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# **Investment Policy Review**

## **Brazil**

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## **PREFACE**

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with an individual country's investment environment. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review (IPR) of Brazil, initiated at the request of the Government, was carried out through a fact-finding mission in December 2003. The mission received the full cooperation of the relevant Ministries and agencies. The mission also had the benefit of the views of the private sector, foreign and domestic, and civil society.

The UNDP Office in Brazil provided financial support and Carlos Lopes and his team collaborated closely with UNCTAD throughout the preparation of the IPR. On 30 August 2004, UNDP and UNCTAD organized a National Workshop in Brasilia attended by Rubens Ricupero, then Secretary-General of UNCTAD. This was followed by a second Workshop in Salvador. These Workshops presented the main findings and recommendations of the report to national stakeholders and elicited their comments. During the Brasilia Workshop, UNDP and UNCTAD announced a "Joint Project to Strengthen Investment Promotion at the Regional Level", in follow-up to the report's recommendations.

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It is hoped that the analysis and recommendations of this review will contribute to improved policies, promote dialogue among stakeholders and catalyse investment in Brazil.

**Geneva, January 2005**

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## **ACRONYMS AND ABBREVIATIONS**

ANATEL	National Telecommunications Agency
ANEEL	National Electric Energy Agency
ANVISA	National Agency for Sanitary Vigilance
BITs	Bilateral Investment Treaties
BK	Capital goods tariff relief scheme
BNDES	National Bank for Social and Economic Development
CADE	Brazilian Competition Authority
CLT	Consolidated Labor Code
COFINS	Social Security Financial Tax
COPEL	Parana Energy Company
CPMF	Provisional contribution on financial transactions
CPqD	Research and Development Center
CSL	Social contribution charge
ECLAC	Economic Commission for Latin America and the Caribbean
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FGTS	Federal Unemployment Compensation Fund
FITEC	Foundation for Technological Innovations
FTA	Free Trade Agreement
GDP	Gross Domestic Product
HDI	Human Development Index
ICMS	State VAT
ICSID	International Convention for the Settlement of Investment Disputes
II	Import duty
INCRA	National Land Reform Institute
INPI	National Institute of Intellectual Property
INSS	National Institute of Social Security
IOF	Financial operations tax
IPI	Federal VAT on industrial products
IPMF	Temporary tax on financial transactions
IRPJ	Corporate income tax
ISA	Invest in Sweden Agency
ISS	Municipal service tax
M&As	Mergers and Acquisitions
MERCOSUR	Common Market of the South
NAFTA	North American Free Trade Agreement
NIFIDC	National Investment Framework Inter-Departmental Committee
PIS/PASEP	Contribution to employees' savings programmes
R&D	Research and Development
RECOF	Special System of Industrial Depots
SDE	Secretariat for Economic Law
SEAE	Secretariat for Economic Monitoring
SMEs	Small and medium enterprises
TEC	Common external tariff
TNC	Transnational Corporation
TRIPs	Trade Related Intellectual Property Rights
UEG	Electric Company
UNCITRAL	United Nations Commission on International Trade Law
UNICAMP	University of Campinas
VAT	Value-added taxation
WDI	World Development Indicators
WIR	World Investment Report



## BRAZIL



### Key economic and social indicators

Indicator	1990	1995	2000	2001	2002
Population (million)	148.8	160.5	170.1	172.4	174.5
GDP at market prices (billion of current dollars)	465.0	704.2	593.8	509.0	452.4
Annual GDP growth (percentage)	-4.3	4.2	4.4	1.4	1.5
Inflation (percentage)	2'947.7	66.0	7.0	6.9	7.7 <sup>a</sup>
GDP per capita (dollars)	3'124.7	4'386.1	3'490.8	2'952.4	2'592.6
Total External Debt (percentage of GDP)	25.8	22.8	40.2	45.0	51.3 <sup>a</sup>
<b>GDP by sector (percentage):</b>					
Agriculture	8.1	9.0	7.4	6.1	6.1
Industry	38.7	36.7	28.3	22.3	21.0
Services	53.2	54.3	64.3	71.6	71.9
FDI inflows (millions of dollars)	988.8	4'405.1	32'779.2	22'457.4	16'566.0
Exports of goods and services (percentage of GDP)	8.2	7.7	10.8	13.2	15.8
Imports of goods and services (percentage of GDP)	8.2	7.7	10.8	14.2	13.6
Gross domestic investment (percentage of GDP)	20.7	20.5	20.3	20.7	20.3
HDI rank <sup>b</sup>	72	72	72	72	72
Adult illiteracy rate (percentage of people aged 15 and above)	18.0	15.3	13.1	12.7	12.3

Sources: UNCTAD, FDI/TNC Database, World Development Indicators database, August 2003  
Human Development Report (HDR2002 and HDR2003).

<sup>a</sup> Estimates by the World Bank country unit staff (Brazil at a glance)

<sup>b</sup> The HDI measures achievements in terms of life expectancy, educational attainment and adjusted real income.





## OVERVIEW

Brazil has a long history of foreign direct investment going back more than a century.<sup>1</sup> Since the Second World War, Brazil has been the largest recipient of FDI in Latin America, as well as the largest source of FDI in the region. Brazil was also the largest host and home country for FDI among developing countries until the 1980s debt crisis, when the country practically disappeared from the investor spotlight for a decade. But Brazil has made a spectacular return to the FDI scene, with inflows reaching a record \$32.8 billion in 2000.

Brazil's locational advantages have made it traditionally attractive to FDI. At the same time, Brazil needs an FDI strategy to realize more fully the potential contribution that FDI can make to sustained economic growth and broad-based development of its complex and diverse economy. Such an FDI strategy should be geared to the contemporary global context and distinct from that pursued in earlier eras.

Attraction of FDI is official policy of the present Administration.<sup>2</sup> The Government recognizes the need to define a clear FDI strategy, including the adoption of more effective institutional arrangements to put that strategy in practice. One of the main objectives of the newly enacted PPPs (Public Private Partnerships) law is to attract FDI to some important sectors. A review of current institutional arrangements in the area of FDI promotion is also under way. This report aims to inform and facilitate that process.

In the past decade, Brazil has come a long way in progressing from the crises and economic shocks of the 1980s and 1990s to an expanding economy with a stable macro-economic environment. After high and chronic inflation came to an end, in the mid-1990s, FDI has made an impressive comeback aided by expanded opportunities in services and, more recently, resilience in manufacturing despite the global slowdown in FDI flows.

Nonetheless, Brazil still faces challenges. Economic growth and investment have not stabilised at levels needed to reduce unemployment and poverty in a substantial manner. Interest rates have been kept at comparatively high levels, after the sudden return of inflationary pressure that followed the steep currency depreciation of 1998-1999 as well as the instability of the election and transition phase in 2002 – thereby crowding out

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<sup>1</sup> Early investment was in railways, ports and infrastructure.

<sup>2</sup> President Luis Ignacio Lula da Silva and the Ministers of Finance, Planning, Development, Industry and Commerce, External Relations and Tourism actively participated in a meeting with some 200 foreign investors, jointly organized by the Brazilian Government and UNCTAD in Geneva, on 30 January 2004. A couple of months later, a similar meeting, targeting investors from the United States was organized by the Brazilian Government in New York, again with the highest level of participation of the President of the Republic and his economic ministers. The last such meeting took place during the 2005 Annual Meeting of the World Economic Forum in Davos, at the end of January 2005.

private investment. The brightest spot in economic performance has been the substantial and growing trade surpluses of the past three years, with resulting surpluses in the current account. In order to consolidate this initial and promising success, however, the economy will have to sustain a daunting effort in the years ahead.

One underlying challenge is competitiveness. Only a limited number of Brazilian firms, like Embraer, have been able to compete on exports of high technology products, although Brazil has been remarkably successful in many areas of agribusiness and is already poised to become one of the most important agricultural exporters in the world. This selective and limited competitiveness contributes to the less-than-satisfying economic growth rates, unemployment, and has indirect repercussions on public finance. The economy as a whole, and not just individual firms or industries, has to become more competitive.

While there is no golden rule that guarantees export competitiveness, experience of other countries suggests that FDI can play a crucial role. Foreign firms can bring in the technology, management know how, access to global markets as well as international experience and exposure needed for export success. However, as is particularly well known in Brazil, FDI *per se* does not necessarily have optimal impacts.

Foreign affiliates have had a positive impact on capital inflows, investment and production in some industries. And sustained FDI in infrastructure and intermediate services should improve the general level of competitiveness of the national economy. Nevertheless, FDI remains oriented towards the domestic market and, until recently, has not met Brazil's expectations of a greater contribution to export competitiveness and shift of production and export towards more technology intensive and more value-added products. It is also the case that FDI does not have an affirmative impact on regional disparities. FDI remains heavily concentrated in the southeast, although other regions have increased their share recently.

These impacts can be improved if the investment environment – a combination of macroeconomic policies and policies specifically addressed at FDI – are designed and implemented in an adequate way to maximize those FDI impacts desired by Brazil's policy-makers. In such a way, the environment can be changed whilst retaining the qualities of a large and growing market that are the bedrock of Brazil's attraction of foreign investors. This review pinpoints *five strategic gaps* that Brazil could address to obtain outcomes in the quality and quantity of FDI that better meet its development goals. These are:

1. Promote higher levels of competitiveness of the national economy
2. Extend market-seeking FDI into export-oriented FDI
3. Facilitate access to large and demanding international markets
4. Promote more FDI in less developed regions
5. Organise institutions to enhance FDI performance

This report is structured as follows:

- Chapter I reviews FDI trends and performance. Brazil's large internal market has always attracted substantial FDI, historically in manufacturing, and recently in services, spurred by one of the largest privatisation programmes in the world. Although current inflows are well below the record level of 2000, FDI inflows are still much higher than before 1995. And inflows to manufacturing and the primary sector in particular have been resilient despite the global downturn. A greater challenge is to improve the business climate that, in turn, would raise the performance of foreign firms, which compares favourably to domestic firms but not necessarily to world standards.
- Chapter II examines the investment framework. Brazil is open to FDI and has a strong record in dealing with investors. The business regulatory regime has not discouraged market-seeking FDI. Nevertheless, Government could consider policy options to enhance the country's competitiveness *vis-à-vis* other locations in relation to efficiency-seeking and export-oriented FDI.
- Chapter III considers in more detail the strategic issues highlighted above - promoting national competitiveness, extending market-seeking FDI into export-oriented FDI, attaining better focus on FDI in less developed regions and organising government institutions to implement an FDI strategy designed to serve national goals.



## **I. FDI TRENDS AND PERFORMANCE**

Brazil made a spectacular come-back to the world foreign direct investment scene in the second half of the 1990s, following a series of domestic reforms that restored a degree of macroeconomic and financial stability and promoted the internationalisation of the Brazilian economy. FDI inflows soared to \$32.8 billion in 2000 and totalled \$196 billion during 1995-2004. But the “FDI boom”, as happened in other developing and developed countries, was largely triggered by the privatisation programme in service industries and should not represent the benchmark for projecting future FDI inflows.

With the economic outlook improving, Brazil's large internal market continues to attract market-seeking investment by TNCs. If FDI is to contribute more significantly to the country's competitiveness and growth, Brazil would need to consider policy reforms to foster the attraction and retention of more efficiency-seeking and export-oriented FDI.

### **A. Inward FDI trends**

#### **1. FDI size, growth and key determining factors**

Foreign direct investment has played a significant role in the Brazilian economy for nearly a century. An import-substitution strategy kept the Brazilian market sheltered from foreign competition and offered, most importantly, the attraction of a large and dynamic domestic market. This made Brazil a leading destination for FDI among developing countries from the Second World War until the early eighties. In 1980 Brazil had the largest stock of inward FDI among developing countries (and the seventh largest in the world) - \$17 billion (leaving Hong Kong, China aside).

The Latin American foreign debt crisis hit Brazil in 1983. Severe macroeconomic and political instability, large budget deficits, hyperinflation (reaching more than 2,500% in one year<sup>3</sup>) and low growth characterized the Brazilian economy for the rest of the decade and into the early 1990s. Brazil lost most of its lustre in the eyes of foreign investors, and FDI flows weakened (from \$1.8 billion annually during 1972-1982 to \$1.4 billion during 1983-1993) at a time of growing competition for FDI worldwide.<sup>4</sup>

China quickly overtook Brazil as the FDI preferred destination, as FDI often tends to be attracted to large and growing markets. Other developing countries were also attracting more FDI. As a result, Brazil's ranking among developing countries as a recipient of FDI

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<sup>3</sup> From February 1989 to February 1990, inflation reached 2,751%.

<sup>4</sup> Curiously enough, most TNCs did not leave Brazil during the long crisis but took a “wait and see” stance. This was due to large fixed assets they had in the country. In addition, the dominant positions many of them enjoyed and continued trade protection underpinned their profitability, enhanced by financial investments. A number of them turned to exports, encouraged by Government's export promotion programme called Befix (Pedro da Motta Veiga “Foreign direct investment in Brazil: regulation, flows and contribution to development”, mimeo., May 2004, p. 17). But they undertook little new investment. As a result, during 1980-1990 total profit remittances on FDI were marginally higher than FDI inflows

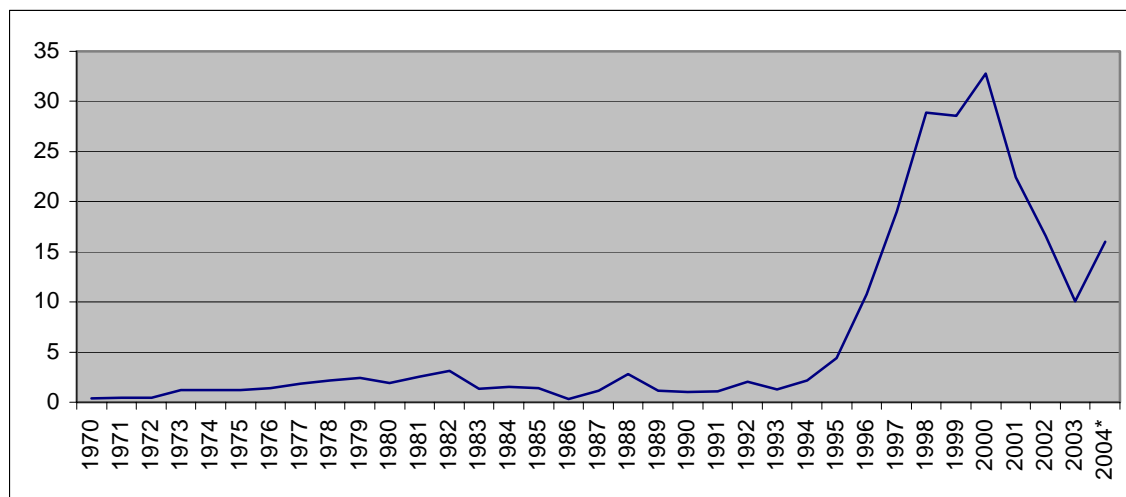
slid from first in 1980 (with 3.6% of global FDI flows) to 11<sup>th</sup> in 1990 (2.6%) and 14<sup>th</sup> in 1993 (1.1%).

