

Changing Social Contracts: Beliefs and Dissipative Inclusion in Brazil

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Resumo

A literatura antiga sobre desigualdade e redistribuição presumia que em democracias pressões para atender aos pobres (eleitor mediano) desestimulariam investimento e crescimento econômico. Trabalhos mais recentes tem mostrado que na realidade redistribuição pode induzir crescimento e que a correlação entre poder político e renda mitiga o mecanismo central dos modelos clássicos. Nós usamos um modelo de desigualdade e redistribuição que permite o surgimento de diversos equilíbrios de *steady-state* em um mesmo país. Nós associamos este modelo a uma nova literatura sobre o papel de crenças (*beliefs*) para argumentar que crenças podem ser um dos principais determinantes de qual equilíbrio emerge e mostramos que mudanças de crenças podem levar o país de um equilíbrio para outro. Há evidência de que crenças são tipicamente muito estáveis ao longo do tempo, porém argumentamos que o Brasil tem passado por uma importante mudança de crenças nos últimos trinta anos. A transição de um contrato social para outro tem se realizado através de um processo que chamamos de ‘inclusão dissipativa’, onde redistribuição e inclusão social são obtidos mas acompanhados de distorções, ineficiências e dissipação de rendas.

Abstract

We rely on a model of inequality and redistribution where multiple steady states can emerge in given country. We link this model to a recent literature on beliefs to argue that beliefs may be a major determinant of which equilibrium ensues and we show how changes in beliefs may shift the equilibrium over time. We present evidence that beliefs are typically very stable over time, yet argue that Brazil has recently undergone a dramatic shift in beliefs which we show is associated with a change in the country’s social contract in the past thirty years. The transition from one social contract to another has taken place through a process which we call ‘dissipative inclusion’, where redistribution and social inclusion are effectively achieved but accompanied by distortions, inefficiencies and rent dissipation.

Palavras-Chave: Desigualdade, Redistribuição, Contrato Social.

Key words: Inequality, Redistribution, Social Contract.

Área ANPEC: Área 5 – Crescimento, Desenvolvimento Econômico e Instituições.

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1 Introduction

Every country has its own peculiar social contract, that is, a different mix of redistributive policies through taxes, transfers and regulation with associated levels of inequality, social mobility and development. Although the concept of a social contract implies a ‘choice’ by each country for that way of organizing itself, it is in effect the result of a process of social choice that aggregates individual preferences in the context of specific political institutions which are in turn endogenous to the social contract. The wide variety of social contracts throughout the world, even in countries which are comparable in many other respects such as general location, history and stage of development, has lead researchers to question what leads to different levels and styles of redistribution, and also what impact this has on economic growth and well-being. The most studied contrast has been that between Europe’s high-budget welfare state and the US’s more *laissez-faire* approach. While European countries, and especially those in Scandinavia, have opted for greater levels of taxes, transfers and social insurance, as well as more stringent regulation of labor and other markets, the US has chosen less redistribution and more flexible regulation, leaving more social insurance to be done by families and firms. These choices have been associated with more inequality in the US, yet greater social mobility and economic dynamism.¹

In the next section we review the literature on the determinants of redistribution. This literature has evolved significantly in the past decades. The initial view that the level of redistribution in a society could be explained as positive function of inequality has been reversed and the emphasis on economic determinants has been replaced by a wider range of political, demographic, institutional and behavioral determinants. More recently greater emphasis has been put on the idea that the choice of social contract may be crucially determined by beliefs. Beliefs are a fluid concept and in much of this literature they are thought of as view on issues such as whether people’s fates are determined by effort or luck, or whether the poor are poor because they are lazy or because society is unfair.² These concepts of beliefs are then operationalized by using data from large surveys such as the World Values Survey or the General Social Survey for the US, usually in cross-country or cross-state comparisons so as to reach conclusions about what determines the different preferences for redistribution.

Our interest is not to explain how different beliefs lead to different social contracts across countries, but rather to analyze the shift from the existing social contract – that is, the equilibrium level of inequality and redistribution -to a new social contract as the result of a change in beliefs. In Section 3 we use the model in Bénabou (2000) to show the channels through which a change in beliefs can lead to a new social contract. Although the data shown in Section 4 suggests that most social contracts are relatively stable and long lasting, or only change incrementally over time, we argue in Section 5 that Brazil has undergone a punctuated change in beliefs and social contract since the country re-democratized in 1985.

This distinct break in beliefs provides an opportunity to analyze the details of how a social contract changes in practice. When one considers different social contracts in a

¹ Note however that Alesina, Glaeser and Sacerdote (2001: 212) argue that “(h)arder data on income mobility do not suggest such strong differences in mobility for the middle classes between the United States and Europe.” See also Alesina and Glaser (2004: 191-195).

² In Section 3 will describe the slightly different concept of beliefs that is used in this paper.

model or in cross-country comparisons one usually compares one stable equilibrium with another, without much consideration of the transition process. But in practice a change in social contract can be traumatic and messy. It involves redistributing income, wealth and opportunity. It uproots established ways of doing things and rewrites the rules. Old rights are diluted or extinguished and new ones created. Losers resist and fight back while winners often take time to adapt. The new policies that are suppose to implement the new status quo rarely work smoothly in such an environment and can lead to waste and inefficiency or other unintended consequences. The upshot is that the new social contract might differ significantly from what was originally expected. If this mismatch is sufficiently large it might feedback and lead to another change in beliefs. Alternatively a new unexpected equilibrium might prevail.

In Section 6 we analyze the transition in Brazil from one social contract to another as beliefs changed. We argue that this process has brought the messiness and dissipation described above as well as significant inclusion and openness that have reduced poverty and inequality to unprecedented levels. We call this process ‘dissipative inclusion’ and argue that the net effect of these competing forces result in higher economic growth and well-being. Finally, in Section 7 we discuss why our interpretation of the process of change in Brazil can be difficult to determine from the data, and simply by looking at current events, because the dissipation is more easily observable than the growth-inducing effects of the inclusion.

2. Literature Review on Inequality and Redistribution

Early models of the determinants of redistribution focused on the proposition that in democracies the income of the median voter is normally lower than the mean income so the electoral process overwhelmingly caters to the poor through the imposition of redistributive policies. Data shows that there is great variability in the median to mean income ratio across countries, from almost equality in Denmark to less than two-thirds in Colombia and Brazil. When the median income is significantly below the mean income a proposal, for example, that pooled all resources and gave everyone the mean income would be economically feasible and attractive to the median (and decisive) voter (Bénabou, 2000: 99). The seminal article in this literature is Meltzer and Richards (1981) which postulated that greater demands for redistribution would lead to lower growth because the taxation required for redistribution discouraged savings and investment, and mitigated incentives for work effort and human capital accumulation. The same negative relationship between inequality and growth was later confirmed using new growth models (Alesina and Rodrik, 1994) and overlapping generation models (Persson and Tabellini, 1994). Importantly, these two papers provided empirical evidence through cross-country regressions that growth and inequality are negatively related.

The growth regressions, however, only captured the reduced form relationship between growth and inequality. The actual channel through which inequality affects growth in the models was not tested. This channel, in these models, is the demand for redistribution which is presumed to be greater the bigger the difference between mean and median incomes. A more rigorous test of this prediction was provided by Perotti (1995), who estimated the full structural relationship including the effect of inequality on redistribution and the effect of redistribution on growth. Although the negative reduced form effect of inequality on growth was confirmed under some specifications, the full system told a different story. The data indicated no effect of inequality on redistribution and a positive, rather than a negative, effect of redistribution on growth. Thus, although Meltzer and Richards (1981), Alesina and Rodrik (1994) and Persson and Tabellini (1994) did get the negative relationship right between inequality and growth, they were wrong on both of the intermediary steps.

Figure 1, which uses data from 2007, shows that the relationship between inequality and social spending is negative. The more unequal countries in the sample (Chile, Mexico, Turkey and the US) have significantly less redistributive social spending than the more equal countries (such as Denmark, Sweden, Austria and Finland). The early model's expectation that greater inequality would lead to greater pressure from the poor for redistribution was based on a median voter logic. But even in most democracies it is more reasonably the case that rather than one-person-one-vote, decisions are more influenced by one-dollar-one-vote (Karabarounis, 2011). This means that the decisive voter has an income above the median and maybe even above the mean and would be less interested in redistribution. Bénabou (2000: 107) shows evidence that richer and more educated individuals have a greater propensity to vote, to try to influence others, to contribute money, attend meetings and work on campaigns.

