The Election: Bolsonaro or Lula?

October 2022

Dear investors,

As is customary in presidential elections, nearly all public debate on politics revolves around who the next president will be. Meanwhile, the seats in the National Congress which largely determine what the future president will actually be able to do occupy a distant second place in public concern.

This lack of attention to legislative seats seems to stem from two reasons: the first is the lower concentration of power in any one person (your congressional candidate would be 1 among 513 in the Chamber, or 1 among 81 in the Senate); the second is a lack of understanding of how the legislative branch operates, and in particular the dynamics of its interaction with the executive branch.

We will therefore summarize the main aspects of the interaction between the president and the National Congress before sharing our view of what awaits us under a Bolsonaro or Lula victory.

What the President of the Republic does

We will focus on the presidential powers that have the greatest impact on the country's economy.

The first is the function of head of state, in which the president leads the country's diplomatic agenda and represents it before other nations, directly influencing the political alliances Brazil will maintain with other countries during the term with consequences for international trade activities and for attracting foreign capital investment. A recent example of this function was Bolsonaro's negotiation with Putin to secure Russia's supply of fertilizers essential to Brazil's agricultural sector.

The second, part of the president's role as head of government, is the right to appoint and dismiss ministers without requiring congressional approval. The president therefore defines the team responsible for the day-to-day management of issues under federal government responsibility, and, directly or indirectly, determines how the budget approved for the federal government is used.

The president also has the power to intervene directly in state-controlled companies, such as Petrobras, which went through successive CEO changes under direct interference from Bolsonaro throughout his term.

In other key powers, the president becomes dependent on legislative branch approvals, which makes clear the importance of having a support base in the National Congress.

Where the president depends on the National Congress

For better or for worse, public administration is required to comply with an extensive body of laws.

Despite appointing his ministers, the president cannot create or abolish ministries and other public administration bodies without congressional approval, so he is forced to govern within a pre-established organizational structure if he lacks legislative support.

The executive branch is also heavily dependent on the National Congress to manage federal finances. Government revenues are derived primarily from the collection of taxes, which is governed by the tax legislation approved by Congress. The executive branch has some autonomy to adjust rates on certain taxes (import and export duties, the IOF financial transactions tax, the IPI excise tax, and fuel taxes), but any other significant fiscal action requires the creation or amendment of legislation and therefore needs congressional support.

In turn, the use of federal revenues must comply with the Annual Budget Law (LOA), which includes an estimate of federal revenues for the following fiscal year, establishes what government expenditures should be, and is approved annually by Congress. The LOA must in turn be drafted in accordance with the Budget Guidelines Law (LDO), which sets spending priorities for the government and is also approved by Congress. The LDO must itself comply with the Multi-Year Plan (PPA), which establishes public administration targets for a four-year period and also requires congressional approval.

In summary, federal revenues and the allocation of collected resources are deeply influenced by the actions of the National Congress. The LOA in particular places significant constraints on the management decisions available to the executive branch, since it prevents the reallocation of resources between different areas of public interest. For example, the government cannot use capital designated for transportation in the LOA for investment in education without congressional approval, regardless of the context. Budgetary rigidity prevents the indiscriminate use of resources, but can also produce incoherent situations. In a caricatured illustration: faced with a sharp spike in food prices, you would have to go hungry but still take your year-end vacation, since resources cannot be reallocated from the tourism budget to the food budget.

The practical effect of our system of government

In general, the president can accomplish very little without the support of a majority of federal deputies and senators throughout the term. The president is therefore practically obliged to negotiate with Congress and make the necessary concessions to secure its support or face having his hands tied when it comes to implementing any change with meaningful impact on the country.

Under this dynamic, the composition of the National Congress heavily influences the direction each government will take, since it determines which presidential proposals will be accepted and can actually be implemented. This is precisely why the election of our deputies and senators so widely ignored by the general public, deserves more attention. Voters should also take care to vote coherently, choosing congressional candidates who are ideologically aligned with their presidential and gubernatorial choices. Otherwise, they are voting for a dysfunctional government in which the executive and legislative branches will be at loggerheads throughout the entire term.