Starting with the Real Plan in 1994, aimed at restoring macroeconomic and financial stability, the situation shifted dramatically. FDI inflows to Brazil boomed, climbing from \$1.3 billion in 1993 to an unprecedented peak level of \$32.8 billion in 2000 (Figure I.1.). The Real Plan and other reforms enabled Brazil to regain the attention of foreign investors. In 2000, it was the second largest FDI recipient among developing countries, following China. During the worldwide economic downturn and FDI slump of 2001-2003, inflows declined (Figure I.1.) but were well above historical levels.

In fact, although the “FDI boom” ended with the winding down of the privatisation programme, FDI flows to Brazil are still significantly higher than at any time before 1996. This is because FDI inflows to the manufacturing and primary sectors have shown remarkable resilience in the face of both the drastic global downturn in FDI flows after 2000 and the slowdown of economic activity in Brazil. UNCTAD estimates, based on data from the Central Bank of Brazil, project FDI flows for 2004 on the rise for the first time since 2000, totalling around \$16 billion.

**Figure I.1. FDI flows to Brazil, 1970-2003**

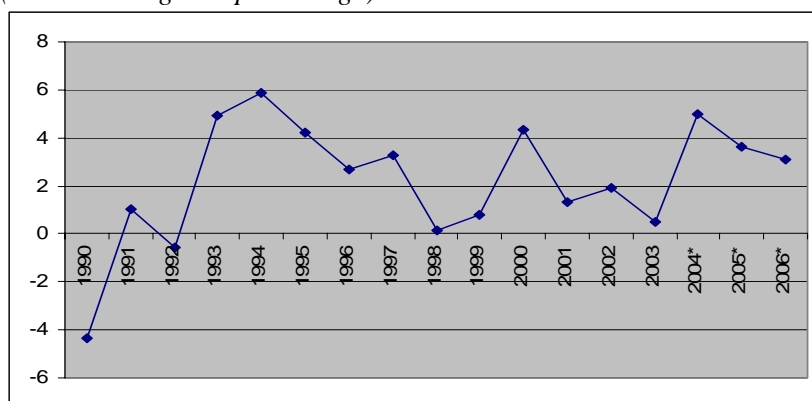
(Billions of dollars)



Source: UNCTAD and Central Bank of Brazil. \*Projected inflows.

The Real Plan mostly succeeded whilst four earlier plans had failed. It introduced a new currency pegged to the dollar, squeezed out hyperinflation, increased investors' confidence and boosted credit availability. Economic growth resumed, achieving levels not seen in Brazil for many years (e.g. 6% in 1994). But at the turn of the century, growth slowed again (Figure I.2.). This occurred due to both internal (the financial crisis of 1998-1999 and the energy crisis of 2001) and external factors (worldwide economic slowdown and the Argentinean crisis).

**Figure I.2. Brazil: actual and projected real GDP growth, 1990-2006**  
(Annual changes in percentage)



Source: 1990-2003, Central Bank of Brazil.

\* Data for 2004, 2005 and 2006 are Economist Intelligence Unit's projections.

A series of structural policy reforms also favoured the recovery of investment flows to Brazil since 1995. Key among them was the amendment of the Constitution in 1995, eliminating the constitutional distinction between Brazilian companies in citizen ownership and those with foreign ownership (see chapter II on this and other measures). This, together with an ambitious privatisation programme, opened up public and especially infrastructure services such as telecommunications and electricity to private investors. Many new opportunities were created for private investors, including foreign investors, especially for services FDI. Indeed, privatisation-related FDI explains much of the recent behaviour of FDI flows into Brazil - their surge to unprecedented levels of \$29-33 billion during 1998-2000 (a period of low economic growth) and their decline later on as privatisation wound down.

Brazil also did much to open up to international trade, beginning to part from less open policies pursued in the past. Throughout the early 1990s, the Government introduced a series of trade liberalisation measures, known as "abertura comercial", which eliminated most non-tariff import barriers. In 1994 average applied tariffs had fallen to one fifth of their level in 1987<sup>5</sup>. In 1991, Brazil was a founding member of the Common Market of the South (MERCOSUR), a customs union with Argentina, Uruguay and Paraguay. Thus trade liberalization was coordinated with these countries. Economic difficulties of MERCOSUR members, notably of Brazil itself and Argentina, led to a temporary reversal of some liberalization measures, but the trend was set and will continue in the future with the improving economic situation.

There is evidence that trade liberalisation related to MERCOSUR attracted some FDI sourced from non-member countries, for example TNC investment in food industry in Brazil and in the automobile industry in Brazil and Argentina. There is insufficient evidence to show whether trade liberalisation in general affected the size of FDI inflows,

<sup>5</sup> From 58 % in 1987 to 11 % in 1994.

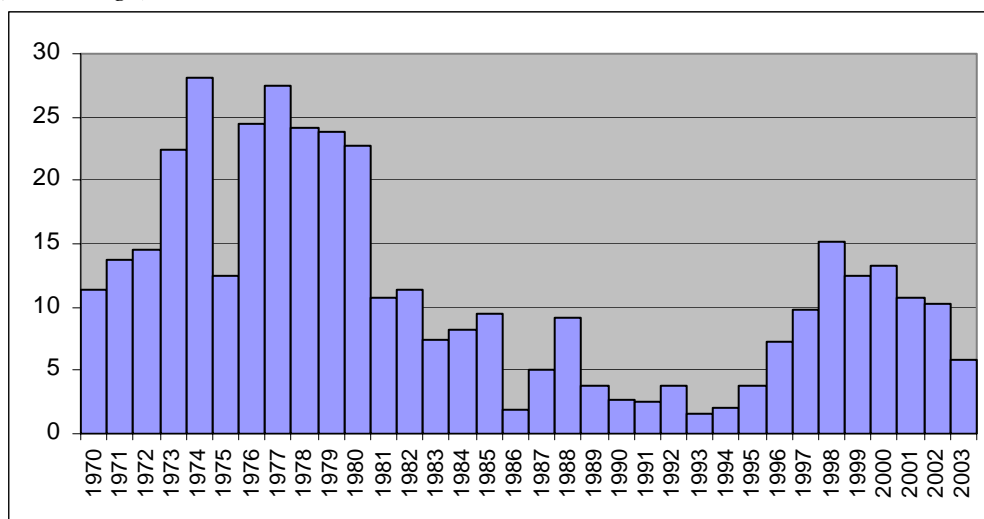
but it was important for FDI operations in Brazil, as it helped to reduce the prices of imported capital goods, used extensively by foreign investors, by half in 2001 compared with 1990.<sup>6</sup>

Among specific industry policies, which affected the size of FDI inflows, the auto industry regime, including in particular significant federal and regional incentives, has been instrumental in attracting large FDI into this industry and influencing its impact.<sup>7</sup> Other specific regulatory changes concerning the Law on Information Technology aimed at increasing benefits from investment in respective activities or industries (notably to encourage R&D), rather than stimulating additional investment.

How does the greatly improved Brazilian performance in attracting FDI after 1994 compare with that of other developing and selected developed countries?

From 1995, Brazil's relative<sup>8</sup> FDI performance increased significantly (as shown in Table I.1. and Figure I.3.). Brazil regained the role of a major player, but not a dominant one among host developing countries, which it held until the debt crisis in 1983 (Figure I.3.).

**Figure I.3. Share of Brazil in FDI inflows to developing countries, 1970-2003**  
(Percentage)



Source: UNCTAD

When FDI flows are compared to the size of GDP, they increased dramatically in Brazil from an annual inflow of \$4 per \$1,000 of GDP during 1991-1995 to \$38 during 1996-2002 (Table I.1.). But as inflows to the developing countries as a whole also accelerated, this meant that Brazil simply caught up with and slightly exceeded the average for developing countries (\$32). On an annual basis, with declining flows after 2000, it has again fallen behind on this measure of relative FDI attraction.

<sup>6</sup> Moreira, M. M., 2004, p.6.

<sup>7</sup> ECLAC, *Foreign Direct Investment in Latin America and the Caribbean*, United Nations 2004, Santiago de Chile, pp. 118-119.

<sup>8</sup> "Relative" means in relation to the size of an economy or a country. FDI as a proportion of GDP is useful indicator for relative importance, because the required data are widely available.



It is common to compare FDI performance of Brazil, the former leader, with that of China, a recent leader among host developing countries. Between 1980 and 1985, Brazil received more than twice the FDI flows of China. Since then, flows to China increased steadily, even after 2000 and the global slowdown in FDI flows. For the period 1996-2002, China attracted twice as much FDI as Brazil and the gap between the two countries is also reflected in higher FDI inflows per \$1000 of GDP in China (\$37.7 for Brazil and \$43.6 for China).

### **Box I.1. Shortcomings of FDI data in Brazil**

In spite of considerable progress in the homogenisation of balance of payments measurement, including FDI flows, in Latin America, shortcomings still persist, making inter-country comparisons of FDI performance a delicate task<sup>a</sup>. Brazil implemented many of the recommendations of the IMF Balance of Payment Manual (so called BPM5), but it stopped including reinvested profits of foreign affiliates (one of the three components of FDI inflows apart from equity shareholdings and intercompany loans) as of 1999, due to difficulties in collecting the data. As a result, data on FDI inflows after 1998 underestimate the actual inflows. Before 1999, the share of reinvested earnings in total FDI inflows decreased during the 1990s, from an average of 19.6% during 1990-1992, to 1.3% during 1996-1998, but the latter figure is, most likely, seriously underestimated, given difficulties in data collection, which led to its suspension altogether.

The measurement of FDI inward stock poses even greater difficulties. FDI stock data are collected on the basis of national surveys of companies with foreign participation. In the case of Brazil, it is the Census of Foreign Capital, carried out every five years since 1995. The latest Census is for 2000. To estimate FDI stock after this year, data on FDI inflows in dollars from the Balance of Payments are accumulated monthly. They are converted to Reals by the average value of the dollar in each month and cumulated for the year, representing an annual addition to Brazil's international investment position. Before adding it to the previous stock in dollar terms, the new annual stock value addition is reconverted into dollars by the end-of-the-year exchange rate. This procedure will understate the value of the FDI stock if the currency depreciated significantly during the year, and overstate it in the opposite scenario. As a result, although the cumulated value of FDI inflows to Brazil for 2001 and 2002 totals \$39 billion, the FDI stock, estimated using this procedure by the Central Bank of Brazil, decreased from \$103 billion in 2000 to \$100 billion in 2002. To better compare Brazilian stock data with those of other countries (in many of which stock is estimated by cumulating annual inflows in dollars) in Table I.1. the FDI stock figure for Brazil for 2002 is calculated by adding to the stock of 2000 (based on the Census) inflows for subsequent years.

<sup>a</sup> On the shortcomings of FDI data in Latin America, see ECLAC, 2004, p.22

**Table I.1. Comparative performance of BRAZIL with selected countries,  
1981 – 2002  
(Dollars and percentage)**

Country	Absolute performance							Relative performance							
	FDI inflows Per year				FDI Stock <sup>a</sup>			FDI inflows Per year				FDI Stock <sup>a</sup>			
	Billions of dollars				Billions of dollars			Per \$1000 GDP (Dollars)				Per capita (Dollars)	As % of GDP		
	1981-1985	1986-1990	1991-1995	1996-2002	1995	2000	2002 <sup>a</sup>	1981-1985	1986-1990	1991-1995	1996-2002	2002	1995	2000	2002 <sup>a</sup>
<b>Brazil</b>	<b>2.0</b>	<b>1.3</b>	<b>2.2</b>	<b>22.7</b>	<b>41.7</b>	<b>103.0</b>	<b>142.0</b>	<b>8.1</b>	<b>3.7</b>	<b>4.2</b>	<b>37.7</b>	<b>578</b>	<b>5.9</b>	<b>17.3</b>	<b>27.9</b>
Argentina	0.5	0.9	3.8	9.0	28.0	67.6	71.8	5.8	8.1	16.0	32.7	949	10.8	25.7	26.7
Australia	2.0	6.7	6.3	7.7	98.9	108.7	126.7	11.1	26.1	18.6	19.6	6'200	27.9	28.9	35.4
Canada	1.8	6.1	6.0	26.4	123.3	212.8	262.2	5.3	12.8	10.4	39.1	7'052	21.1	29.0	37.2
Chile	0.3	0.7	1.7	4.7	15.5	45.4	51.5	12.7	26.6	33.1	67.6	2'814	23.8	60.0	77.5
China	0.8	2.9	22.5	44.1	134.9	348.3	447.8	3.3	9.0	43.1	43.6	350	19.6	32.3	37.6
India <sup>b</sup>	0.1	0.2	0.8	2.9	5.6	17.5	24.4	0.3	0.6	2.5	6.5	24	1.6	4.1	5.0
Indonesia <sup>c</sup>	0.2	0.6	2.3	-0.2	50.6	60.6	55.8	2.6	6.1	14.1	-5.1	273	25.0	40.4	38.4
Malaysia	1.1	1.2	5.1	4.0	28.7	52.7	56.5	37.4	30.6	76.4	43.5	2'325	32.3	58.6	64.1
Mexico	2.1	2.1	6.8	14.8	41.1	97.2	136.2	10.8	11.5	19.6	30.0	1'539	14.4	16.8	21.8
Thailand	0.3	1.2	1.9	4.0	17.7	30.1	35.0	7.3	17.2	15.3	32.1	570	10.4	20.3	30.3
All Developing	20.4	27.3	79.9	197.3	916.7	1939.9	2311.5	8.2	8.8	16.4	31.5	466	16.5	31.1	35.5

Source: UNCTAD/ TNC database (WIR2003), World Bank (WDI2002)

<sup>a</sup> The stock values for 2002 are computed adding the cumulated inflows for 2001 and 2002 to the stock values of 2000. For more details, see Box I.1.

<sup>b</sup> The stock figure for 1995 corresponds to the FDI cumulated inflows since 1970, due to lack of stock data before 1997.

<sup>c</sup> The stock figure for 2000 corresponds to the stock figure for 1999 plus the FDI cumulated inflows for 2000, due to lack of stock data for 2000.

## 2. FDI by sector, type and industry

### *The sectoral pattern*

Throughout the first half of the 20<sup>th</sup> century, FDI in Brazil was concentrated in services: transportation, finance, trading and electricity.<sup>9</sup> Later on, FDI shifted towards manufacturing. The State took over the provision of key services and pursued a vigorous policy of attracting FDI into manufacturing under an import-substitution strategy. Consequently, TNCs were instrumental in building up a sizeable manufacturing sector in Brazil. During the 1970s, for example, TNCs accounted for almost half of the total capital in manufacturing, playing much greater roles in capital- and technology-intensive industries.<sup>10</sup> By the end of the 1980s, manufacturing accounted for 71% of total FDI inflows and, in 1995, its share of FDI stock was 67%.