[Figure 1 here]

Similarly the expectation that higher redistribution hinders investment and accumulation is contradicted by the data. Lindert (2011) argues that although "the intuition that taxing and giving hurts economic progress is centuries old, (pg. 3)" the data actually show that the "bigger tax bite to finance social spending does not correlate negatively with either the level or the growth of GDP per capita (pg. 2)." In part this is because most high-budget welfare states actually tax capital and property more lightly than low transfer private market economies like the US and Japan, choosing to finance the social bill by taxes on the least elastic factors of production such as labor income as well as consumption (Lindert, 2011). Besides Perotti (1995) mentioned above, several other papers have also found a positive effect of redistribution on growth: Bénabou (2002), Easterly and Rebelo (1993), Sala-i-Martin (1996), Saint Paul and Verdier (1996), Aghion and Bolton (1997), Galor et al. (2009) and Engerman and Sokoloff (2000). Galor (2011) argues that in most present day societies human capital rather than physical capital has become the major engine of growth so that in the presence of credit constraints and fixed costs of investment in education, redistribution may improve human capital formation with strong impacts of economic growth. Of course, whether redistribution is growth enhancing or not ultimately depends on the details of the policies and their implementation. A World Bank study analyzing 56 public transfer programs in Latin America finds both redistributive schemes that significantly increased welfare and others that resulted in waste (Lindert, Skoufias and Shapiro, 2006).

Given the failure of the early models to explain the patterns in the data we needed a model that could account for a negative relation between inequality and redistribution. Bénabou (2000) developed a model that yielded a U-shaped curve where redistribution is negatively related to inequality at low levels of inequality but positively related at higher levels. We explain the model in greater detail in the next section. Here we provide the basic intuition to motivate the discussion below on the determinants of a country's social contract. The crucial downward sloping portion of this curve results from incorporating two stylized facts that the early models got wrong. The first is the efficiency gain from redistribution, which is related to the existence of credit and insurance constraints that impede the poor from realizing their human capital potential. The efficiency gains imply that even at low levels of inequality there will be high support for redistribution, e.g. a large middle class is willing to tax the few rich. The second is the wealth bias in the process being a determinant of redistribution, as opposed to the median voter being the sole determinant. The wealth bias reduces the support for redistribution as inequality grows and the number of rich individuals who are harmed by redistribution increases. This high level of support at low levels of inequality together with growing resistance to redistribution as inequality rises results in the negative portion of the curve. But after a

certain level of inequality the number of the poor is large enough to overcome the opposition of those who lose from redistribution and thereafter the relationship becomes upward sloping, which is the result obtained in the early models.

The key achievement of the model is that it shows that there can be multiple steady-states for a given country, or for countries with similar ‘fundamentals’, e.g. democracies with a similar level of income.³ A given country therefore has the possibility of ending up in low inequality – high redistribution equilibrium, or a high inequality – low redistribution equilibrium. The model thus accommodated the prototypical contrast between Europe and the US without having to resort to assumptions of different preferences of the population.⁴ It bears stressing that the model implies that the same country (or similar countries) could very well be in either equilibrium, under the same institutions and preferences. This naturally raises the question of which equilibrium prevails. We argue that a country’s equilibrium is initially determined by conditions related to endowments and historical circumstances and then remains on that equilibrium unless a shock knocks it to another. These can be, for example, shocks to the distribution of wealth in the form of immigration, educational discrimination, new technologies or shifts in demand, or shocks to the political system such as expansions of the franchise. These shocks, even if temporary, can move a country permanently from one equilibrium to another, thus history matters.

It is interesting that Bénabou (2000: 97) establishes at the outset the goal of explaining the choice of social contract “without appealing to exogenous differences in tastes, technologies, or political systems.” In a later paper (Bénabou, 2004: 1) he reiterates the intention to answer the question focusing only on political and economic factors and not relying on social norms or beliefs, which he dismisses as ‘easier explanations’ (Bénabou, 2000: 107). Yet subsequent authors have not been shy about appealing to beliefs as a main determinant of the choice of social contract and a vibrant literature has emerged, once again largely focused on the US/Europe puzzle, often using data from surveys like the World Value Survey to quantify beliefs.

In “Why Doesn’t the United States Have a European-Style Welfare State?” Alesina, Glaser and Sacerdote (2001)⁵ analyze economic, political and what they call behavioral answers to this question. Although at times they seem to be reluctant towards relying on beliefs as an explanation, yet in the end beliefs turn out to be a central part of their answer. Alesina, Cozzi and Mantovanz (2009) introduce the belief in fairness in a model that “reconciles several empirical observations which would be inconsistent with models based upon individual income (and position in the income ladder) as the only determinant of voter views about taxes and transfers.” Fong (2001) uses survey data for the US to show that preferences for redistribution are not explained by self-interest, but rather by people’s beliefs on whether the fate of the poor is due to self-determination or exogenously determined. Jusko (2011) shows that cultural diversity can reduce preferences for redistribution in specific contexts. In “Beliefs in a Just World and Redistributive Politics” Bénabou and Tirole (2006) develop a model where beliefs help to explain international differences in levels of redistribution and aggregate incomes. Alesina and Ferrara (2004: 897) find that “preferences for redistribution respond to individual beliefs on what determines one’s position in the social ladder ... *ceteris paribus*, people

³ This will be shown graphically in the next section.

⁴ For a discussion of the European social contract and its changes over time see the discussion in Eggertsson (2005).

⁵ Later expanded into a book entitled: *Fighting Poverty in the US and Europe: A World of Difference* (Alesina and Glaser, 2004).

who believe that the American society offers 'equal opportunities are more averse to redistribution.'" Alesina and Giuliano (2009: 8) argue that people can have views about inequality and social justice both indirectly in their utility function, because it affects their consumption (e.g. through externalities due to crime or education) as well as directly because they have "views about the distribution of income above and beyond how the latter affects their own income."

If one accepts that beliefs matter, this raises the question of what determines beliefs. Several papers have tried to endogenize beliefs. Alesina and Giuliano (2009) provide a broad survey and discussion of the literature on beliefs and redistribution. Giuliano and Spilimbergo (2009: 1) propose the 'impressionable years hypothesis' that "individuals growing up during recessions tend to believe that success in life depends more on luck than on effort." Bénabou and Tirole (2006) introduce some psychology into political economy by developing a theory of differences in ideology and redistributive policies that considers for example that people may simply derive comfort from thinking they live in a just world. Alesina and Fuchs Schundeln (2007) show how indoctrination may influence people's views. Piketty (1995) argues that preferences for redistribution arise from personal history. Alesina, Giuliano and Nunn (2012) argue that the use of the plough by some societies and not others determined the current differences in beliefs about the appropriate role of women in society

In this paper we focus on what we argue is a relatively rare event in the modern world; a large punctuated change in beliefs and the ensuing shift in social contract. In Section 4 we show that in Brazil, as the military regime fell in 1985, beliefs in economic growth at all costs in a stratified society were replaced by beliefs in social inclusion and open access. Because we are dealing with a single country we can make a more detailed case for which beliefs prevailed than studies using a cross-section and relying on one or two survey questions. We show that the new belief initially brought chaos as social inclusion was sought without concern for fiscal sustainability. When social inclusion was interpreted as everyone having a right to everything, hyperinflation was the natural consequence. The profound turmoil and distress of a decade of hyperinflation eventually gave rise to a belief that we call 'fear of inflation,' where society sees the avoidance on a return to the inflationary past as a policy imperative that supplants any other objective. The previous and still held belief in open and equal access along with the new 'fear of inflation' resulted in a belief in fiscally sound social inclusion. The new belief has been the basis for the drastic shift in the social contract in the past two and a half decades.⁶ The shift in the dominant belief allows us to investigate the transition from one equilibrium to another over time. First, however, we develop a framework that provides the tools for understanding the determinants of multiple steady-state social contracts and the shift from the status quo to a new steady-state.

