves wins the election, he will have to reach across party lines to achieve a majority. Congressional dynamics do not bode well for coalition management by an opposition-led government.

While the structural reform outlook is somewhat bleak, there is a silver lining for macroeconomic policymaking. On the management of fiscal accounts, for example, the positive shift would be clear under Neves, but even a second Rousseff government is also likely to make constructive adjustments, though incrementally, to avoid losing Brazil’s investment-grade status.

In other words, it is not likely that a Neves administration would be as positive as many expect or a Rousseff administration as negative. The main difference is that while the policies of Neves would be driven more by conviction, those of Rousseff would be a byproduct of necessity.