Since 1995, although FDI increased in all Brazilian sectors, it concentrated more in services. Thus, the sectoral share of FDI once again shifted towards services. In 2000, services accounted for 66% of total FDI stock (Table I.2.). The high average share of services continued during 2001-2003 (57%), but on annual basis it declined to 35% by 2003.

By contrast, FDI in the primary sector was traditionally negligible, in spite of Brazil's rich natural resources. Until 1994, foreigners were banned from extractive industries, and in 1995 FDI stock in the sector was only \$1 billion, or 2% of the total stock. After opening mining to FDI, investment increased (Table I.2.), reaching an all-time high in 2003, and accounting for almost 10% of total FDI flows to Brazil. FDI in agriculture remains negligible.

**Table I.2. FDI stocks, 1995 and 2000 and flows by sector 2001-2003**

(Billions of dollars and percentage)

	1995		2000		Difference 2000-1995	2001-2003	
	Stock	%	Stock	%	Stock	Cumulated flows	%
<b>Primary sector</b>	<b>0.9</b>	<b>2.2</b>	<b>2.4</b>	<b>2.3</b>	<b>1.5</b>	<b>3.6</b>	<b>6.9</b>
<b>Manufacturing</b>	<b>27.9</b>	<b>66.9</b>	<b>34.7</b>	<b>33.7</b>	<b>6.8</b>	<b>19.1</b>	<b>36.2</b>
<b>Services</b>	<b>12.9</b>	<b>30.9</b>	<b>65.9</b>	<b>64.0</b>	<b>53.0</b>	<b>30.0</b>	<b>56.9</b>
Telecommunications	0.4	1.0	18.8	18.2	18.4	11.2	21.2
Holdings	5.0	11.9	11.0	10.7	6.1	2.4	4.5
Financial intermediation	1.6	3.9	10.7	10.4	9.0	4.1	7.8
Electricity and gas	0.0	0.0	7.1	6.9	7.1	3.6	6.9
Commerce	2.9	6.9	10.2	9.9	7.4	4.6	8.6
Other services	3.0	7.2	8.1	7.8	5.1	4.2	7.9
<b>TOTAL</b>	<b>41.7</b>	<b>100</b>	<b>103</b>	<b>100</b>	<b>61.3</b>	<b>52.7</b>	<b>100</b>

Source: Central Bank of Brazil

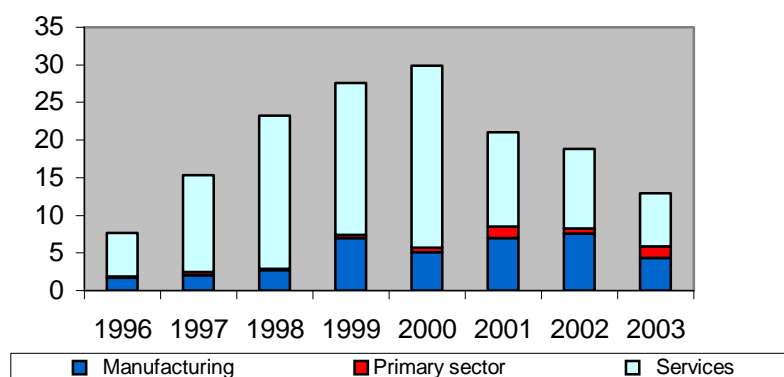
<sup>9</sup> Da Motta Veiga, P., *Foreign Direct Investment in Brazil: regulation, flows and contribution to development*, May 2004, p. 15.

<sup>10</sup> Chudnovsky, D., Kosacoff, B., Lopez, A., *Las multinacionales latinoamericanas: su estrategia en un mundo globalizado*, FCE, 1999).

### The privatisation programme

The single most important factor that triggered this shift of FDI since the mid-1990s from manufacturing to services was the privatisation programme, opening activities previously closed to foreign investors, most notably public utilities and financial services.

**Figure I.4. FDI inflows to Brazil, total and by main sectors, 1996-2003**  
(Billions of dollars)



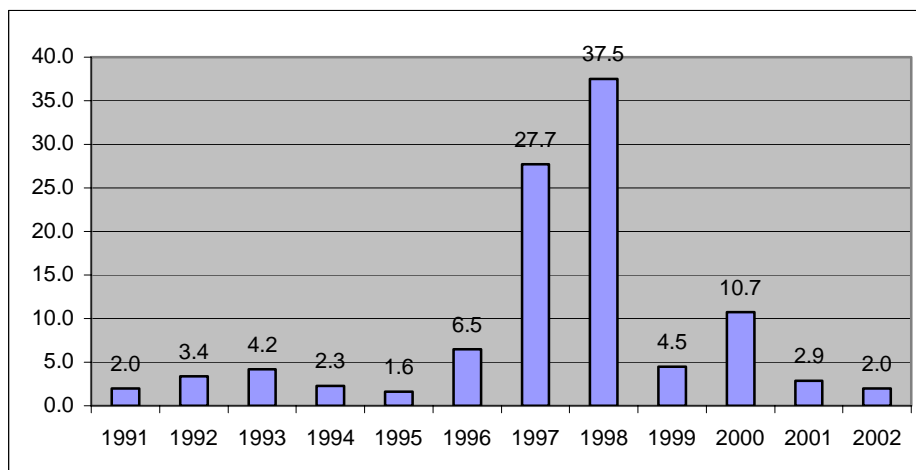
Source: Central Bank of Brazil (from 1996 to 2000, only flows above \$10 million. Since 2001, total flows).

Brazil's privatisation programme was one of the biggest in the world: during 1991-2002, total sales of state-owned companies to private investors amounted to \$105 billion, with the largest sales, totalling \$65 billion, in 1997-1998 (Figure I.5.). Both domestic and foreign investors participated in the programme equally, each accounting for half of the purchases. Services attracted almost three quarters of sales capital, with telecommunications and electricity accounting each for 31% of the total (Figure I.6.).

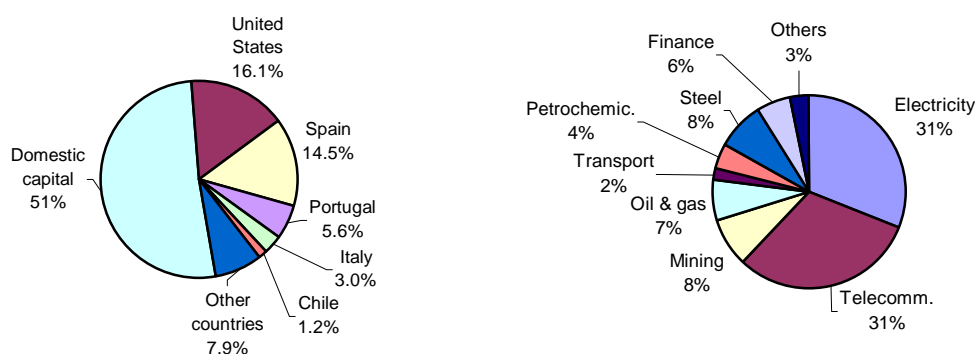
The privatisation programme was carried out in two phases. The first one, from 1990 to 1994, focussed on non-service companies. 33 companies were privatised in aeronautics, mining, chemicals and petrochemicals and fertilizers. Foreign investors played a minor role in this phase, accounting for only 5% of the total proceeds. In the second phase, from 1995 to 2002, the Government included large state-owned service companies, notably in public utilities,<sup>11</sup> increasing the services sector's share of privatisations to 80% (Table I.3.). During this phase, foreign investors became important players, accounting for 53% cent of the total sales from the privatisation programme. This is what boosted FDI flows into Brazil and shifted both flows and stocks towards services. During 1996-2000, privatisation-related direct sales accounted for a quarter of total FDI inflows into Brazil. Note, however, that this figure does not include post-privatisation investment financed by FDI means, and, in reality, it is much higher. Consequently, with big privatisations completed, the unprecedented high level of FDI, especially during 1998-2000, is unsustainable.

<sup>11</sup> Between 1987 and 1999, amongst the 50 largest privatisations in the world involving foreign firms, 10 took place in Brazil. All 10 were in telecommunications (including cellular telephony) and electricity.

**Figure I.5. Annual sales of State-owned enterprises in Brazil**  
(Billions of dollars)



**Figure I.6. Privatisation in Brazil: distribution of capital sales by country of origin and privatisation sales by sector, 1991-2002.**  
(Percentages)



**Table I.3. The second phase of privatisation, 1995-2002**  
(Millions of dollars and percentage)

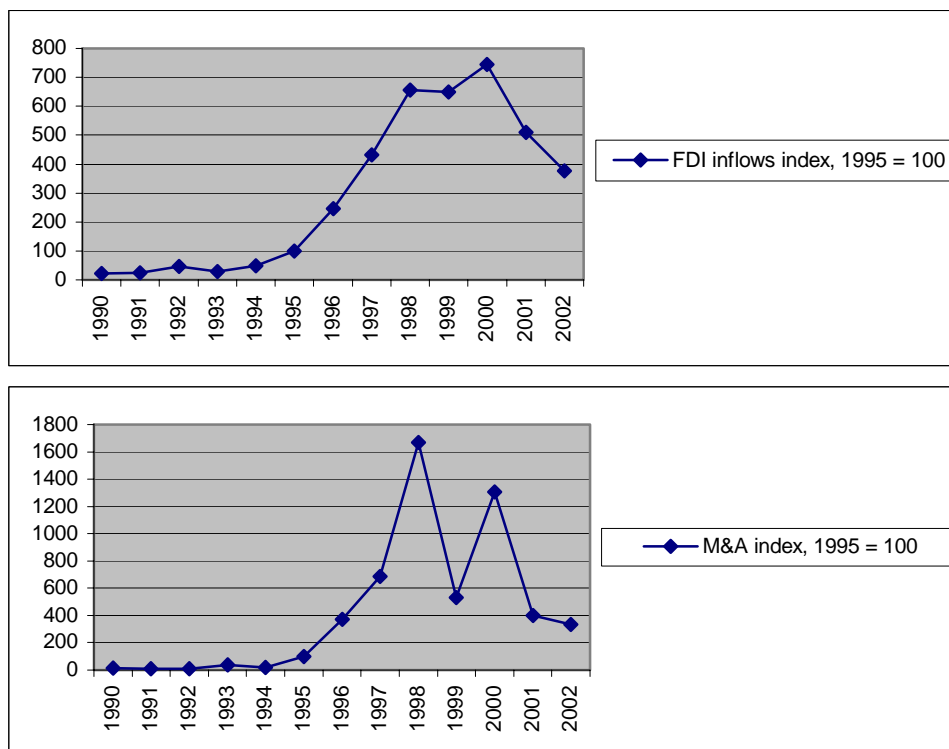
Sectors	Sale proceeds	%
Infrastructure and other services	62,281	80%
Manufacturing	10,852	14%
Minority shareholdings	4,481	6%
<b>Total</b>	<b>78,614</b>	<b>100%</b>

Source: BNDES

### The rise of M&A

One implication of the services FDI boom has been the rise of cross-border M&As as a mode of FDI entry into Brazil.

**Fig. I.7. Brazil, FDI inflows and cross-border M&A**  
(Millions of dollars)



Source: UNCTAD, WIR 2003

M&A activity by foreign investors hardly existed prior to 1995. It surged thereafter and even after the peak years of privatisation, it remains well above historical levels (Figure I.7.). M&A data are not directly comparable to total FDI inflows data<sup>12</sup> and Table I.7. gives at best a sense of the correlation between them. Although there is evidence of considerable greenfield investment in manufacturing industries, notably in the auto industry, it is likely that much or even most of TNCs' recent investment in Brazil took the form of M&As.

Not all the rise in M&A activity can be attributed to privatisation. This can be inferred from the significant increase of FDI in trading (where the stock more than tripled between 1995 and 2000, to \$10 billion, and large inflows continued during 2001-2003), other services and holdings (Table I.2.). These business areas are populated with privately owned rather than state-owned companies, and a typical mode of TNC entry is acquisition rather than new investment.

<sup>12</sup> In fact, although both M&A data and FDI flows measure similar phenomena, they do so in different ways. When a company from one country acquires a company from another country, the M&A database records the whole value of the transaction (on an announcement or completion basis) in a particular year, even if actual payments are phased out over several years or the actual value of the transaction differs from the announced one. FDI data will record only the part of the transaction financed by acquiring company's own funds. Furthermore, only actual payments in a particular year would be registered. In addition, FDI data would not register the transaction at all if it were financed by a loan raised in the capital market of the host country. For more on this, see UNCTAD WIR 2000, pp. 104-106.

During 2001-2003, a new development in the area of M&As has been the withdrawal of some services TNCs from the Latin American region, including from Brazil, through the sale of previously purchased assets to other foreign investors or to Brazilian firms. The former cases include telecommunications and retail trade, while the latter ones include banking.<sup>13</sup> Some TNCs were unable to build to a sustainable scale and others withdrew due to changes in global strategy or circumstances.

#### *Continued focus on import-substitution in manufacturing*

FDI in Brazil in manufacturing remains predominantly market-seeking, judging from the composition of sales of majority-owned affiliates of United States TNCs in Brazil<sup>14</sup> (Table I.4.). Export propensity of US TNC affiliates increased marginally, from 14% in 1989 to 18% in 1999. It is much lower than in other Latin American countries, where, in 1999, 41% of affiliates' sales were exports. In the auto industry, which attracted large FDI during the 1990s, and tripled exports between 1990 and 2003, the propensity to export remained at a low 20%. In contrast, the export propensity in the Mexican auto industry doubled between 1990 and 2002, from 34% to 74%, accompanied by a near fivefold increase in export sales.<sup>15</sup>

Foreign affiliates' preference for local sales reflects characteristics of the entire economy, including a policy bias towards import substitution, in spite of the Government efforts to overcome this bias. The shift of FDI towards services after 1995, most of which are not tradable, has further shifted total FDI towards market-seeking FDI, raising concerns in Brazil about the impact of FDI on trade balance (see on this the section on FDI impact).

**Table I.4. Sales of goods by majority-owned foreign affiliates<sup>16</sup> of United States TNCs in Brazil, Mexico and Latin America, 1989, 1994 and 1999**  
(Billions of dollars and percentage)

Country/region	Total sales of goods billions of dollars			Local sales of goods as % of total sales		
	1989	1994	1999	1989	1994	1999
Brazil	29	31	45	86	87	82
Mexico	16	37	74	68	68	62
L.A. excluding Brazil	44	85	150	59	62	59

Source: Calculated from U.S. Department of Commerce, *U.S. Direct Investment Abroad*, Benchmark Surveys, 1989, 1994 and 1999.

#### *The pattern of manufacturing FDI*

What has been the recent pattern of manufacturing FDI?