3. What Determines which Social Contract Emerges?

Early models of redistribution predicted that redistribution correlated positively with inequality (Meltzer and Richards, 1981; Alesina and Rodrik, 1994; Persson and Tabellini, 1994). This result was driven by the assumption that redistribution reduces economic efficiency and by reliance on a median voter rule for aggregating preferences. The subsequent literature reversed the thinking on both of these assumptions. Transfers were shown to be potentially efficiency-enhancing and the median voter model has proved to be a poor portrayal of how choices on redistribution are actually made, as wealth significantly biases the influence of different groups and individuals. Bénabou (2000) presented a model that, based on more realistic assumptions concerning these two points,

⁶ We elaborate in Section 5.

provided an account of how a given country could face multiple steady states of redistribution and inequality. In this section we provide a simplified description of the model that allows us to analyze: the determinants of the potential steady states; and the determinants of the shifts from one equilibrium to another.⁷

The model assumes that incomes follow a lognormal distribution with a variance equal to Δ^2 . The distribution is right-skewed so that the median income is below the mean. The level of Δ is a measure of the level of inequality. Suppose that there is a choice of policy where either everyone consumes their own endowments, or all resources are pooled and everybody consumes the mean income. Suppose also, for now, that redistribution entails no dead-weight loss or other form of waste. The support for the redistributive policy is equal to the fraction of the population that lies below the mean income, as the mean income, which they would receive, is higher than their current income. Because the median voter, who is the decisive voter, is below the median, that policy will have enough support to be approved. Even if the decisive voter is above the median but below the mean income, the policy will still be approved. Transforming the log-normal distribution to a standard normal distribution allows us to quantify the fraction of the population that would be in favor of a given policy. The proportion in favor of the redistributive policy is then the fraction p of voters below the mean level of income:

$$p = \Phi(\Delta/2) \quad (1)$$

where $\Phi(\cdot)$ is the cumulative distribution function of a standard normal.⁸ Note that this implies that support for redistribution increases as inequality worsens. Even if the threshold level of support for approval of the redistributive policy is above the median due to wealth effects over political influence, the important result is that $\frac{\partial p}{\partial \Delta} > 0$, that is, the greater the inequality, the greater the support for redistribution. This relationship is shown in the straight line in Figure 3 where $B=0$.

The result found in the early literature (Meltzer and Richards, 1981; Alesina and Rodrik, 1994; Persson and Tabellini, 1994) was actually even more pronounced than that in (1), due to the assumption of deadweight losses from redistribution. Let B be the level of deadweight losses involved in the redistributive policies.⁹ The level of support for the policy of redistributing the now smaller level of total wealth is:

$$p = \Phi\left(\frac{-B + \frac{\Delta^2}{2}}{\Delta}\right) = \Phi\left(\frac{-B}{\Delta} + \frac{\Delta}{2}\right) \quad (2)$$

At high levels of deadweight loss (large B) but moderate to low levels of inequality, p will be low as the proposed redistribution is so wasteful it makes most people worse off. But as inequality increases $\frac{-B}{\Delta}$ tends to zero and $\frac{\Delta}{2}$ becomes larger. The result is that $\frac{\partial p}{\partial \Delta}$ is even more positive than before (see the bottom curve in Figure 3 where $B < 0$). As we have seen, however, this result is not reflected in the data as more unequal countries are not found to redistribute more.

[Figure 2 here]

If, however, as argued in the previous section, we consider that redistributive policies can be efficiency enhancing by, for example, allowing the poor to invest in their human capital in the presence of credit constraints, then B will be positive and the support for redistribution is:

⁷ We rely on the ‘simplified presentation of the main ideas’ in Section 1 of Bénabou (2000: 98-101). The complete model is considerably more complex and elaborate than that presented here.

⁸ Given that incomes are distributed $N(\mu, \Delta^2)$, the mean of the log-normal distribution is $\mu + \Delta^2/2$. Thus a transformation to the standard normal results in $\Phi((\Delta^2/2)/\Delta) = \Phi(\Delta/2)$.

⁹ That is, income is reduced from y to ye^{-B} , where $B > 0$.

$$p = \Phi\left(\frac{B + \frac{\Delta^2}{2}}{\Delta}\right) = \Phi\left(\frac{B}{\Delta} + \frac{\Delta}{2}\right) \quad (3)$$

This case can be interpreted by realizing that there are two effects that determine the support for redistribution. The first effect arises because redistribution increases the size of the pie. This effect is measured by $\frac{B}{\Delta}$, and its impact is high if society is sufficiently equal. But this impact becomes smaller as inequality increases, because there will be more rich people that lose out and oppose the redistribution, even after considering the gain in efficiency. The second effect is related to the term $\frac{\Delta}{2}$, which as before captures the fact that as inequality increases there will be more and more support from the poor to redistribute from rich. The first effect captures a negative relation between inequality and redistribution and the second captures, as above, a positive relation. Together they describe a U-shaped trajectory of the support for redistribution as inequality increases. This is shown in the upper curve in Figure 2 where $B > 0$. The data cited in the previous section indicating that inequality and redistribution are negatively related (see Figure 2 and the literature cited above), suggest that the more empirically relevant part is the negatively inclined part of the curve.

Whether redistribution effectively occurs depends on the social choice mechanism in each country that translates support for redistribution into actual tax, transfers and regulation. For the sake of simplicity assume that a proposal will be approved if a proportion of voters above a certain threshold support the redistribution. This proportion is typically greater than 50% due to wealth effects that bias the weight of the support from the rich. Figure 3 shows that if inequality is below Δ^1 or above Δ^2 the redistributive policy will be approved, but at intermediate levels it will not pass. Whatever happens, the level of redistribution that is chosen will feedback into the level of inequality. It is therefore important to understand how the dynamics of this relationship determines which steady-state will emerge.

We replicate in Figure 3 the curve with $B > 0$ which represents the political mechanisms through which inequality affects the support for redistribution. In addition Figure 4 shows the accumulation mechanism which maps the effect on inequality from the redistributive policies implemented. When redistribution is high, inequality is reduced. When society is at a level of inequality where the political mechanism results in a level of redistribution lower than that which the accumulation mechanism requires for that level of inequality, then inequality increases. Conversely, for any level of inequality, when the political mechanism is above the accumulation mechanism, inequality decreases. The arrows in Figure 3 show how these dynamics can lead to steady states where the chosen level of redistribution is compatible with the level of inequality and thereafter nothing changes unless external shocks alter the position of the curves.

[Figure 3]

We drew Figure 3 to portray a situation where there is more than one steady state. This shows that a country with political and economic ‘fundamentals’ represented by those specific political and accumulation mechanisms can end up in very different social contracts; S^1 with low inequality and high redistribution or S^2 with higher inequality and less redistribution. The consequences of these steady states for economic growth depend on the costs and benefits of redistribution. The benefits derive from the potential efficiency gains that arise as redistribution relaxes the credit constraints that hinder the investment in human and physical capital by the poor. The costs relate to the tax distortions involved in funding redistribution and other associated disincentives to investment and work effort. One equilibrium might involve growth-enhancing

redistributions (e.g. East Asia) and another might involve sacrificing employment and growth for social insurance (e.g. Western Europe).

What determines the various equilibria across countries? Historical factors that determine political systems, power, and demographics, in turn determine the shapes and location of the political and accumulation mechanisms which in turn give rise to inequality and redistributive policies.

Some shocks may affect the shape and location of the curves. Any change that affects the social choice process of preference aggregation or the nature of the wealth bias in the policy making process would naturally change the political mechanism curve. Similarly, any change that affected the effectiveness of redistributive policies in reducing inequality, such as a less distorting tax or improved targeting in social programs, would affect the accumulation curve. More importantly, if beliefs about inequality and redistribution suddenly changed, then both curves would be simultaneously affected, as those other determinants are likely endogenous to beliefs.

Figure 4 illustrates the impact of a change in beliefs. PM^1 and AM^1 are the initial political and accumulations mechanism curves, this time drawn such that there is a single steady state at S^1 in which there is relatively high inequality and low redistribution. Suppose something happens in this country that causes a punctuated change in beliefs over a relatively short time period. In this example the beliefs have changed towards being more inclusive and redistributive. This would shift the political mechanism upwards, as the same level of inequality would induce more support for redistribution. It would also make support for redistribution less elastic (a flatter curve) as an increase in inequality would entice more subdued opposition from the rich who vote against redistribution. Similarly, the new beliefs would shift the accumulation mechanism to the left, as the same level of redistribution would have a bigger impact on reducing inequality. Also, this curve would become more elastic (the axes are inverted for the accumulation curve) as changes in redistribution now have a greater impact on inequality. The total effect of these changes is a shift of the steady-state from S^1 to S^2 , where there is less inequality and more redistribution.

The shift shows that a relatively sudden change in beliefs can lead to a discontinuous change in social contract. Clearly, beliefs and the other possibly endogenous determinants of the ‘choice’ of social contract change incrementally over time, yet our interest in this paper is in a more punctuated change. This allows us to investigate how the practical transition from one equilibrium to another transpires once the underlying factors prompt policy makers to ‘decided’ on a new social contract. Whereas slow incremental changes involve a gradual process of adaptation, a more discontinuous change is more disruptive producing dissipation in its wake.

[Figure 4 here]

4. How Common are Punctuated Changes of Social Contracts?

This section has been dramatically shortened due to space limitations. What the original section does is to show data that indicates that social contracts are relatively stable over time. We then claim in Section 5 that in contrast to this general trend, the experience of Brazil since the mid-1980s has been a relatively rare instance of more abrupt and less continuous change driven by a punctuated shift in beliefs. In this version we maintain figure 5 which show evidence that inequality and beliefs, respectively, have not changed dramatically over time in a large sample of countries.