Setting aside the utopia of what should be done, the current (and historical) composition of Congress is highly fragmented. In the Chamber of Deputies, the largest party (PL) holds 15% of seats. In the Senate, the most represented party (MDB) holds 16%. The minimum number of parties that would need to align in order to reach an absolute majority — assuming all members of those parties vote together, would be 5 parties in both the Chamber and the Senate.

Gravity pulls toward the center

Due to this fragmented structure of the Brazilian legislative branch with the National Congress made up of deputies from 23 parties and senators from 17 different parties, a practice known as coalition presidentialism has emerged, in which the government builds a political alliance with a sufficient number of parties to achieve the majority needed in both the Chamber and the Senate to pass its legislation and budget proposals.

This mode of governing consistently draws criticism, but it is a symptom of a political context in which the president depends on Congress to govern and Congress is so fragmented. It is the pragmatic solution grounded in the concept that "politics is the art of the possible," and one that nourishes what is known as the "centrão" (a group of politicians who set idealism aside and focus on brokering deals to secure congressional approvals, with motivations that are at times questionable).

In this political environment, the most ideologically pure agendas, whether from the right or the left, tend not to survive the congressional process. They are progressively diluted through amendments, highlights, and partial vetoes until they accumulate enough votes to be passed. As a result, any future reforms will likely be slow, due to the time required to coordinate among numerous political leaders with differing interests, and moderate, due to this process of dilution tied to the concessions needed to gather votes.

Bolsonaro vs. Lula

According to recent polling, the electorate is fairly evenly divided between right and left. The congressional base is therefore likely to remain fragmented and dependent on several centrist parties to aggregate a majority. Given this premise and the dynamics of the Brazilian political system, which favors the status quo, we believe that either president will be forced to govern through coalitions, with a low probability of being able to implement their campaign proposals in the way their voters expect. This substantially narrows the gap between the two scenarios.

That said, with Bolsonaro and Paulo Guedes as Finance Minister, a more liberal, market-friendly government is expected: one that prioritizes streamlining the public sector and entrusts the private sector with driving the country's economic development.

With Lula, who has not yet indicated who would occupy his Finance Ministry, the expectation is of a government that seeks to strengthen the public sector and charts an economic development plan driven by government stimulus policies.

On state-owned companies, a Bolsonaro government would likely be less interventionist (despite its track record with Petrobras) and would pursue further privatizations, as we saw with Eletrobrás. A Lula government, by contrast, would likely follow his historical pattern of using state-owned companies as arms of the government to execute policies in the public interest, which could result in those companies being guided by motivations other than the pure interests of their private shareholders.

Our expectations

Regardless of which candidate wins, we do not expect major advances in the Brazilian macroeconomy. Over our careers as investors, we have had a very brief period in which the market was enthusiastic about Brazil. Our normal state, unfortunately, is one of tepid growth or outright crisis. We therefore seek to position ourselves in businesses capable of remaining healthy even in this difficult environment. Any better future would be a welcome surprise.

Despite this skepticism, we believe it would be positive for the direction set by Paulo Guedes, whom we regard as a good Finance Minister, to be maintained. In that sense, a Lula victory introduces the uncertainty of whether we will have a capable minister or not. There have been overtures toward Henrique Meirelles, whom we consider a potentially strong candidate for the role, but there is resistance to him from within the PT’s base, which makes his appointment uncertain. Even so, it seems to us that Lula is mindful of not alienating the market and should avoid highly controversial appointments.

In the event of a Lula victory, there is greater risk of political intervention in state-owned companies, which could destroy value for their shareholders. We are therefore avoiding allocating significant capital to that type of company. Today we hold only a small percentage of the portfolio in CELESC, an electricity distributor in Santa Catarina that is controlled by the state government but has EDP as a meaningful minority shareholder acting as a counterweight to the controlling shareholder and advocating for technically driven management. We also bought these shares at a very attractive price, which considerably limits the downside risk of that investment.

Looking on the bright side, Brazil today is better positioned than many developed-economy countries. Moreover, it is the recent difficulties that caused the stock market to fall and allowed us to invest in new theses at low prices. In the midst of crises, opportunities always emerge.

Finally, we reiterate the importance of choosing your senatorial, federal deputy, and state deputy candidates carefully. In this election, we wish good luck to all of us and to our Brazil!