As already noted, the share of manufacturing FDI relative to total FDI fell after 1995 but in absolute terms, it rose sharply. The largest increases appear to be in established industries.

<sup>13</sup> ECLAC, Foreign Investment in Latin America and the Caribbean, 2003 Report, May 2004, pp. 55-58.

<sup>14</sup> The data for US affiliates is for sale of goods which includes manufactures and commodities. In Brazil, the data reflect manufactures sales, as there is little FDI in commodities production.

<sup>15</sup> ECLAC, 2004, pp. 117 and 120.

<sup>16</sup> Majority-owned non-bank affiliates of non-bank U.S. parents. These affiliates accounted for 80% of sales of all non-bank U.S. foreign affiliates in Brazil in 1999.

Historically, FDI in manufacturing has been in capital- and technology-intensive industries<sup>17</sup> (with the largest investments in chemicals, automotives and capital goods, and food and beverages industry). This pattern has remained almost unchanged in recent FDI. The former group of industries accounted for 70% of cumulative inflows into manufacturing during 1995-2002 (with automotive FDI responsible for a quarter). Food and beverages remained the largest FDI industry among resource-based and labour-intensive industries, accounting for 16% of total manufacturing FDI inflows (Table I.5.).

**Table I.5. FDI flows to manufacturing, by industry, 1996-2002**  
(Millions of dollars)

	1996	1997	1998	1999	2000	2001	2002	Cumulated flows 1995-2002	% of total manufacturing
<b>A. Capital/Technology-intensive industries</b>	<b>877</b>	<b>1'291</b>	<b>2'261</b>	<b>4'938</b>	<b>3'665</b>	<b>5'212</b>	<b>4'995</b>	<b>23'239</b>	<b>70.0</b>
Chemical products	222	368	355	1'272	1'118	1'546	1'573	6'454	19.4
Plastic and rubber products	30	139	157	207	58	176	183	951	2.9
Machinery and equipment	179	207	175	87	579	344	391	1'962	5.9
Office machines and computing equipment	10	20	49	631	23	23	96	851	2.6
Electrical machines, devices and apparatus	30	138	111	340	66	327	372	1'384	4.2
Electronic devices and communication equipment	62	186	263	520	655	1'166	544	3'396	10.2
Manufacture of medical, optical, automation equipment, time apparatus	58	11	0	0	20	28	29	145	0.4
Manufacture and assembly of motor vehicles, trailers, vehicle bodies	286	223	1'060	1'831	961	1'550	1'757	7'668	23.1
Manufacture of other transportation equipment	0	0	91	49	186	51	51	429	1.3
<b>B. Resource/Labour-intensive industries</b>	<b>863</b>	<b>745</b>	<b>506</b>	<b>2'065</b>	<b>1'422</b>	<b>1'789</b>	<b>2'560</b>	<b>9'950</b>	<b>30.0</b>
Food and beverages	186	323	133	1'239	975	563	1'873	5'292	15.9
Manufacture of tobacco products	250	0	0	168	0	6	72	496	1.5
Textile products	73	50	22	90	36	56	98	425	1.3
Making of garments and accessories	0	10	24	0	15	40	5	94	0.3
Production of leather articles and shoes	0	0	0	0	0	19	14	34	0.1
Wood products	0	88	17	23	32	71	17	247	0.7
Pulp, paper and paper products	22	0	0	13	10	150	11	206	0.6
Edition, printing and recording	0	12	12	77	16	140	44	300	0.9
Production of coke, petroleum, nuclear fuels and alcohol	0	11	11	11	0	0	6	38	0.1
Manufacture of non-metallic mineral products	195	208	85	289	67	130	124	1'098	3.3
Basic metallurgy	30	0	118	113	246	431	138	1'076	3.2
Manufacture of metal products	64	0	40	42	26	108	90	371	1.1
Manufacture of furniture and other industries	43	43	44	0	0	41	68	240	0.7
Recycling	0	0	0	0	0	33	1	34	0.1
<b>Total Manufacturing</b>	<b>1'740</b>	<b>2'036</b>	<b>2'766</b>	<b>7'002</b>	<b>5'087</b>	<b>7'001</b>	<b>7'555</b>	<b>33'189</b>	<b>100.0</b>

Source: Central Bank of Brazil

The main drive behind the FDI attractiveness of those sectors were:

- in the case of food and beverages, the rapid growth of food consumption in Brazil. In addition, many TNCs in this industry have chosen Brazil as their headquarters location for export-oriented investment geared to MERCOSUR markets. Other factors included low labour costs and access to raw materials from a fast growing and competitive agricultural sector<sup>18</sup> (see Box I.2.).
- in the case of automotive products and machinery and equipment, a high degree of market protection and selective investment incentives.
- the privatisation-led boost in the case of electronic devices and communications equipment.
- the quest for national/regional market access for FDI in chemicals.

<sup>17</sup> Centre for Competition, Investment & Economic Regulation, Investment Policy in Brazil – Performance and Perceptions, discussion paper, UNICAMP, 2003.

<sup>18</sup> See: Farina, E. M. M. Q. and C. Viegas, "Multinational Firms in the Brazilian Food Industry", in Ruth Rama (ed.), *Multinational Agribusiness*, 2002. Or Inter-American Development Bank, "The Food Industry in Brazil and the United States: The Effects of the FTAA on Trade and Investment", INTAL-ITD, Working Paper – SITI – 07, March 2004.



### Box I.2. FDI in Agribusiness in Brazil

Agribusiness comprises agricultural and livestock products produced or transformed by an industrial process, to add value. In 2003, employing 17.7 million people, agribusiness represented 37% of total employment in Brazil. It also accounted for 33.8% of Brazil's GDP and for 44% of Brazilian exports. In fact, in products such as sugar cane, orange juice, coffee and soybeans, Brazil is the world's leading exporter. The main export market is the EU, which accounts for more than 40% of all Brazilian agribusiness exports, followed by the United States (15%) and China (8%).

Brazil's competitiveness in agribusiness relies, among other things, on the quality of production and its low costs, innovation in tropical agriculture technology and qualified labour and management. Moreover, agricultural output has been increasing steadily and Brazilian soya productivity is now among the world's highest, and harvests have doubled in recent years. There has also been a determined effort to upgrade infrastructure to reduce losses and costs between farm and markets, both domestic and export. This effort includes building and/or upgrading highways, railroads, waterways and ports. For 2004 the government budgeted more than \$65 million specifically for farming-related highway improvement.

Since the mid-1990s, improved economic stability and growing internal demand in the initial period of the Real Plan, matched with the possibility of making Brazil an export base to MERCOSUR spurred FDI in agribusiness, where FDI grew faster than any other manufacturing industries. FDI inflows in this industry rose by more than 900%, from \$186 million to \$1.87 billion between 1996 and 2002.

The main form of entry for FDI in agribusiness is through cross-border M&As. TNCs from Argentina (Grupo Magri), the United States (ADM, Bestfoods, Sara Lee and Kraft Foods), and the EU (Unilever, Nestlé, Danone and Parmalat) were the major purchasers of Brazilian food assets in the late 1990s. In 1994, the top ten food processing companies in Brazil had a combined market share of 28%. Among these companies, five were TNCs. In 2001, the aggregate market share of the top ten food companies fell slightly to 26%, but the number of TNCs in that group rose to eight. These eight large TNCs controlled about 20% of the Brazilian food market. The Brazilian-owned firms in the top ten are Sadia and Perdigão, leaders in the poultry processing and processed meat markets.

There is evidence that the entry of TNCs in the Brazilian food processing industry resulted in the use of more capital-intensive techniques, rise in productivity and increased competition. As a result, important price reductions occurred in industrialized foods (from 30 to 40 % decrease in real prices of processed foods), exactly where FDI was focussed, and where supermarkets are most important in distribution. Survey data indicates that the food industry productivity increase that resulted in consumer price reductions came from better logistics and procurement strategies (including outsourcing), higher labour productivity and the adoption of food quality programs in order to reduce raw materials wastage. Also, increased competition led to a diversification in production, and the number of new product launched between 1994 and 2002 increased by 200%.

*Source:* Roberto Rodrigues, Minister of Agriculture, Livestock and Food supply, in the presentation: *Agribusiness in Brazil, a highly competitive sector*, Brazil & Partners, Investment Opportunities; InvesteBrasil; and Farina, E. and C. Viegas, *Foreign Direct Investment and the Brazilian Food Industry in the 90s*, in *International Food and Agribusiness Management Review*, Vol. 5, Iss 2, 2003

### 3. FDI by country of origin

The United States remains the single most important source of FDI in Brazil, accounting for about one quarter of total FDI stock. Until the mid-1990s, Germany (with 14% share in 1995), France, Switzerland and Japan (around 6-7% each) were the next most important home countries. Since then, privatisation-led FDI has changed the ranking of home countries (Table I.6.). Spain and the Netherlands are now the second and third largest home countries. Portugal has also become a very important home country.

**Table I.6. Brazil: FDI stocks and accumulated inflows, 1995-2003, by country of origin**  
(Billions of dollars and percentage)

Country	End 1995		End 2000		Difference 2000-1995	2001-2003	
	Stock	%	Stock	%	Stock	Accumulated flows	%
United States	10.9	26	24.5	23.8	13.6	9.528	18,1
Spain	0.3	0.6	12.3	11.9	12	4.06	7,7
Netherlands	1.5	3.7	11.1	10.7	9.6	6.689	12,7
France	2.5	6	6.9	6.7	4.4	4.548	8,6
Germany	5.8	14	5.1	5	-0.7	2.181	4,1
Portugal	0.1	0.3	4.5	4.4	4.4	2.924	5,5
Italy	1.3	3	2.5	2.4	1.2	1.141	2,2
Japan	2.7	6.4	2.5	2.4	-0.2	2.697	5,1
Switzerland	2.8	6.8	2.3	2.2	-0.5	852	1,6
Canada	1.8	4.4	2	2	0.2	1.554	2,9
Sweden	0.6	1.4	1.6	1.5	1	302	0,6
United Kingdom	1.9	4.5	1.5	1.4	-0.4	1.135	2,2
Argentina	0.4	0.9	0.8	0.7	0.4	-	-
Belgium	0.6	1.3	0.7	0.6	0.1	164	0,3
Tax havens*	4.2	10	13.5	13.1	9.3	11.349	21,5
Other countries	5	11.9	11.4	11.1	6.4	3.574	6,8
<b>Total</b>	<b>42.2</b>	<b>100</b>	<b>103</b>	<b>100</b>	<b>60.8</b>	<b>52.698</b>	<b>100,0</b>

\* Antigua & Barbuda, Dutch Antilles, Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Panama, British Virgin Islands.

Source: Central Bank of Brazil and Sobeet.

Note: TNCs often invest from countries other than their home-country and this is not taken into account in the official statistics, which only report the origin of the investment.

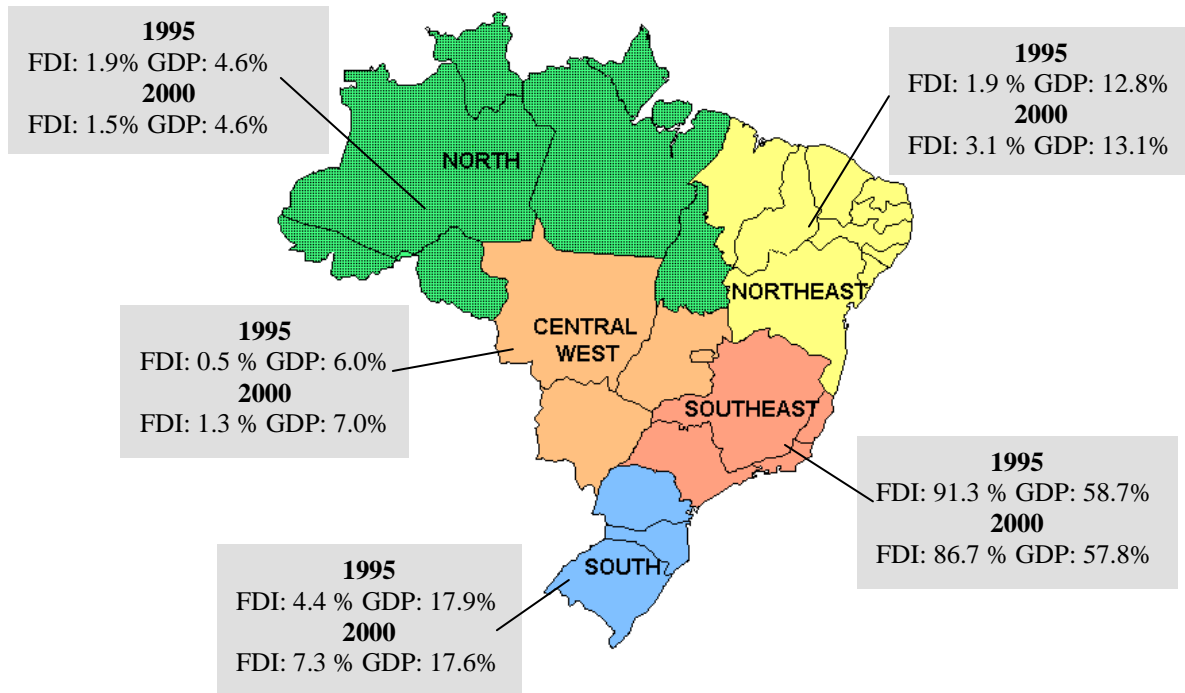
The two Iberian countries accounted for 16.3% of total FDI stock in 2000, compared with just 0.4% in 1995 (Table I.6.). Most of their FDI went to telecommunications, electricity and financial services and was related to privatizations. Dutch companies have become large investors in Brazil's telecommunications, retail trading and financial services. New investments from the United States were channelled to services (especially to telecommunications and electricity and, less so, to financial services) as well as manufacturing (mainly food and beverages, chemicals, machinery and equipment, and automotives). All in all, these four countries accounted for two-thirds of the increases in FDI stock in Brazil between 1995 and 2000. They also remained the largest home countries for inflows during 2001-2003, although both French and Japanese companies have again stepped up their investment in Brazil.

FDI from "tax havens" is large and increasing. Between 1995 and 2001-2003, the share of FDI entering Brazil from these countries more than doubled (Table I.6.). The nationality of investors generating these inflows is not known, but private sector sources in Brazil agree in believing that part of them originates from Brazilian citizens and companies, probably for tax reasons. The high share of tax havens in outward FDI from Brazil tends to confirm this view (see section on outward FDI from Brazil).

#### 4. FDI by regions

The distribution pattern of FDI in Brazil follows the country's regional concentration in growth and development -- although this concentration is more pronounced for FDI. The Southeast, which is Brazil's most developed and dynamic region and includes the key States of Sao Paulo, Rio de Janeiro and Minas Gerais, accounted for more than 91% of total FDI in 1995, and more than 86% in 2000 (Fig. I.8.).