[Figures 5 here]

5. Changing Beliefs and Social Contract in Brazil

After twenty-two years of military dictatorship Brazil re-democratized in 1985. Ever since then the country has been undergoing a dramatic process of change. In this section we argue that this process has in effect amounted to a shift in the social contract from a high-inequality/low redistribution equilibrium to a significantly lower-inequality/high redistribution equilibrium. We show how the nature of policies has changed and we provide evidence that those policies had an impact on inequality and redistribution, changing the social contract. In addition we argue that these changes were motivated by a punctuated change in beliefs regarding the nature of the social contract.

The first ten years of the military dictatorship (1964-1974) encompassed a period of extremely high economic growth that is known as the Brazilian miracle, achieved through central planning and massive state intervention. In Alston et al. (2012) we identify a dominant belief in this period that we call 'developmentalism'. This is a belief that economic issues must take precedence over social and political concerns such as poverty and political participation. This belief is encapsulated in the maxim of first increasing the pie to divide it later. During this period the budding dissatisfaction with the authoritarian nature of the regime was mitigated by the stellar economic performance. But as that performance deteriorated after 1974, the discontentment with the oppression, repression, censorship, torture and the general lack of freedom grew exponentially and the regime underwent a slow and painful ten year decline in which the belief in 'developmentalism' gave way over a relatively short period of time to the belief in social inclusion.

Up to the present time, there is a belief that social inclusion must be a central goal of society, explicitly pursued by governmental policies and an integral part of the country's social, political and economic life. The first early manifestation of this belief was the massive street protests for direct elections in 1984, a collective catharsis that served as a watershed between the old and the new social order. This was followed by an unprecedented extension in the franchise that included the illiterate and opened the way for the first presidential election (in 1990) in which more than half of the population voted. It is noteworthy that this extension of the franchise was not a strategic decision by a threatened elite, as has often been the case in history (Acemoglu and Robinson, 2000, 2006). Instead it was a choice made by a new regime that had just come to power under the belief of social inclusion and was an expression of the rejection of the exclusionary ways of the past regime. At the same time the new Constitution of 1988 codified the belief in social inclusion by establishing a wide array of extremely progressive rights and protections. Even though many constitutions in other countries have similar progressive styles, Alston et al. (2012) argue that this nature of the new Brazilian Constitution has been crucially consequential in biasing policies irreversibly towards inclusion, openness and representation. This bias, however, did not preclude the wealthy from continuing to command a more than proportional influence on policy, nor interest groups from insulating their transfers in the Constitution. Government expenditures nearly doubled in the wake of the 1988 Constitution under the demands of both inclusive and particularistic policies. Alesina, Glaser and Sacerdote (2001: 225) find a strong correlation (52%) between social spending and the year of the most recent constitution for a sample of OECD countries. The Brazilian Constitution of 1988 surely fit this pattern.

The natural consequence of this new policy environment was hyperinflation. Brazil had intermittently endured high levels of inflation throughout the 20th century, but what took place after 1985 was a whole new experience (see Figure 12). Ten years of annual inflation rates of over 1,000% had a profound effect on the economy and society. Though it did not undermine the belief in social inclusion it did instill a second belief that would come to lexicographically dominate; the fear of inflation. The ten years of suffering and despair, struggling against the irresistible force of ever rising prices, etched in the

souls of a generation of Brazilians the understanding that inflation wreaks havoc to the daily lives of the nation, firms and individuals. This is an understanding that only those that have experienced a hyperinflation can truly grasp. To this effect Mervyn King (2004) cites the diary of a Frankfurt resident in 1923:¹⁰ “[I]t was more than disorder that smashed over people, it was something like daily explosions ... the smallest, the most private, the most personal events always had one and the same cause; the raging plunge of money.”

When Brazil finally tackled inflation in 1994 the country embarked on a new chapter of its history that has lasted to the current day. Free from the overbearing distraction of dealing with inflation and its consequences the government turned towards pursuing the myriad essential reforms that the country badly needed. Importantly, this process was undertaken under the dual beliefs of social inclusion and fear of inflation which amounted to a paradigm of fiscally sound social inclusion which has since been the dominant force shaping policymaking and government action. Alston, Melo, Mueller and Pereira (2008, 2009a, 2009b, 2012) argue that this process has given rise to political institutions that increasingly endowed the President with overwhelming powers, yet subject to strong and effective checks and balances as well as electoral and market incentives to pursue those dual overriding objectives. Under this regime monetary stability has been an imperative irrespective of which party or person has been in power. Similarly, redistributive and inclusive policies have and continue to be expanded. This includes not only the well-known *Bolsa Familia* conditional cash transfer program that is frequently held as a successful model for other countries, but myriad other programs and regulations in every conceivable area.¹¹

We provide examples of the reach of public policy in the next section, where we also address how these policies affect economic performance and efficiency. Here, however, we show that the belief in fiscally sound social inclusion had an impact on the social contract. There was a sharp increase in federal social spending from 1995 to 2009. This was an increase of 146% in real terms and 104% in per capita terms (IPEA, 2011: 25). As a percentage of GDP the increase is more modest but still considerable, justifying Brazil to be classified by Lindert et al. (2006: 3) as a ‘high spender’ in the context of Latin American countries and social spending. Partly as a consequence of the need to finance these expenditures in a fiscally sound manner Brazil has had an extremely high and growing tax burden, especially for a developing country. Out of 179 countries Brazil ranks as the 33rd highest tax burdened in 2012 (34.3% of GDP), above countries like Canada (31.3%), Japan (28.1%) and the US (26.9%) (Heritage Foundation, 2012). Compared to other BRIC economies Brazil’s tax burden is approximately double that of India’s (16.8%) and China’s (17.5%), yet on par with Russia (34.4%). However, while Brazil allocates more than 60% of its total government spending to social programs, matching OECD levels, Russia spends only 50% (World Bank, 2011: 16).

Besides direct government expenditure on social programs Brazil also has heavy pro-social regulation that is indirectly redistributive, such as labor legislation that is strongly biased towards the employee. Perhaps one of the most important redistributive regulations in recent years has been the minimum wage policy. Whereas in 1995 Ramos and Reis (1995) found very little impact of minimum wage policy on reductions of inequality, more recent studies indicate that at least 35% of the fall in inequality by 2005 could be attributed to the minimum wage policy (Saboia, 2007). The real level of the minimum wage in Brazil increased significantly from 1984 to 2012. Since 2006 the official rule for annually adjusting the minimum wage has been to add the variation of

¹⁰ King (2004) cites this quote from Ferguson (2001: 154).

¹¹ See Lindert et al. (2006) for a comprehensive survey and evaluation of the multiple types of social programs in Brazil and other Latin American countries.

inflation in the preceding year plus the growth of GDP two years back. Following this rule the increase in 2012 reached an unprecedented 13%, due to the high level of growth in 2010 and the moderately high inflation of 2011. Although this rule has direct and fiscally perverse impacts on government social security spending, it also serves as a floor and a benchmark used by the private sector.¹² The policy incorporated millions of new consumers into the markets for goods and services, including a plethora of durable goods such as automobiles. Increased social spending is fundamentally changing society in novel ways. The Economist (2011: 48-50) points out that Brazil is undergoing a similar transition as Britain in the 1880s, when rising incomes led to a shortage of domestic servants. It cites a study by IPEA that found that while in São Paulo from 2008 to 2012 the size of the workforce rose 11% and wages 8%, the number of domestics fell by 4% and their wages rose 21%.

Have all these social policies, spending and regulations had an impact on inequality? The evolution of inequality and poverty in Brazil from 1981 to 2009, indicates the answer to this question is 'yes'. Although we do not present a rigorous analysis that there is direct causation from the social policies to the distinct fall in inequality and poverty since the mid-1990s, there is broad consensus in the literature that the redistributive policies have been effective (Barros et al. 2006; IPEA, 2009; Neri, 2012). Both poverty and inequality have oscillated in the past in response to shocks and the macroeconomic cycles, yet it is clear in the data that both have been systematically falling since the early 1990s.

As a consequence of these changes the size of the middle class (class C) has grown from 31% of the population in 1993 to 55% in 2011. Over the same period the richer classes (A and B) have also increased, doubling from 6% to 12% of the population. The growth of the three upper classes was achieved at the expense of the two lower classes (D and E) which nearly halved from 63% to 33% from 1993 to 2011. If it is true that a large middle class is important for economic growth (see Easterly, 2001; and the discussion in Banerjee and Duflo, 2008), then these recent changes in Brazil have the potential to be very consequential.