**Figure I.8. Brazil: distribution of FDI stock by regions, 1995 and 2000**  
(Percentages)



Source: Central Bank of Brazil, "Censo de Capitais Estrangeiros" (1996 and 2001). Elaboration by UNCTAD.

FDI data for 1995 and 2000 indicate that, although the Southeast firmly maintains its lead as preferred destination of FDI, all other regions, with the exception of the North, have increased their share of the total stock of FDI to Brazil by more than 50%. There is some evidence that the so-called "fiscal wars" played a role in such redistribution.<sup>19</sup> Since 1994, in fact, various State governments in Brazil have conducted a policy of attracting industry investment with tax holidays and subsidies. However, this fierce competition, particularly intense in the automotive sector, was often very costly for both the State losing the competition and the new destination of the foreign firm, resulting in bidding wars for the relocation of few major companies that negotiated directly with local authorities a whole package of incentives<sup>20</sup> (see chapter III).

It is notable that FDI has not become a force to redress the imbalances in economic activity. All regions outside the Southeast obtain a lower share of total FDI than their share of national GDP.

## B. Outward FDI from Brazil

In line with the trend for developing countries, Brazil's FDI outflows have been increasing since the 1980s. However, Brazil's share of FDI outflows in the Latin

<sup>19</sup> See: OECD, "Incentives-based Competition for Foreign Direct Investment: The Case of Brazil", WP on International Investment N°2003/I.

<sup>20</sup> See: Hanson, G.H, *Should Countries Promote Foreign Direct Investment*, in UNCTAD, G-24 Discussion Paper Series, No. 9, February 2001.

American region decreased from 25% in the early 1980s to 7% in the years 1996-2002 (Table I.7.).

**Table I.7. FDI outflows and outward stock from Brazil and major home developing countries in Latin America and Asia, annual average**  
(Millions of dollars and percentage)

	FDI outflows				FDI outward stock
	1981-1985	1986-1990	1991-1995	1996-2002	2002
Developing countries	2 622.8	11 385.8	35 098.9	64 278.6	849 463
<b>Brazil</b>	<b>178.9</b>	<b>321.0</b>	<b>685.9</b>	<b>1 099.6</b>	<b>54 423</b>
Argentina	- 10.6	32.2	876.4	1 294.0	19 407
Mexico	73.6	134.2	300.5	969.0	12 425
Chile	10.6	7.5	523.9	1 788.5	13 439
Latin America and the Caribbean	707.0	1 388.1	5 570.7	15 528.4	173 187
Latin America's share in dev .countries	27.0	12.2	15.9	24.2	20.4
<b>Brazil's share in Latin America (%)</b>	<b>25.3</b>	<b>23.1</b>	<b>12.3</b>	<b>7.1</b>	<b>31.4</b>
China	225.0	711.0	2 662.6	2 819.4	35 538
Hong Kong, China	537.2	2 282.2	15 045.8	25 099.2	370 296
Taiwan Province of China	52.4	3 417.0	2 451.2	4 915.6	59 553
Singapore	133.8	684.2	2 313.4	5 808.1	71 336
Korea, Rep. of	194.4	806.8	2 000.6	4 021.5	43 500
Malaysia	246.2	212.8	1 234.0	1 751.4	20 194
Asia and the Pacific	1 495.9	9 168.3	27 585.1	47 497.2	632 701
Asia's share in developing countries	57.0	80.5	78.6	73.9	74.5

Source: UNCTAD and Central Bank of Brazil

Notwithstanding the decreasing share in FDI outflows, according to the *Census of Brazilian Capital Abroad*,<sup>21</sup> the FDI outward stock from Brazil reached \$55 billion in 2003, the fourth largest FDI outward stock among developing countries, and the largest in Latin America. A closer look at the *Census* reveals that:

- Only a small part of Brazil's outward stock can be attributed to international production by Brazilian TNCs. More than 70% of the stock is located in tax haven economies, and more than half of the total is in "financial intermediation", a typical activity for this type of investment<sup>22</sup> (Figure I.9.).
- Among the world's top 100 non-financial TNCs in 2002, ranked by foreign assets, none was from Brazil. Brazil's FDI outward stock is more than four times larger than that of Mexico but, in 2002, only three Brazilian TNCs appeared in the list of the largest 50 non-financial TNCs from developing countries (Petrobras, Vale do Rio Doce and Metalúrgica Gerdau). This contrasts with seven for Mexico (mainly from the food and beverages industry, but also in telecommunications and metal sectors).<sup>23</sup>
- When considering only the largest TNCs based in Latin America and the Caribbean in the primary and secondary sectors, the Brazilian presence is limited to 5 TNCs, against 18 TNCs from Mexico. But in finance and insurance services, three Brazilian banks top the list, ranking (by total assets) as the largest TNCs from Latin America (Banco do Brasil, Banco Bradesco and Banco Itaú).

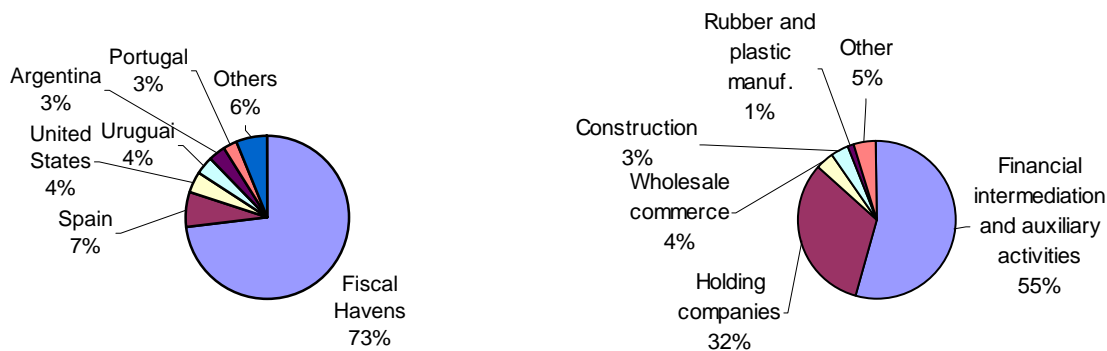
<sup>21</sup> Central Bank of Brazil - Departamento de Capitais Estrangeiros e Câmbio: "Capitais Brasileiros no Exterior", Results for 2001 and 2002.

<sup>22</sup> Most likely, much or most of it is reinvested in Brazil, as suggested by the considerable amount of FDI stock in Brazil from tax havens (see Table I.6.)

<sup>23</sup> UNCTAD, World Investment Report 2004.

- Leaving financial activities and holding companies aside, the structure of the remaining stock indicates that trade-related investments undertaken in support of exports, typically a large activity in outward FDI from developing countries, constitute also the largest component in Brazil.
- In manufacturing, no industry reaches 1% of the total outward FDI stock, with the exception of rubber and plastic, and investment appears to be motivated by considerations such as the proximity to consumers, natural resources access and trade barriers "jumping". One example is Metalúrgica Gerdau, the second largest non-financial TNC from Brazil, which operates steel mills in Chile, Uruguay, Argentina, Canada and the United States.<sup>24</sup> Another example is that of Brazilian orange juice producers, such as Cutrale and Citrosuco, which, facing difficulties in accessing the North American markets via exports, started operations in Florida, by acquiring existing plants and forming alliances with independent distributors.

**Figure I.9. Brazilian outward FDI stock by country of destination and by economic activity, 2002**  
(Percentage)



Source: Central Bank of Brazil, *Capitais brasileiros no exterior, resultados 2001-2002*

The distribution by country of the FDI outward stock, excluding tax havens, shows that Spain and the United States are among the leading destinations of outward FDI from Brazil, but also reflects the impact of MERCOSUR's integration on FDI, with Argentina and Uruguay respectively second and third main hosts of Brazilian FDI stock abroad.

Developing countries increasingly see outward FDI as one of the channels to improve the competitiveness of domestic firms by acquiring a portfolio of foreign locational assets. In China, for example, not only the central government but also some provincial administrations have encouraged Chinese firms to invest abroad through a series of policy measures that include, among others, easier access to loans from commercial banks, a relaxation of the approval system for outward FDI and corporate income tax exemption. Brazil has also initiated some steps to promote the internationalisation of Brazilian companies, although so far these are limited to case-by-case financial support to foreign investments by domestic firms through the national development bank

<sup>24</sup> See: Industrial Development Studies Institute (IEDI), *O Investimento Estrangeiro na Economia Brasileira e o Investimento de Empresas Brasileiras no Exterior*, 2003.

(BNDES), rather than being a structured policy. However, the Government has recently expressed its wish that Brazilian companies have a greater presence abroad.<sup>25</sup>

### **C. The increasing presence of TNCs in Brazil**

Since 1995, the number of foreign affiliates has doubled from 6,322 to 11,404.<sup>26</sup> TNC presence has increased in traditional areas and extended to new activities, services in particular.

One example is the auto industry, which historically attracted the largest FDI inflows in the manufacturing sector. Recently, TNC presence has expanded in the auto-parts segment of this industry. In all, between 1994 and 2002, the share of foreign companies in the auto industry's sales increased from below a half to three quarters.<sup>27</sup>

TNCs are now exhibit a significant presence in electricity and telecommunications. Between 1995 and 1999, in fact, the share of employment by TNCs in total employment increased from 20% to 74 % in the case of electricity and from 3% to 55% in the case of telecommunications. Also, foreign banks now (2001) account for half of total bank assets as compared with 8% in 1994.<sup>28</sup> In trading, foreign affiliates employed 227,000 people in 2000 compared with 95,000 in 1995.<sup>29</sup>

The presence in Brazil of the largest global companies provides another perspective. Foreign affiliates of Fortune 500 companies are prominent amongst the largest Brazilian companies. Some sources suggest that 80% of the Fortune 500 companies have some presence in Brazil.

Another perspective is provided by Exame's latest annual survey<sup>30</sup> of Brazil's largest non-financial companies (ranked by total sales). 227 of the top 500 firms -- and 10 of the top 20 -- are foreign-owned. Of the 227 largest foreign companies, 24 are in telecommunications, 17 in the automotive sector, 8 in computers and electronics and 8 in pharmaceuticals.

The most recent data (2000) suggest that TNCs now account for almost half of national sales and total business assets. They are much less significant as employers, reflecting the concentration of FDI in capital-intensive industries (Table I.8.).

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<sup>25</sup> On 11 July 2003, President Luiz Inacio Lula da Silva addressed the Portuguese Industrial Association in Lisbon and declared that: "It is time Brazilian businessmen abandon their fear of becoming multinational businessmen".

<sup>26</sup> Central Bank of Brazil, *Censo de Capitais Estrangeiros* (1996 and 2001).

<sup>27</sup> ECLAC 2004, p. 116.

<sup>28</sup> ECLAC, *Foreign investment in Latin America and the Caribbean 2002*, United Nations 2003, Santiago de Chile, p. 108

<sup>29</sup> Central Bank of Brazil, *Censo de Capitais Estrangeiros* (1996 and 2001).

<sup>30</sup> Brazilian business magazine, July 2003 issue.

**Table I.8. Foreign affiliates in Brazil, 1995 and 2000***(Billions of dollars<sup>a</sup> and percentage)*

<b>Foreign affiliates variables</b>	<b>1995</b>	<b>2000</b>
Total number of foreign affiliates	6322	11404
<b>A. Employment</b>		
in thousands employees	1353	1710
as % of total employment	1.9	2.1
<b>B. Total assets</b>		
in \$ billions	280	500
as % of GDP	39.8	46.0
<b>C. Sales</b>		
as % of GDP	35.0	46.9
<b>D. Tax revenue</b>		
in \$ billions	46	47
as % of total tax revenue	22.8	23.7

Source: Central Bank of Brazil, "Censo de Capitais Estrangeiros" (1996 and 2001), World Bank, WDI 2004; Grupo Expert J.A (2000). <sup>a</sup>Data converted at annual average exchange rates.

## **D. Impact of FDI on the Brazilian economy**

With greater presence, the potential for FDI to contribute to the economy and Brazil's development has increased. To date, the impact of FDI has been more prominent in areas such as capital inflows, investment and expansion of production in some industries and exports. Unfortunately, however, its impact on technology transfer or spillovers to local firms has been limited. In this respect, FDI has not lived up to the expectations of those who anticipated greater level of technological learning, through backward and forward linkages, from the presence of foreign affiliates in the Brazilian economy.

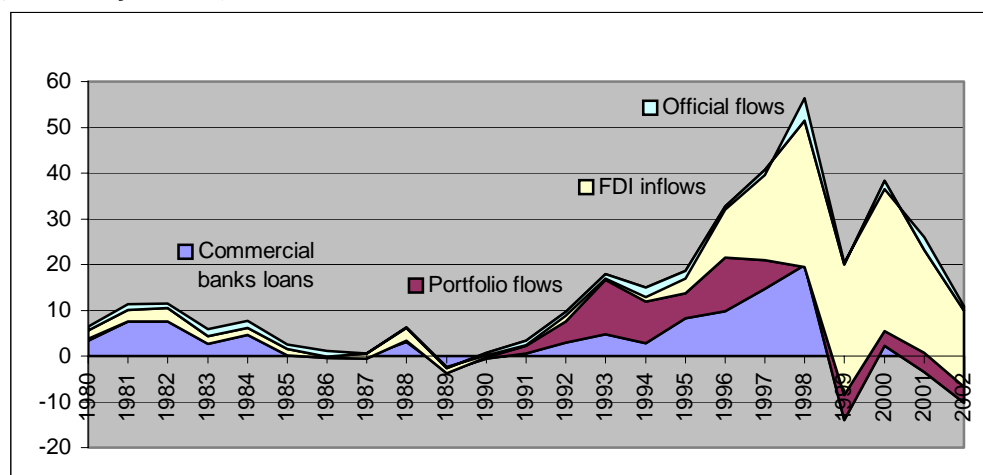
### **1. Capital inflows and investment**

From 1991 to 2002, huge FDI inflows contributed to unprecedented levels of foreign capital inflows to Brazil. In this period, FDI accounted for 63% of total capital inflows of \$280 billion (Figure I.10.). During 1999-2002, when portfolio capital inflows and foreign lending dried up as a result of financial difficulties, FDI dominated the inflows.

FDI-related flows probably provided strong net support to the balance of payments during the trade deficits experienced in the years 1995-1999 (the impact on the trade balance itself is discussed below). In this period, profit remittances abroad from FDI rose but were outbalanced by a huge margin, by FDI inflows (Figure I.11.).

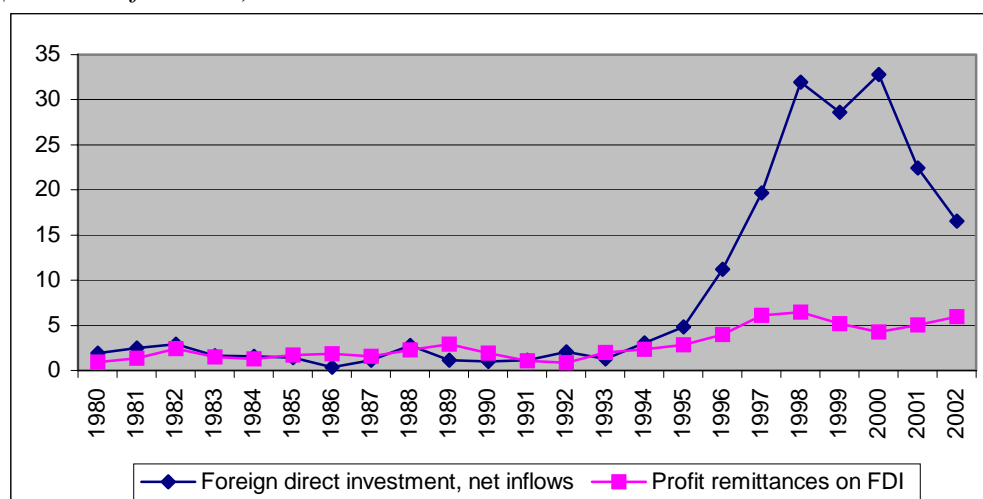
FDI inflows related to privatisations also contributed significantly to Government revenues in a period of severe budgetary constraints.

**Fig. I.10. Total capital inflows to Brazil, 1980-2002**  
(Billions of dollars)



Source: World Bank, Global Development Finance 2004.

**Figure 1.11. FDI inflows and profit remittances on FDI, 1980-2002**  
(Billions of dollars)



Source: World Bank, Global Development Finance 2004.

Greater capital inflows, representing external savings, boosted the national savings rate by nearly 25% annually during 1996-2001.<sup>31</sup> This permitted a much higher investment ratio than otherwise would have been possible. This impact is the more valuable because Brazil has a comparatively low investment ratio.<sup>32</sup>

The recent change in FDI contribution to investment appears to be dramatic. FDI inflows as a share of gross fixed capital formation (GFCF) have increased from below 3% in the eighties and early nineties to 19.5% for the years 1996-2002. They are now higher in Brazil compared to the world average, or the average for developing countries<sup>33</sup> (both around 12%). However, a note of caution is needed when making such statistical comparisons. Much of Brazil's recent FDI took the form of cross-border acquisitions of state-owned and private companies, reflecting changes of ownership of

<sup>31</sup> ECLAC, *Economic Survey of Latin America and the Caribbean 2001-2002*, United Nations 2002, Santiago de Chile, p. 118.

<sup>32</sup> 15% between 1990 and 1992, see da Motta Veiga, 2004 p.35 and Bielchowsky, R., *Investimento e reformas no Brasil: indústria e infra-estrutura nos anos 1990*, IPEA/ECLAC, 2002.

<sup>33</sup> UNCTAD, WIR 2003, pp. 267-277.



existing assets rather than the creation of new assets that adds directly to domestic investment.

Nevertheless, there are many indications that FDI increased investment considerably through greenfield projects, i.e. by setting-up new companies, or post-privatization investment.

An example of substantial greenfield investment is given by the auto industry, where investment during 1995-2002 amounted to \$16 billion, compared to \$6.6 billion in 1987-1994. This led to a doubling of car production in 1997, when compared to the early 1990s, although it subsequently declined and the industry has faced overcapacity problems.<sup>34</sup>

Telecommunications provides an example of post-privatisation investment in which substantial new capacity was created with a significant contribution of FDI. The number of fixed telephone lines increased from 15 million in 1995 to 50 millions in 2003. Annual investment in this industry increased from a low \$520 million in 1994 (in constant 2001 prices) to \$10 billion in 2001, continuously increasing in the years in between. By contrast, although investment in electricity increased in 1997 as compared with 1994, it fell after that and was generally at a lower level than in the late 1980s and early 1990s, due to, among others, regulatory problems provoking disputes that delayed investment plans.<sup>35</sup>

## **2. Employment**

TNCs employ relatively few people in Brazil compared with their presence measured by share of business assets or national sales. Despite the surge in FDI, employment in foreign affiliates in Brazil increased from 1.4 million in 1995 to 1.7 million in 2000, representing only a small gain in share of total employment from 1.9% to 2.1% (Table I.8.). The strongest gains in this period were in services, where employment increased from 300,000 to 730,000. Manufacturing employment was largely unchanged at around 950,000.<sup>36</sup>

These changes represent various impacts, on which one can only speculate in the absence of more detailed data. It is surprising that in manufacturing, where a great deal of greenfield investment took place, employment stagnated.<sup>37</sup> But, most likely, it increased at the time of new investment projects (many of them took place in the mid-1990s – vide the auto industry) and fell after 1997, with weakening demand and the economy stagnating. The increase in services is encouraging given that much of the new FDI in services entailed the acquisition of existing companies through the privatisation programme. Typically, employment in privatized companies initially falls, as part of the modernization effort. It recovers with post-privatization investment and can start growing again, if the economy grows. This is what most likely happened in the telecommunications industry, where total employment fell from 118,000 in 1997 to 105,000 in 1998 and started increasing in 1999 (to 109,000), not keeping pace however with rapidly increasing investment outlays.

<sup>34</sup> ECLAC, 2004.

<sup>35</sup> ECLAC, 2004, pp. 54 and 57.

<sup>36</sup> Not increasing or even falling in large FDI manufacturing industries such as food and beverages, machinery and equipment or the auto industry.

<sup>37</sup> One possible explanation is that productivity increased as a result of imports of capital goods, therefore producing such effect.

But for further increases in investment and employment not only in foreign but also domestic companies, the economy has to return to sustainable economic growth without inflation. By mid-2004, the economic outlook of Brazil had improved substantially – projected GDP growth for the next couple of years is above 3% annually (see Figure I.2.). Much will depend on how the Government will handle the delicate balance between interest rates (which are too high to spur investment) and competitive exchange rate (which helps increase foreign demand and exports). (See Box I.3.).

### Box I.3. Brazil's macroeconomic outlook

Brazil's economic outlook improved substantially in 2003 and 2004. The real devaluation of its currency that followed the financial crisis of 1999 has boosted exports and restrained imports. Brazil's volume of exports in 2003 was 64% higher than its pre-devaluation level of 1998 (during the five previous years, the export quantum only increased by 11%). Export growth and import reduction have partially compensated for the contraction of domestic demand. Despite ongoing weakness of investment and drops in real wages and private consumption in 2002 and 2003, an outright recession was avoided. Nevertheless, the officially recorded unemployment rate reached more than 12%.

The monetary authorities, in face of strong inflows of portfolio capital, fought the threat of a higher valuation of the currency by directly intervening in the currency market. However, the central bank has not been prepared to cut interest rates. Real interest rates are still very high and prohibitive for a strong revival of domestic investment. Additionally, intervention in Brazil's case is costly as the country offers very high interest rates to international investors and earns much lower rates from the investment of these funds in US treasuries. As the inflation rate has been coming down remarkably despite the devaluation, the central bank could have revised its restrictive course that aims at controlling inflation in the short term. The slow response of the inflation rate to the import price rise in the wake of the devaluation has shown that the traditional high sensitivity of the economy to supply side shocks is no longer a threat.

If Brazil succeeds in keeping the high level of external competitiveness that it has achieved at the beginning of the new century it should be able to continue its encouraging trade performance in 2005. However, sustained economic growth will need a substantial recovery of domestic investment and private consumption in the short and medium term. Such a scenario would be in line with the 2004-2007 National Plan ("Plano Plurianual") that includes a pick-up of investment in infrastructure, more social projects and economic growth driven by "mass consumption". The government aims at a virtuous circle between higher worker's income, widening domestic markets, more private investment, productivity gains and increased employment and income.<sup>38</sup> From a macroeconomic point of view, however, this will require further cuts in interest rates, rising real wages of workers and a less ambitious fiscal consolidation in the short run.

Source: UNCTAD

Whilst foreign investors are relatively minor employers, they appear, on average, to offer higher quality employment. In manufacturing, for example, foreign affiliates pay generally higher wages than domestic companies: the average monthly wage of a foreign firm's employee (\$842) is two and a half times higher than that of a local firm (\$328). Foreign affiliates' employees also stay longer with the firm (63 months on average versus 43 months in a domestic company<sup>39</sup>). This may provide greater

<sup>38</sup> "In the long run, the Plano Plurianual 2004-2007 is aimed at inaugurating a growth process based on the expansion on the mass consumption market, and on the progressive incorporation of working families into the consumption market of modern firms. (...) Mass consumption-led growth is sustained on big gains of productivity, linked to the size of domestic market; on improved scale economies through the conquest of foreign markets, as the result of the scale gains from domestic markets; and on the process of learning and innovation embedded in investment aimed at expanding the capacity production of mass consumption goods in modern sectors". See *Plano Brasil de Todos*, Anex 1: Orientação Estratégica de Governo.

<sup>39</sup> De Negri and Acioly, *Novas Evidências Sobre os Determinantes do Investimento Externo na Indústria de Transformação*, IPEA, Discussion Paper 1019, Brasília 2004. Data on wages and labour turnover are computed as averages for the period 1996-2000, at constant 2000 values.

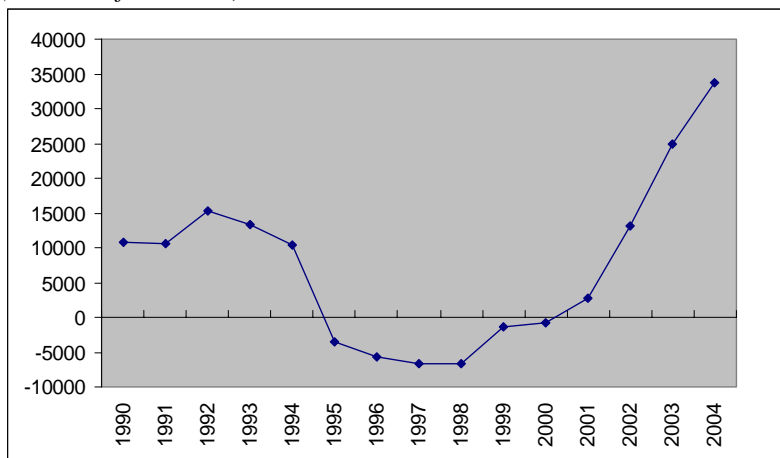
opportunities for on-the-job learning and skills development in foreign companies. Indeed, a survey of 30 manufacturing and services companies in Brazil, 24 of them TNCs, conducted recently by Instituto Observatório Social, concludes that during the 1990s foreign affiliates tended to adopt principles and guidelines established by their headquarters, thus improving labour standards of their operations in Brazil. This impact was particularly visible in operations in less industrialized regions, where the most immediate result was “an upgrading of the average level of environmental and labour standards prevailing in these regions”.<sup>40</sup>

### 3. Trade

When FDI surged in the second half of the 1990s, it coincided with a lengthy trade deficit (Figure I.12.). This sparked a debate on the impact of FDI on the trade balance. The issue is sensitive in Brazil since external accounts imbalances have historically posed a threat to the country’s economic stability. In addition, many expected that the FDI boom would improve the export orientation of the Brazilian economy, and help reduce imports. Many studies have recognized that TNCs in Brazil are more export-oriented than their Brazilian counterparts. At the same time, however, they believed that during the 1990s TNCs had a negative impact on the trade account.<sup>41</sup> This generated an interesting debate on the causes for the trade deficit in the second half of the 1990s and the role of FDI in this process.

**Figure I.12. Trade balance in Brazil, 1990-2003**

(Million of dollars\*)



Source: SECEX. \*Exports are on the F.O.B. base

The debate lost its heat once the Real (pegged to the dollar since 1994 and considerably overvalued) was devalued in January 1999 and then floated. The trade deficit moderated. By 2001, the trade account was clearly in surplus and continued to improve in the following years. In 2003, Brazil registered a record trade surplus of almost \$25 billion, as exports grew by 21% and imports grew only by 2%. A new all-time record trade surplus of \$33.7 billion was registered in 2004 and this trend is projected to continue in the near term.

<sup>40</sup> da Motta Veiga, 2004, p. 47.

<sup>41</sup> De Negri, F., *Desempenho Comercial das Empresas Estrangeiras no Brasil na Década de 90*, Campinas, 2003; Laplane, M., *The Impact of Foreign Direct Investment on the Brazilian Economy*, Campinas, 2003 (2003); Hiratuka, C., *Empresas Transnacionais e Comércio Exterior*, Instituto de Economia, UNICAMP, (2002).

Nevertheless the impact of TNCs on Brazil's trade performance is an important issue. The Central Bank's *Census of Foreign Capital*<sup>42</sup> with data for 1995 and 2000 only, provides some indication of the role of TNCs in Brazilian trade and their impact on trade balance. These are the facts in these two years (Table I.9.):

- Between 1995 and 2000, total Brazilian exports grew by 18%, while exports of foreign affiliates grew by 53%, increasing the contribution of the latter in total exports from 46% to 60%.
- Total imports grew by 12% while foreign firms' imports grew by 63%, increasing their share of total imports from 39% in 1995 to 57% in 2000.
- The "trade balance" of TNCs was positive in both years, but the surplus declined from \$2.4 billion in 1995 to \$1.7 billion in 2000. The "trade balance" of nationally owned companies was negative in both years, although it declined from -\$6 billion to -\$2.4 billion.
- As regards trade pattern of TNCs by sector: TNCs in the services sector produced (increasing) trade deficit, which was however more than compensated by growing surplus of manufacturing TNCs and (declining) surplus of primary sector TNCs (Table I.9.). Quite likely, an important component of the increasing trade deficit of services companies reflects increased capital goods to modernize and expand privatized industries.

**Table I.9. Trade by foreign and domestic companies, 1995 and 2000**

(Billions of dollars)

	1995			2000		
	Exports	Imports	Balance	Exports	Imports	Balance
<b>Foreign companies</b>	<b>21.7</b>	<b>19.4</b>	<b>2.3</b>	<b>33.3</b>	<b>31.6</b>	<b>1.7</b>
Primary sector	2.2	0.1	2.1	1.9	0.3	1.6
Secondary sector	18.2	16.6	1.6	27.2	24.0	3.2
Tertiary sector	1.3	2.6	-1.3	4.2	7.3	-3.1
<b>Domestic companies</b>	<b>24.8</b>	<b>30.6</b>	<b>-5.8</b>	<b>21.8</b>	<b>24.2</b>	<b>-2.4</b>
<b>Total</b>	<b>46.5</b>	<b>50.0</b>	<b>-3.5</b>	<b>55.1</b>	<b>55.8</b>	<b>-0.7</b>

Source: Central Bank of Brazil, *Censo de Capitais Estrangeiros* (1996 and 2001).