The data provided in this section shows that Brazil has clearly increased its level of redistribution and reduced the level of inequality since the return to democracy in 1985, which is the point where we identified a sharp change in beliefs towards what would become by the mid-1990s a belief in fiscally sound social inclusion. In short, Brazil has changed its social contract. In the spirit of Bénabou (2000) and as illustrated in Figure 3 we see the changes in Brazil as a move from a low-redistribution/high-inequality equilibrium towards a higher-redistribution/lower-inequality equilibrium. We say 'towards' because it is likely that a new equilibrium has not yet been reached and that the process of transition is still actively underway. Figure 6 plots federal social spending against inequality for 1980, 1985, 1990 and 1996-2009 (due to comparable data availability). The data show a move from the southeast to the northwest, consistent with a change in the social contract. The changes appear modest given the scale of the graph, but keep in mind that the Gini coefficient seldom budges. Also the near doubling of federal social spending from 1985 to 2009 certainly sub-estimates the level of redistribution as a large part of the inclusive policies in Brazil are not through direct government redistribution, but rather through regulation that increases access and participation. And importantly, as noted above, the direction of change in the past decade is indicative that the shift towards a more northwesterly equilibrium has not yet been concluded and that

¹² We will discuss the distortions inherent in the minimum wage policy in the next section.

greater reductions in inequality and increases in redistribution are likely to materialize in the coming years.¹³

[Figure 6 here]

6 – Changing Social Contracts through Dissipative Inclusion

If we accept that Brazil has changed its social contract, the question automatically arises: what happened to social welfare and economic performance? Social contracts are not Pareto rankable, as by definition there are distributional consequences. One cannot, for example, state unambiguously whether a US-style social contract is better than a European-styled one. Therefore, in principle we cannot judge if the new equilibrium in Brazil is superior to that in the early 1980s. We can argue that the new social contract is a direct consequence of the dominant belief in fiscally sound social inclusion.

[Figure 7 here]

If we look narrowly at economic growth instead of social welfare, the picture remains inconclusive. Figure 7 shows the level of GDP growth in Brazil from 1950 to 2007 with the world average GDP plotted in the continuous line. The dotted lines show the GDP growth of the countries at the 20th and 80th percentile. The data show that until the mid-1970s Brazil's economic growth was predominantly above the world average and often higher than the top 20th percentile. Thereafter economic growth has been overwhelmingly below the world average, including most years after 2000. This pattern of high growth under inequality/low redistribution and low growth under less inequality/higher redistribution would seem to suggest that Brazil is moving from a stereotypical US social contract to a European social contract. However, in Bénabou (2000: 113 and 2004: 9) the growth implications of different social contracts are more nuanced than this dichotomy implies, relying instead on the relative magnitudes of the tax distortions associated with redistribution and the presence of credit constraints that hinder investments in human capital and entrepreneurship. More specifically, when tax distortions are high and credit constraints are low, redistribution is expensive and does relatively little to improve the allocation of investment expenditures. In this situation a more redistributive social contract leads to lower income growth. On the other hand, when tax-distortions are relatively small and credit constraints are high, there are net gains to redistribution and a more redistributive social contract induces higher economic growth. Bénabou (2004) describes this result as follows:

Are the potential growth-enhancing effects of redistributive policies in the presence of credit constraints significant, or trivial compared to the standard deadweight losses? While the answer must ultimately come from empirical studies of specific policy programs or experiments, recent quantitative models suggest very important long-run effects, ranging from several percentage points of steady-state GDP to several percentage points of long-run growth, depending on the presence of accumulated factors, such as physical capital or knowledge spillovers, that complement individual human capital. (Bénabou, 2004: 9)

What have been the growth implications for Brazil from these two forces? How does the extent of the dead weight losses involved in the increased redistribution of the past decades compare to the potential for improved investment allocation as redistribution compensates for ill-functioning asset markets? It is not straightforward how each of these constraints can be measured and compared. Given that growth has been below par for the past two decades during which redistribution has been effectively reducing inequality, one might presume that the tax distortion effect had a greater impact than the credit constraint

¹³ That the country would have taken this route is by no means obvious. As recently as ten years ago Medeiros (2001) analyzed the trajectory of the Brazilian Welfare State from the 1930s to the 1990s and concluded that "... there is no evidence that the Brazilian Welfare State has undergone a change of trajectory in the 1990s towards more equalitarian models."

effect. But such a conclusion is premature. Although the growth in incomes as measured by GDP per capita has certainly been low relative to the world average, or even the Latin American average, it is nevertheless also the case that parallel to the reduction in inequality the Brazilian economy has been undergoing dramatic changes in other economic variables besides GDP, such as the drop in poverty, attainment of investment grade status in 2008, record levels of foreign reserves and foreign direct investment, and a dramatic modernization and growth of agriculture (see Alston and Mueller, 2011.) It may be that the increased redistribution in Brazil has been compensating for credit constraints and that many of those who have the talent and opportunity but did not have the wealth, have been investing more and better, but that the impacts on economic growth are simply slow to materialize and have not yet been captured by measures of GDP. This is quite plausible as many of the gains to be had from redistribution work through investment in human capital, entrepreneurship and innovations (or new ways of doing things), all of which typically payoff only in the long run.

What can we say about the relative impacts of tax distortions and credit constraints in Brazil? There are good reasons to expect both to be quite large. A highly unequal country with myriad untapped productive opportunities like Brazil is likely to have huge gains from getting round constraints to better investment allocation. As for tax distortions, Brazil has a highly developed tax system but one that is nevertheless full of inefficiencies and distortions (Lledo, 2005). Furthermore the relevant distortions are not only those in the formal tax system but in all kinds of redistributive policies, such as labor regulation, judicial bias and social security rules that provide work disincentives and impede contracting.

If both tax distortions and credit constraints are high in Brazil, which prevails? We propose to answer this question by looking at how Brazil transitioned from one social contract to the other. This process of transition is more nuanced than would be suggested by theoretical models such as the one presented in section 3. When beliefs and other determinants of the social contract change, the country does not automatically jump from one equilibrium to the next. The process through which beliefs change is not immediate and only consolidates slowly as outcomes match expectations over time. There is a long and messy transition during which it is far from obvious what transformations are taking place. New institutions emerge, creating new constraints and new incentives with many distributional consequences. Those harmed by the changes resist, distorting the intended outcomes of the new policies and capturing part of the gains intended for others. Those who benefit often do not immediately recognize the gains and are often reluctant to back up the changes. Old habits die hard and a clear understanding of how things work under the new institutions takes time to emerge.

Tax distortions and credit constraints crucially affect the ultimate outcomes on growth and inequality. But, we interpret tax distortions more broadly than mere dead-weight losses to include all the rent dissipation that arises as people react to the new institutions and policies, e.g., lobbying, rent-seeking, striking, political squabbling, gridlock, and corruption. In the extreme this dissipation can wash out all of the gains that the redistribution creates. In turn, we also interpret the gains from redistribution more broadly than simply the removal of credit constraints for investment in human capital and entrepreneurship. The redistribution enables access by formerly excluded sections of society to both economic and political organizations and markets. Much current research on economic development stresses ‘access’ as playing a central role to a sustained process of economic and political performance (North, Wallis and Weingast (2009); and Acemoglu and Robinson (2012)). North, Wallis and Weingast (2009) have open access, rule of law for all, and impersonal administration of the law as the defining characteristics of a

developed society. Similarly, Acemoglu and Robinson (2006 and 2012) argue that the lack of inclusive political and economic institutions is the main reason why nations fail.

The shift from low to high redistribution social contracts prompts both dissipation and inclusion. The relative impact of each and the net impact on economic growth and performance depends on the context of each country. In Brazil the transition to a new social contract embodies considerable dissipation and inclusion. We classify this transition as a process of ‘**dissipative inclusion.**’

The starting point of dissipative inclusion is the belief in fiscally sound social inclusion. Social inclusion without the fiscal discipline is self-defeating, as it was from 1985 to 1994 in Brazil when it led to hyperinflations. The inclusion gets written into the laws and policies and gradually becomes a part of the way of doing things. In many cases these goals may initially seem like folly or wishful thinking and are often ignored or badly enforced, generating perverse incentives and other distortions. But over time formal laws and informal norms embody the inclusion, prompting organizations and individuals to accept the changes.

Some examples of dissipative inclusion, pointing out first the dissipation and then the inclusion help describe the process. A prominent example is land reform, which was a central policy of the first civilian government in 1985 and has featured high in the programs of all governments since. The goal has been to redistribute land from unproductive *latifundia* to the masses of landless peasants. The unintended consequence of these policies has been over 18 thousand rural conflicts and more than 1,200 deaths from 1985 to 2010 (Comissão Pastoral da Terra, 2010). The land reform programs have clearly entailed significant dissipation. But at the same time there has also been significant inclusion. By 2010 more than 900 thousand families received land through the land reform programs, in what amounts to a transfer of approximately 87 million hectares, an area greater than Portugal and France combined. Even though a large proportion of these have not managed to become independent producers and many have eventually sold their land, large scale redistribution has nevertheless taken place (Alston, Lib. and Mueller, 2010).