Of course data for two years are not sufficient to settle the discussion on the FDI impact on trade balance. The biggest trade deficit occurred during 1996-1998 and, most likely, TNCs had their good part of it. But assuming that their increased imports were mainly capital goods for investment – the timing of the deficit corroborates this supposition – then it is likely that the resulting improvement and availability of intermediate services (and in at least telecommunications and banking and, to a certain extent, electricity, this was indeed the case) would have contributed to the competitiveness of all firms. In this scenario, the deficit would not have been so harmful for the economy. And one should not forget that capital inflows through FDI during this period greatly exceeded the total trade imbalance.

<sup>42</sup> The population included in the Census comprised institutions that received foreign direct investments and those that benefited from foreign credits; giving the information was mandatory for those corporations with a direct or indirect share of non-residents in their authorized capital, on 12.31.2000, of at least 10% of stocks of quotas with a right to vote or 20% of direct or indirect share in total capital.

What is behind the growing trade surplus during 2001-2004? First, of all the devaluation and floating of the Real, from parity with the dollar to more than R\$3 per one dollar in 2002-2003, undoubtedly helped and lent support to those who argued that a key reason for earlier trade deficit was an overvalued Real. Secondly, contracting domestic demand prompted many companies, including foreign-owned ones, to look abroad for more dynamic markets, such as recovering Argentina, China and other countries (excluding the United States to which exports were sluggish). Thirdly, as Brazil's integration in international markets increased, there was an increase not only in imports but also in exports. Finally, Brazil has been well poised to participate in the global boom in commodities. Much of the production of commodities and simple manufactures originates from nationally owned companies. But foreign affiliates also participate. For example, exports of cars increased from 370,000 units in 2000 to 535,000 units in 2003.<sup>43</sup> In addition a number of new export-oriented FDI projects have been announced recently in the steel industry, agricultural commodities and even cars (by General Motors), although most auto firms still struggle with overcapacity and losses.<sup>44</sup>

But the recent upsurge of exports and a few export-oriented FDI projects notwithstanding, the problem of Brazil's long-term export competitiveness remains and needs to be addressed in a comprehensive way. Relying on low exchange rate competitiveness too long is often unsustainable. The role of TNCs in exports illustrates this problem: it is high and growing and yet TNCs' export propensity is low, much lower than in other Latin American countries, supporting that FDI in Brazil is predominantly oriented towards the domestic market.

#### **4. Technology**

In some industries, Brazilian companies have been able to develop admirable technological capabilities, making them important world players or even leaders, often with the support of the Government. Brazil is a world leader in deep-sea exploration, it developed a sophisticated software industry and is a player in the short-haul commercial aircraft industry and some areas of biotechnology (notably genomic sequencing of plants). But technology is very costly and Brazil, as any other country, cannot develop all the technology that it needs. That's why FDI is expected to contribute to the technological development of Brazil as one of its key benefits.

In the 1960s and 1970s, Brazil indeed attracted a large number of foreign firms to technology- and capital-intensive manufacturing industries. But having been built behind high import barriers, these industries were not designed to produce goods that would meet the standards and prices set at the international level. Although many were able to export, in particular to regional markets, they were not under pressure to develop the level of competitiveness needed to become active players in international markets. Their impact on local technological progress was, therefore, limited and this was often criticised - as part of criticism of the import substitution strategy Brazil pursued vigorously during that period.<sup>45</sup>

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<sup>43</sup> ECLAC, 2004, p. 120.

<sup>44</sup> EIU, Press Release, "Brazil: direct investment flows disappoint", 31 May 2004.

<sup>45</sup> On the costs and benefits of FDI during the period of import substitution, see Fritsch and Franco (1988), Franco (1996) and Moreira (1999).

Beginning in the late 1980s, Brazil began to change strategy and initiate trade liberalization. One expected outcome was to encourage TNCs and domestic companies to link more to the world market, to increase efficiency of their operations, to export more and to intensify technological effort (incentives for R&D in some areas have been an additional encouragement). Indeed, these policies induced many TNCs to improve their productivity as to service the wider market of MERCOSUR and, in few instances, the global one. There is evidence that foreign companies were better equipped to face the increased international competition that resulted from the trade opening reforms. But the scale of these changes has not yet been sufficient to alter significantly the market-seeking nature of FDI in Brazil, as has been demonstrated above.

But still foreign companies exhibit on average higher technological levels than domestic ones. A survey of firms in the manufacturing sector for the years 1996-2000 concludes that, on average, foreign companies are larger than domestic ones in terms of employees and revenue; they employ better-qualified workers and productivity of labour – a proxy commonly used to measure technological intensity – in these companies is higher<sup>46</sup> (Table 1.10.). A strong positive correlation between the growth of labour productivity and the presence of foreign companies in the manufacturing industry in the period 1990-1997 was also found in other studies.<sup>47</sup>

**Table I.10. Main indicators for domestic and foreign companies' activities (1996-2000)**

Companies		Number	%	Revenue (R\$ mil)	Employees	Productivity*	Schooling Years
Locally-owned	non exporting	42,186	78.3	4,316	62	69	6.7
	exporting	9,436	17.5	45,406	298	144	7
	Total	51,622	95.8	11,853	105	83	6.7
Foreign-owned	non exporting	344	0.6	32,032	190	307	8.7
	exporting	1,894	3.5	161,575	636	382	9.1
	Total	2,238	4.2	136,479	549	368	9
<b>Total</b>		53,860	100	18.176	128	97	6.9

Source: De Negri (2003). \* Labour productivity index: average for 1996 = 100.

Another study confirmed generally superior technological characteristics of foreign companies over domestic ones, including in technological innovation.<sup>48</sup> The results can be summarized as follows:

- TNCs are, on average, more innovation-oriented than domestic companies (Table I.12), both in relation to managerial methods and quality control (use of *just in time* processes, total quality and statistical control of process) and to innovation incorporated in capital goods (use of robots and computers).
- Although TNCs also appear to invest more in knowledge generation than domestic firms,<sup>49</sup> this investment is concentrated primarily on product adaptation to the Brazilian market and not devoted to the development of new products.

<sup>46</sup> De Negri (2003) analyzed the characteristics of national and foreign manufacturing companies in Brazil in the years 1996-2000, based on a sample of 53,860 companies, of which 2,132 are foreign owned.

<sup>47</sup> See Moreira (1999).

<sup>48</sup> Braga Nonnemberg M.J., "Determinantes dos Investimentos Externos e Impactos das Empresas Multinacionais no Brasil – As Décadas de 1970 e 1990", discussion paper n. 969, IPEA, 2003, where he studies domestic and foreign firms using a database of companies in the manufacturing sector in the State of Sao Paulo ("PAEP", Pesquisa de Atividade Econômica Paulista) for the year 1996.

<sup>49</sup> SOBEET, *Comportamento Tecnológico das Empresas Transnacionais em Operacao no Brasil*, Sao Paolo, 2000.

- The intensity of industrial automation depends on the technological level of industries in which the companies operate. In the most technology-intensive industries, differences between domestic and foreign firms appear very small. However, in traditional industries, the degree of industrial automation is significantly higher in TNCs than in domestic companies, suggesting that spillovers have been limited (Table I.11.).

Some TNC affiliates are clearly at the forefront of modern managerial practices (Box I.4.).

**Table I.11. Selected indicators of technology in Brazil, 1996**  
(Percentages)

Domestic	Foreign	Difference	Domestic	Foreign	Difference		
<b>Use of computer equipment</b>			<b>Internal Just in Time</b>				
group 1	30.48	47.73	-17.25	group 1	37.50	57.50	-20.00
group 2	33.90	48.22	-14.32	group 2	31.71	41.04	-9.33
group 3	24.88	22.11	2.77	group 3	28.04	39.35	-11.31
group 4	12.88	24.49	-11.61	group 4	28.19	29.85	-1.66
<b>Use of industrial Robots</b>			<b>External Just in Time</b>				
group 1	7.55	16.28	-8.73	group 1	20.90	40.00	-19.10
group 2	3.14	9.42	-6.28	group 2	19.86	27.61	-7.75
group 3	2.58	4.92	-2.34	group 3	15.20	21.60	-6.40
group 4	1.72	2.04	-0.32	group 4	12.31	17.91	-5.60
<b>Total Quality</b>			<b>Statistical control of Process</b>				
group 1	58.00	70.00	-12.00	group 1	65.67	57.50	8.17
group 2	56.17	67.79	-11.62	group 2	50.83	63.30	-12.47
group 3	47.65	70.97	-23.32	group 3	53.76	68.95	-15.19
group 4	42.98	36.76	6.22	group 4	49.85	68.66	-18.81
<b>Growth of industrial automation 1994-1996</b>							
group 1	56.22	53.85	2.37				
group 2	50.58	56.55	-5.97				
group 3	49.37	60.19	-10.82				
group 4	46.97	62.32	-15.35				

Source: Braga Nonnemberg, 2003.

Notes: the analysis divides industrial sectors in 4 groups, where group 1 is the most technology-intensive (electronic systems, communication equipment etc.) and group 4 the least technology-intensive (dairy products, furniture etc.).

In spite of general technological superiority of foreign firms over domestic ones, the technological contribution of TNCs to Brazil's economy is not considered as sufficient or meeting expectations. In addition, recent improvements in the efficiency of TNC operations have a downside for domestic companies. One observer has pointed out that while modernization efforts and economies of scale achieved by foreign investors tended to improve efficiency, thus amplifying some benefits of investment, they also led to higher concentration of production and the loss of market share by domestic companies, particularly in the capital-intensive industries.<sup>50</sup> Others noted the lack of productivity spillovers to nationally-owned companies or cases of discontinuation of local engineering activities by foreign affiliates, as well as substitution of imported capital goods for domestically-produced machinery and equipment.<sup>51</sup> For example, in 1996 and 1997, a number of TNCs acquired several large domestic auto parts producers – Metal Leve, Freio Vargas and Cofap. Subsequently, the R&D activities of the local firms were downgraded, and their frontier research was relocated to the parent firms'

<sup>50</sup> Moreira (1999).

<sup>51</sup> See Gonçalves, J. E. P., *Empresas estrangeiras e transbordamentos de produtividade na indústria brasileira, 1997-2000*, Master thesis, IE-Unicamp, 2003.

R&Ds centres in their home countries.<sup>52</sup> One study has even gone so far as to conclude that “most of the local innovative firms have been acquired by TNCs subsidiaries that, as part of their strategies, are downgrading the technological activities carried out locally”.<sup>53</sup>

#### **Box I.4. Siemens and ShareNet: building knowledge**

Siemens, a German transnational corporation active in approximately 190 countries, established an affiliate in Brazil in 1905. Siemens Brazil, with 7,236 employees and \$1,423 million in sales, is today one of the leading companies in manufacturing electronic products for a range of areas that varies from information and telecommunications, to medicine and energy.

Since 1994, Siemens Brazil has opened 19 Centers of Competence for the production of a variety of electronic products and components. Becoming a Center of Competence is particularly important for Siemens Brazil, as the company defines Center of Competence as a site where new products that fulfill international standards and high-quality criteria are developed to supply the world markets.

In 2000, Siemens implemented in Brazil an innovative management initiative, the ShareNet system. The system has already been adopted in more than 70 countries and it includes 900 users in Brazil. Siemens defines it as a methodology used to manage people’s structures and relationships inside the business environment.

The ShareNet system has been developed with the objective of connecting people around the world and exchanging knowledge across Siemens affiliates. Before the ShareNet system was adopted, a lot of time was consumed in the attempt to retrieve information on the company's projects in different places around the world. Today, when a new project is launched, Siemens' employees can check on ShareNet whether or not other projects of the same type have been generated elsewhere and how.

Through ShareNet, Siemens can also recognize the management of knowledge within the organization, measuring the qualifications of the employees and evaluating if they are over or under qualified with respect to the latest products and solutions of the market. From this evaluation the company can make decisions regarding the investment in terms of acquisition of knowledge (education) and facilitation of the practices of job-rotation (socialization of knowledge).

According to Siemens, the implementation of the ShareNet in Brazil contributed to higher productivity through time saving, higher quality, cost reduction and sales increases.

*Source:* UNCTAD interviews

Leaving these negative impacts aside, especially the question of how widespread they are, and their full costs/benefits analysis in economic terms, there is no doubt that there is still considerable unexploited potential as regards technological contributions of TNCs -- given Brazil’s top class universities and research institutions, skilled labour and pockets of technological excellence in a number of industries. The question is how to unleash this potential. To give one example of Government efforts, research activities in Brazil have been encouraged since the mid-1980s through a series of "Informatics Laws". Typically, these laws have granted tax incentives to firms, local and foreign, investing a certain percentage of their total sales in R&D. They have provided a stimulus to partnerships between public institutions or universities and TNCs.<sup>54</sup> In some regions of Brazil, these have resulted in the development of technological poles (see

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<sup>52</sup> UNCTAD, WIR 1999.

<sup>53</sup> Cassiolato, J. E. and Lastres, H., *Transfer of Technology for Successful Integration into the Global Economy, A case study of Embraer in Brazil*, UNCTAD/UNDP 2002, p.1.

<sup>54</sup> A more detailed analysis of the New Informatics Law is contained in the next chapter.



Box I.5.). Tax incentives have encouraged foreign companies to intensify their R&D effort (Box I.6.).

### **Box I.5. R&D partnerships: the case of UNICAMP**

A series of research partnerships between Universities and the private sector, including foreign investors, have been established in a number of regions in Brazil since the mid-nineties. The University of Campinas (UNICAMP) in the State of Sao Paulo represents one of the most successful examples.

UNICAMP is at the origin of several partnership projects for research and development of new technologies, including the CPqD – FITEC (Centro de Pesquisa e Desenvolvimento - Fundação para Inovações Tecnológicas), known as the main technological center in Brazil. There, university experts are able to connect a company's needs for research with the expertise of UNICAMP's institutes, professors and researchers. They can even contribute to the company's own product development projects and processes.

A partnership with UNICAMP is based on the existence of a common ground between the company's interest in product R&D and the research competences of the university. More than 250 partnership agreements with private companies and 60 agreements with public companies have been established at UNICAMP so far. The agreements include companies such as Ericsson, for the development of technology of fiberglass for optical amplifiers and Motorola, for the development of professional capabilities in electronic specific areas. Others include: Aventis, Bayer, Bristol, Compaq, Glaxo, IBM, Roche, Novartis, Syngentha, HP, Monsanto and Tetra Pak.

The partnership contracts include the details of the project and settle the conditions of the intellectual property rights, such as the license, disclosure and non-disclosure of information. UNICAMP holds around 300 patents; however, only 3 of them are licensed. UNICAMP intends to obtain a percentage of 3% over the net profit of the licensee.

The success of R&D partnerships has been such that UNICAMP is now launching a new, bolder initiative: the creation of the "UNICAMP Innovation Agency" and the development of a "Techno Park", an area of 7 million square meters meant to provide human and physical resources, as well as all facilities and services required for R&D. It is expected that the creation of the Park will contribute fundamentally to the generation of employment, income and innovation through the attraction of companies and activities in the research and development area.