Other examples of dissipative inclusion in Brazil are: expansion of the social security net; (Castro and Ribeiro, 2009); judicial activism towards social goals (Brinks and Gauri, 2012); pro-worker labor laws (Barros and Corseuil, 2004; Almeida and Carneiro, 2009); and quotas in public universities, *inter alia*.

Figure 8 show a typology of policies where the horizontal axis measures the level of inclusiveness and the vertical axis measures the level of economic efficiency. This inclusion-efficiency space is divided into different areas for which we provide descriptive labels. In principle a given country can have different policies in any and all of the areas in this space. But given that all policies in a given country are affected by the same basic political and economic determinants, we would expect them to have similar characteristics. Policies in the bottom left corner are classified as ‘Inefficient Extractive’ as they both exclude much of the population and are economically inefficient (eg. North Korea). In contrast, policies in the top right corner are termed ‘Efficient Inclusion,’ as they simultaneously promote growth and inclusion (eg. Most OECD countries). In the intermediate areas in the policy space we distinguish four other types of policies. ‘Growth-Promoting Authoritarian policies are those that promote successful economic growth through authoritarian means (eg. China). ‘Populist Inclusion’ are policies that have a veneer of inclusion but originate from opportunism and demagoguery of a short-termist government, so that much of the promised inclusion never materializes or gets reversed over time (eg. Argentina). ‘Efficient with Limited Access’ are economically efficient policies that are more inclusive than an authoritarian government would pursue but not yet fully inclusive (eg. late 19th century US). Finally,

‘Dissipative Inclusion’ are policies that achieve significant inclusion, participation and empowerment of previously excluded social groups, promoting changes that in time may be conducive to better economic performance. But this is accompanied by inefficiencies and dissipation of rents as the new policies encounter resistance from those that lose out in the process of redistribution. We argue that these characteristics pervade much of the policymaking in Brazil today.

[Figure 8 here]

The net effect of dissipative inclusion in Brazil is hard to determine because it is hard to quantify both the dissipation and the inclusion, but also because the process is still ongoing and the outcomes on either side do not necessarily materialize at the same time. In many cases the dissipation is quicker to emerge and tends to be much more conspicuous than the inclusion. It may also be, as suggested by Lindert (2003), that over time social spending tends to become less distortive, whereas learning and adaptation tends to make inclusion more effective. For these reasons it is common for the process of dissipative inclusion to be confused with purely dysfunctional policy-making that has no compensating benefits. In the end only time will tell whether the net effect on growth and welfare will be positive or negative. Yet, without a doubt the belief of fiscally sound social inclusion produced an incredible amount of institutional strengthening in Brazil in the past decades. As a result we cannot discount the powerful transformative impact that inclusion is silently achieving amidst the sound and fury of the accompanying distortions and inefficiencies.

7 – Concluding Remarks

Brazil has moved from a high-inequality low-redistribution social contract before 1985 to one characterized by lower-inequality, higher-redistribution today. The repressive years under military dictatorship and the oppressive years under hyperinflation motivated the shift in beliefs. The resulting belief of fiscally sound social inclusion has been the driving force reducing poverty and inequality. We label the transformative process ‘dissipative inclusion’ as it entails effective inclusion but at the expense of significant dissipation of rents.

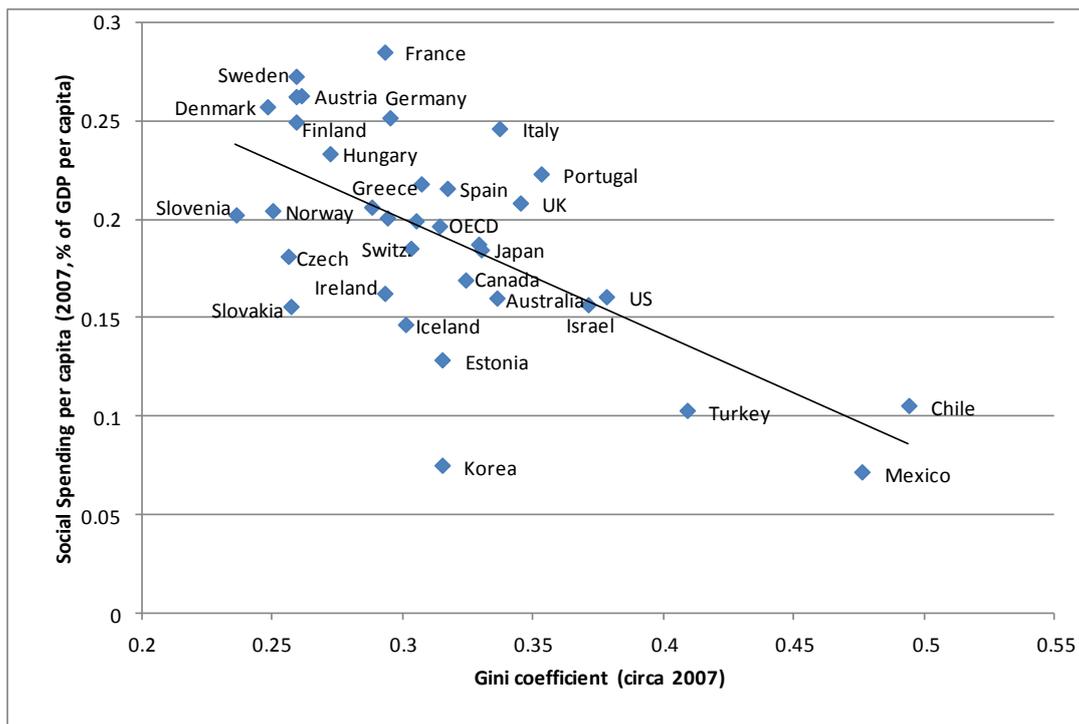
It is tempting to suggest that governments could tweak the process to enhance inclusion and avoid distortions. Naturally, there is room for interventions to improve the terms of the trade-offs. However, the fundamental nature of dissipative inclusion has no short-term fix because it is determined by the distribution of power in society. In the spirit of North, Wallis and Weingast (2009) and Acemoglu and Robinson (2012) the distribution of power means that there are limits to what can be achieved through redistribution in the short run without upsetting the social order. In this sense the dissipative nature of social inclusion may be efficient from a ‘remediableness’ criterion (Williamson, 1996). In the long-run, however, the process of dissipative inclusion should endogenously change the distribution of wealth and power, allowing for less inefficiencies and consequently more growth.

Finally, is the concept of dissipative inclusion specific to Brazil or are there any general insights gained to better understand the process of development? The key element in dissipative inclusion is the existence of some force pushing for inclusion that is capable to match and overcome the formidable forces that naturally resist redistribution. In Brazil the force is the overarching belief in social inclusion. If this belief were not strongly rooted and infused in the country’s lifeblood, from the Constitution to the culture, the judiciary, the press, the educational system, and the political parties, the policies aimed at achieving openness, empowerment and inclusion would be in vain. Any country trying to achieve these same goals motivated by some less powerful force would fail in the face of strong resistance.

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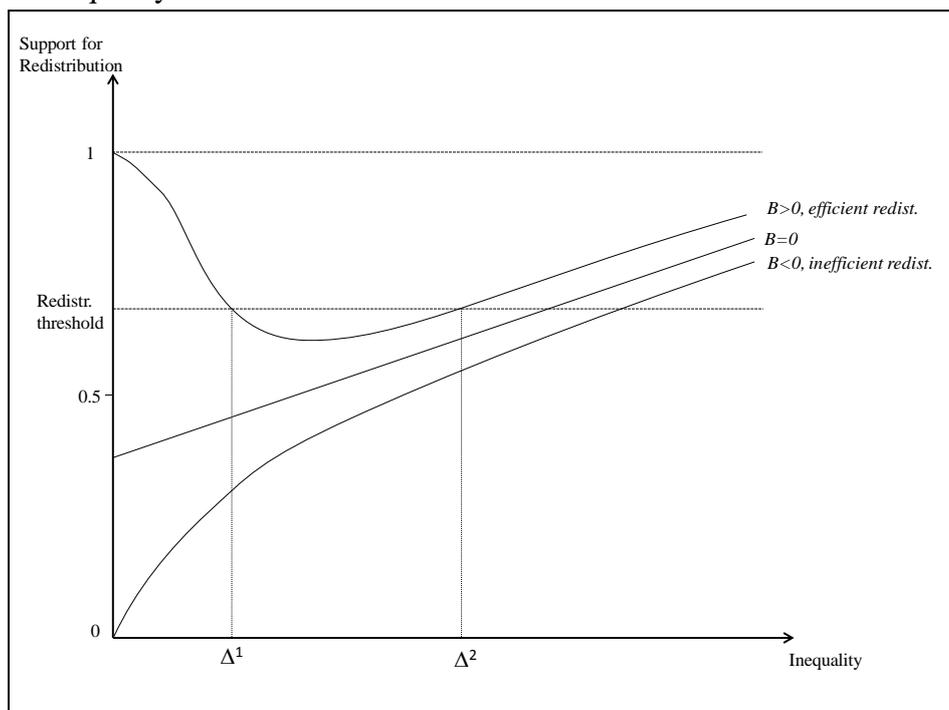
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Figure 1 – Social Spending and Inequality



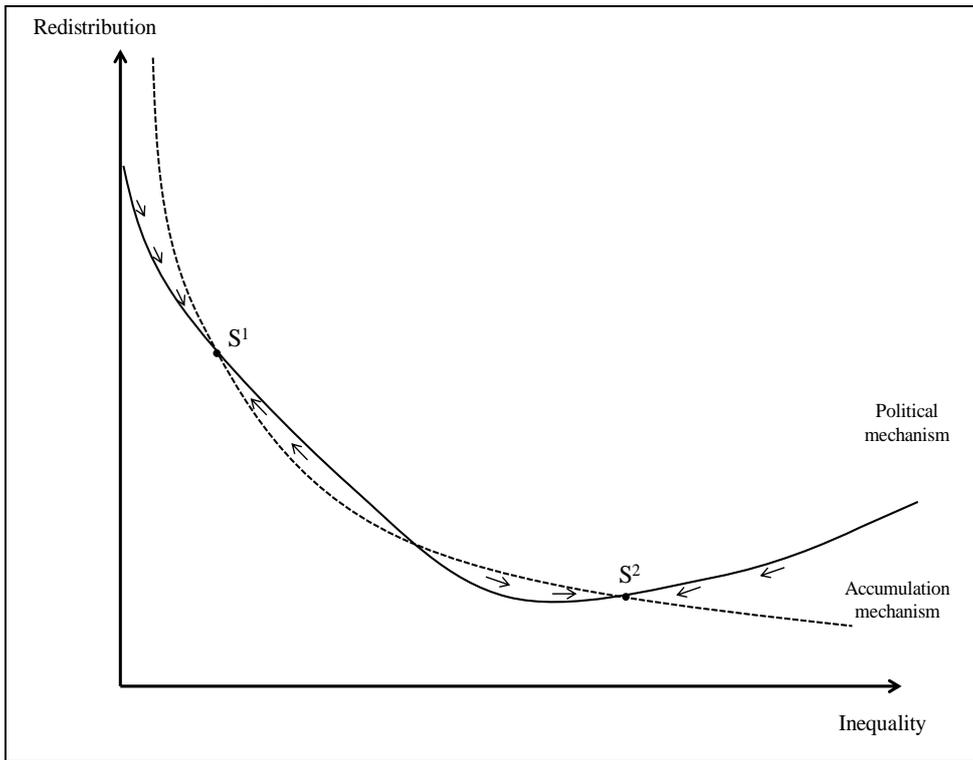
Source: OECD Statistics. <http://www.oecd.org/>. Social spending per capita and GDP per capita are measured at current prices and PPP's.

Figure 2 – Inequality and Redistribution with different levels of Redistributive Efficiency.



Source: Bénabou (2000: 100).

Figure 3 – Multiple Inequality – Redistribution Steady States



Source: Bénabou (2000: 101).

Figure 4 – The Impact of a change in Beliefs

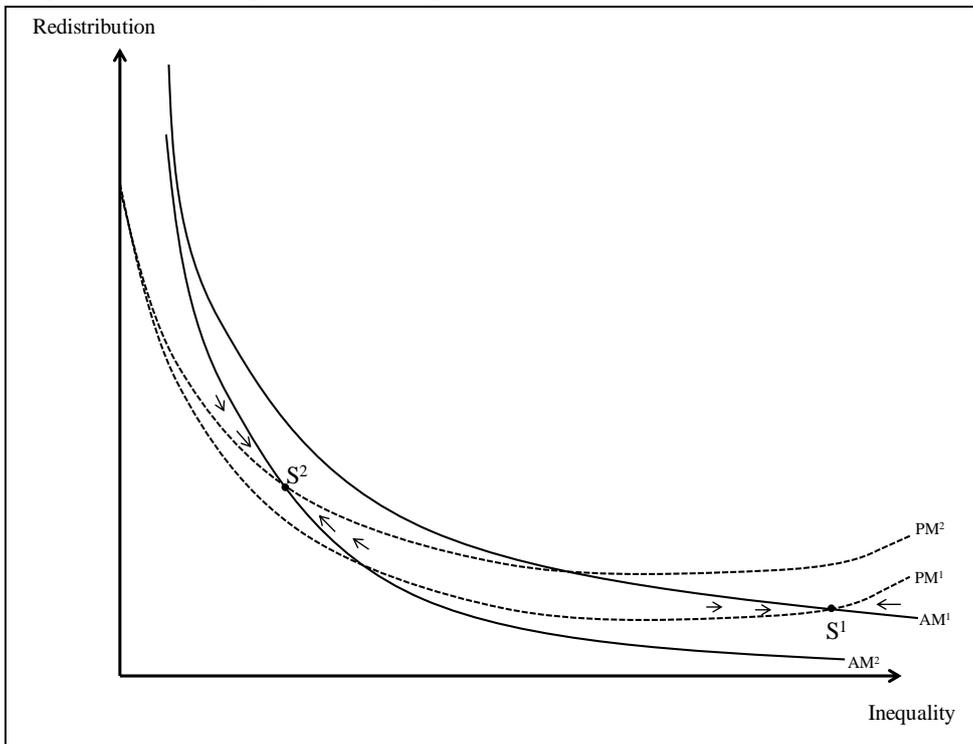
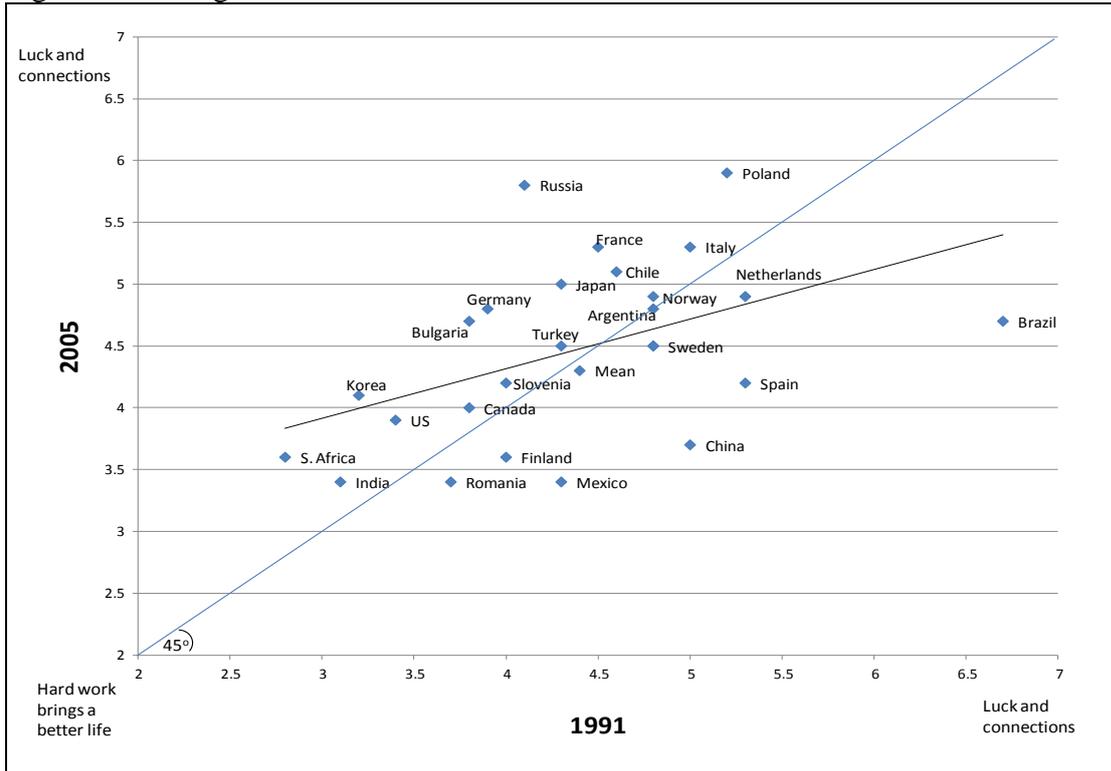
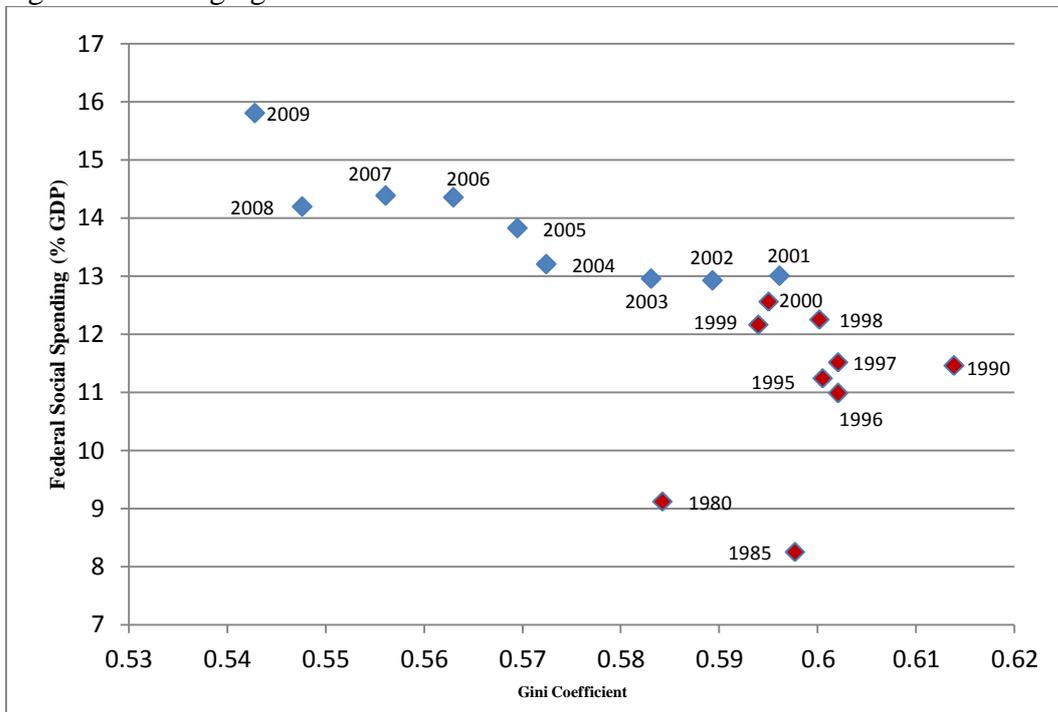


Figure 5 – Change of Beliefs over Time – Hard Work vs. Luck.



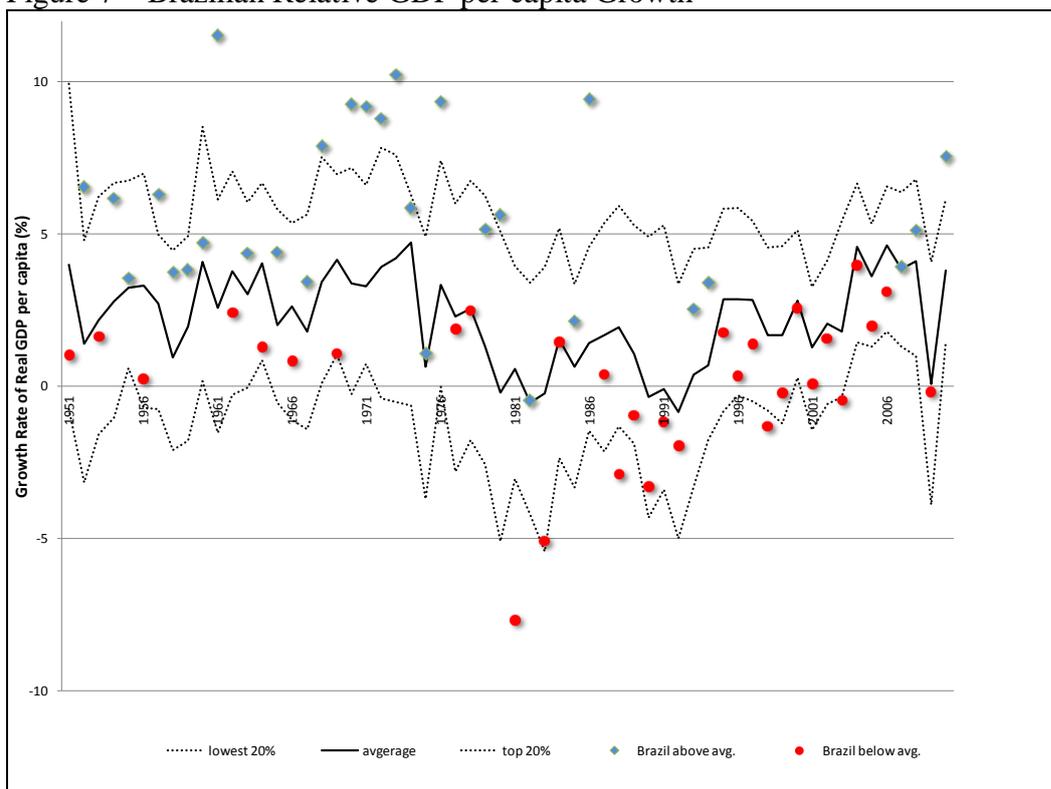
Source: World Values Survey, fifth wave WVS 2005-2008 for 2005 data and Four Wave Aggregate for 1991 data.

Figure 6 – Changing Social Contract in Brazil



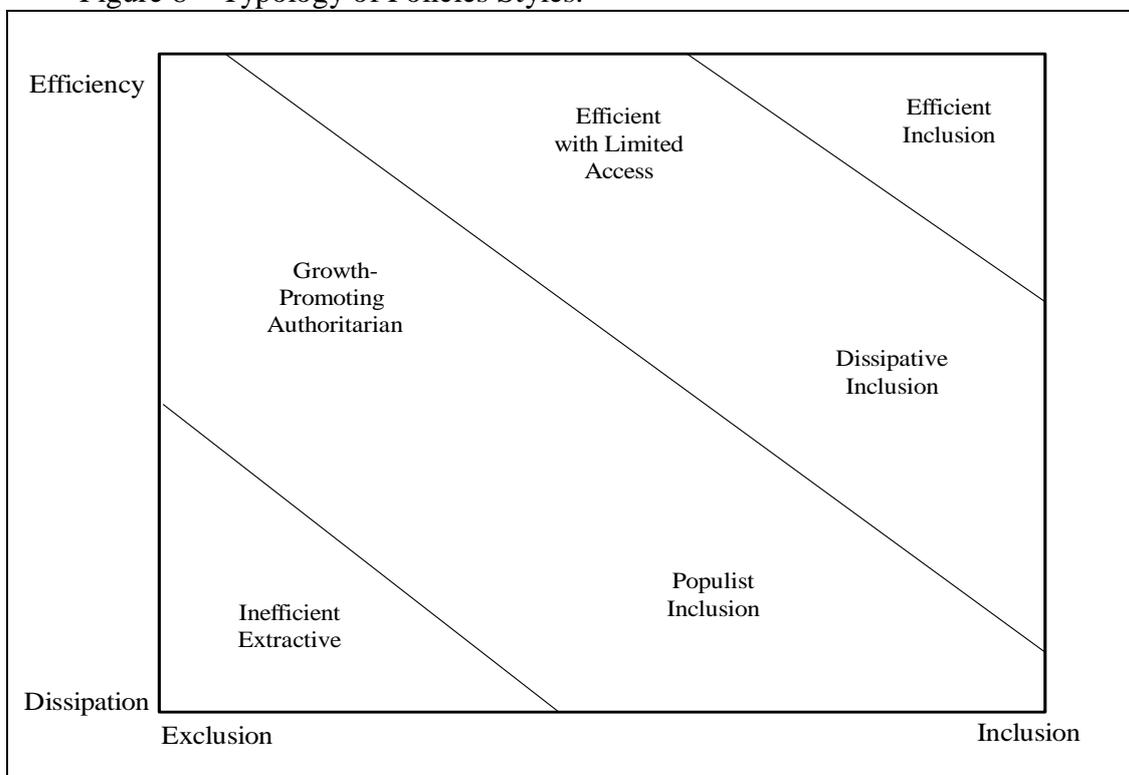
Source: Federal social spending data for 1995 to 2009 from Ipea (2011). Data for 1980, 1985 and 1990 calculated using estimates of total (federal, state and municipal social spending) and estimates of % federal in Ipea (2009: 42-44).

Figure 7 – Brazilian Relative GDP per capita Growth



Source: Data for 1950-2007 from Heston, Summers and Aten (2009), constant 2005 prices (RGRGDPCH). Data for 2008-2010 from IMF (2010)

Figure 8 – Typology of Policies Styles.



Source: Author's elaboration.