*Source:* UNCTAD interviews.

Another noteworthy initiative in the area of technological innovation was the launching, in 1999, of the "Sectoral Funds" of the Ministry of Science and Technology, created with the objective of establishing long-term finance for infrastructure, development and scientific and technological research. To date, 15 Funds are active, and cover various activities including oil and natural gas, transport, R&D, infrastructure, IT and mining. One of the funds (Fundo Verde e Amarelo) supports research interactions between universities, research centres and companies to booster innovation. The Funds are financed from different sources, including revenue from companies that benefit from tax incentives, royalties for technology transfer, donations and loans. So far, the resources devoted to the funds have amounted to more than \$750 million, but they are expected to reach \$1.9 billion by 2005. Although the Funds are available to both Brazilian and foreign investors, it appears that mostly domestic firms have applied for funding. An assessment of the impact of the Funds relative to their objectives would be premature, but the initiative represents an important step towards the financing of R&D activities and encouraging dialogue between the different stakeholders in the area of innovation.

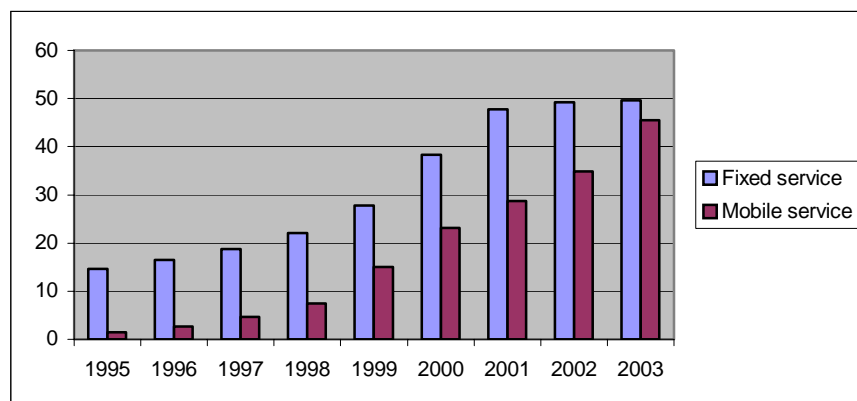
More recently, on 2 December 2004, a new Innovation Law was passed, which is meant to provide incentives to increase innovative activities, as well as to facilitate scientific and technological research by private companies, especially by Small and Medium-sized Enterprises (SMEs). With the new regulation, SMEs can enter contractual arrangements with public scientific and technological institutions for the use of their laboratories. The law also regulates the use and the negotiation on IP generated from collaborative activities between public scientific and technological institutions and firms, and allows for the benefits from the commercialisation of intellectual property to be shared among researchers, public scientific and technological institutions and private firms.

## 5. Modernization of intermediate services

Inadequate intermediate services, such as infrastructure, financial or business services, under-invested during the years of the debt crisis and hyper-inflation, were one of the key factors hampering Brazil's international competitiveness. The problems became acute in the early 1990s. In response, successive governments launched privatisation programmes, open to FDI. As mentioned earlier, investors responded, especially in telecommunications, electricity and banking and less so in other areas of infrastructure, which were still awaiting a passage of a private-public partnership law.

The impact on infrastructure development and improvement of services in the case of telecommunications was immediate. In the early 1990s, a telephone line in some regions of Brazil could cost up to \$2,000 and it would take two to three years for a phone to be installed. Still in 1995, in the whole country, only 15 million fixed telephone lines were functioning. By 2003, fixed lines increased to 50 million and the installation cost dramatically decreased, not exceeding \$30 in many cities. The main standards of quality, such as the network digitalisation index, the average time to get a dial tone, the local and long-distance phone rates and the number of orders placed for repair services per 100 public telephones also improved significantly during this period.<sup>55</sup>

**Fig. 1.13. Telephone lines in operation in Brazil**  
(Millions)



Source: Anatel

<sup>55</sup> For more details, see: Anatel/Brazilian Government, "PASTE - Perspectives on the expansion and modernization of the telecommunications sector", 2000.

Even more impressive has been the explosion in mobile phone communication. In 1995, Brazil had 1,4 million mobile accesses in operation. By 2003, this figure increased to more than 45 million, making Brazil the fifth largest telephone market in the world (fixed and mobile).<sup>56</sup>

In electricity, until 1995 there was very little private capital both in generation and distribution. Private companies accounted for 2.7% of installed generation capacity and 2.4% of electricity distribution.<sup>57</sup> After 1995, privatisation started with the sale of concessions in distribution. The privatisation of generation companies was more limited and began only in 1998. Today, 65% of electricity distribution and 23% of generation are in private hands. FDI participation in privatisation reached 42% in distribution and above 90% in generation.

But progress was much less spectacular than in telecommunications, owing to regulatory problems (see chapter II) and drought in 2001, which led to the energy crisis and rationing at the beginning of the 21<sup>st</sup> century. But still there were some improvements in the efficiency and quality of services provided by concession holders (Table I.8.).

**Table I.8. Electric power distribution: Technical-Operating Indicators**

(DISTRIBUTORS)	1995	1999	Variation (%)
<b>Efficiency Indicator</b>			
Energy Losses (%)	13.6 %	12.4 %	- 9
<b>Quality Indicator</b> (supply interruptions)			
DEC (number of hours)	27.41	18.36	-33
FEC (frequency)	27.68	17.64	-36
<b>Productivity Indicator</b>			
MWh sold per employee	1,572	3,705	136
Consumers per employee	283	607	114

Source: BNDES

<sup>56</sup> See InvesteBrasil, "Scenario", Year 2, number 5, Jul/Aug 2003.

<sup>57</sup> BNDES, "Infrastructure Report", N. 53, December 2000.

### **Box I.6. Lucent: exporting Brazilian technology**

Lucent Technologies, an American company that designs and delivers the systems, services and software for next-generation communications networks, has been operating in Brazil since 1997. It now has 700 employees in the country and has invested more than \$250 million in Brazil in the last 7 years, signing more than \$3.5 billion worth of contracts with the main local and global service providers and operators in fixed, mobile and long-distance communication.

In Brazil, Lucent invested in manufacturing facilities, regional offices and integrated laboratories. Since its establishment, Lucent has obtained several awards recognizing its performance in Brazil, including an ecology recognition award. Lucent benefits from tax incentives in accordance with the Informatics Law.<sup>58</sup>

Lucent's Brazilian affiliate is responsible for the development of some of the products that are now part of the worldwide portfolio of the company, such as the switch BZ 5000, launched in 2000 and BZSP, announced in 2002. The initial technology for BZ family products came from Batik and Zetax – local Lucent's company acquisitions – and was improved by Lucent. The switches have a simple, modular architecture designed specifically for service providers operating small networks and can accommodate a variety of network architectures, with little customisation required, making it particularly suitable for use in telecommunications in rural areas.

Such characteristics have enabled Lucent to export its switch family to other developing countries. Thus far, the switches have been exported to Argentina, Bolivia, Belize, Colombia, Guatemala, Guinea Bissau, Indonesia and the Philippines. Also it is from Brazil that Lucent provides technical assistance for the product worldwide.

Lucent's local affiliate engineers have been working in partnership with Bell Labs in the United States, the research arm of Lucent Technologies. As a result, Lucent recently launched a new product, the iGEN<sup>TM</sup> Compact Switch, which will also integrate the company's worldwide portfolio.

Since 2000, Lucent Technologies in Brazil has contributed positively to the Brazilian balance of trade. The local unit achieved \$71 million in exports in 2003, representing an increase of more than 20% compared to the previous year.

Lucent's experience in Brazil sets an example of how a local technology developed for the domestic market can find a new life through the access to the international markets offered by a TNC. At the same time, it shows how a TNC can benefit by valuing local capacities and sharing knowledge.

*Source:* UNCTAD interviews

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<sup>58</sup> See the "informatics law" in Chapter 2.

## **E. Overall assessment**

Brazil is in a unique position with respect to FDI relative to other developing countries. It has both a long FDI history, which started more than a century ago, and a large presence of TNCs in its territory. But during the lost decade of the 1980s and into the early 1990s, when competition for FDI among countries intensified, Brazil remained outside the FDI inflows map.

The successful reforms that started in the early 1990s have restored macroeconomic and financial stability and growth and, consequently, Brazil's traditional attractiveness to FDI. In addition, FDI inflows were boosted to boom proportions by the privatisation programme in service industries. Although the boom is over, FDI inflows are considerably higher than in any of the years preceding 1996, showing remarkable resilience in spite of the global FDI downturn after the year 2000.

Since the 1990s, FDI has again been an important source of capital inflows and investment. It has played a role in improving the competitiveness of the Brazilian economy, especially in the provision of some intermediate services. But given the significant and prolonged presence of TNCs in the country, its contribution to competitiveness is modest. Evidence on the technological impact, including spillovers from TNCs to domestic firms, is limited. In addition, in spite of the current export boom, neither foreign companies in Brazil, nor the domestic ones appear to have reacted to the opening to trade and the new opportunities offered by MERCOSUR in a sustainable way that would guarantee export success in the long run.

The modest performance is largely related to the market-seeking nature of FDI that entered Brazil, including in the recent past, and to the reliance on policies that have favoured this type of investment. However, in an economy characterized by decreasing barriers to trade and increasing international competition, if Brazil is to benefit more from FDI, it becomes critical that national policies work to create better conditions for enhancing the competitiveness of the companies already in Brazil (domestic and foreign ones) and to attract more export-oriented and efficiency-seeking FDI.



## **II. THE INVESTMENT FRAMEWORK**

Brazil has had a successful century of attracting and retaining FDI. Its market and policies have been conducive to the attraction of market-seeking foreign investors. Privatisation and financial sector liberalisation are but recent examples. In the new century, Brazil has wider goals – to encourage existing and new foreign investors that will not only serve the local market but also be catalysts for export development and world-class technical competence. In this respect, quality of FDI becomes as important as its quantity in maximising the benefits of FDI.

The question to be addressed is whether the policies that promote FDI in its market-seeking mode are still optimal in retaining and attracting foreign investors, especially efficiency-seeking investors, that will contribute towards these goals of Brazil. The chapter examines the tax and regulatory policies, and their administration, that collectively make up the investment framework. The evidence of this chapter is that important elements of the investment framework are not optimal when investors are sought or encouraged to link their Brazilian operations more closely to global markets.

The Government's new Industrial, Technology and Trade Policy recognises these strategic themes insofar as it speaks of the need to improve national competitiveness. It acknowledges that foreign affiliates have an important role as they can establish in Brazil the basis for increased exports as well as contribute to national technological capacity. The Industrial, Technology and Trade Policy proposes measures to improve Brazilian competitiveness and these will be reviewed where relevant to an assessment of the investment framework.

### **A. Specific FDI measures**

Brazil accepts FDI in almost all business activities, especially so since the constitutional distinction between foreign and national ownership of investment was removed in 1995. National treatment applies in principle and practice to foreign investment, once established through a Brazilian entity. There is no FDI law in a modern sense<sup>59</sup> and there are no bilateral investment treaties (BITs) in force. This has not impeded FDI since, more importantly, Brazil accords acceptable standards in practice.

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<sup>59</sup> That is, a national law with principles and process governing the regulation of FDI entry and setting out standards of foreign investor treatment and protection.

## **1. Entry of FDI**

Brazil has a long history of receiving FDI. For example, Pirelli, the Italian tyre company, has been in business in Brazil for ninety years, longer than most developing countries in the world have been politically independent. Currently almost all businesses open to the private sector are also open to FDI.

For many decades FDI was accepted but was intended to support business sectors not taken up by government and by the national private sector. For a brief period this was formalised when, from 1988 to 1995, the Constitution distinguished between Brazilian enterprises with domestic capital and those with foreign capital and laid the basis for a non-national treatment regime. A 1995 landmark amendment eliminated a constitutional distinction between Brazilian companies in citizen ownership and those with foreign ownership. This amendment removed the constitutional basis for non-national treatment both pre- and post- establishment. At the same time, the Constitution was amended to reduce the scope for government-owned monopolies. Together, the amendments widened the scope for FDI as shown in Table II.1.

Many persons interviewed in both the public and private sectors believe that the 1995 constitutional amendment eliminated all restrictions on FDI entry. This is not the case. There are some restrictions on FDI entry into selected sectors set out in the Constitution or in various sectoral laws. Table II.1. shows that the 1995 changes were significant but indicates where restrictions remain. In most such cases there is no absolute prohibition of FDI but a requirement that foreign investments receive case-by-case approval.



**Table II.1. FDI entry restrictions before and after 1995**

Sector	Pre 1995		Post 1995	
	Public monopoly?	FDI restricted?	Public monopoly?	FDI restricted?
Mining	No	Yes, to 49%	No	No <sup>1</sup>
Oil and Gas	Yes	Yes	No	No
Telecommunications	Majority public	Yes	No	Yes <sup>2</sup>
Electric power	Yes	Yes	National grid only	No
Petroleum refining	Yes	Yes	No	No
Media	No	Yes, to 30% <sup>8</sup>	No	Yes, to 30% <sup>8</sup>
Financial services	No	Yes <sup>2</sup>	No	Yes <sup>2</sup>
Air services <sup>3</sup>	No	Yes, to 20%	No	Yes, to 20% <sup>4</sup>
Highway freight	No	Yes, to 20% <sup>4</sup>	No	Yes, to 20% <sup>4</sup>
Security transport	No	Yes	No	Yes
Rural land	No	Yes <sup>5</sup>	No	Yes <sup>5</sup>
Border land	No	Yes <sup>6</sup>	No	Yes <sup>6</sup>
Lotteries	Yes	Yes	Yes	Yes
Hospital services	No	Yes <sup>7</sup>	No	Yes <sup>7</sup>

Notes:

- 1- Except for mining of radioactive ore, in which FDI is forbidden.
- 2- FDI permitted, by Presidential decree, on a case-by-case basis since 1995, if the home country grants reciprocal access or an international agreement provides for access and if the investment is deemed to be in the national interest. "Financial services" includes banking, securities services and insurance. In the case of telecommunications the President is empowered to block a foreign investment.
- 3- Foreign companies permitted to operate international air transport services only.
- 4- 20% of the ordinary shares.
- 5- FDI requires case-by-case approval.
- 6- FDI in land situated within 150 km of the national border requires security clearance.
- 7- FDI not permitted in public hospital services. FDI permitted in private hospitals.
- 8- 70% of media businesses must be owned by citizens of descent or those who have been naturalised for at least 10 years. In the case of cable TV, foreign investors may only hold 49% of voting control although up to 100% of non-voting shares.

How severe are these restrictions and to what extent are they implemented in practice? Media restrictions are prevalent elsewhere and border-land restrictions are common in Latin America. Both have little economic impact. In financial services, the opening to FDI has been cautious. For example, since 1995 it appears that the liberalisation in banking has been confined to foreign acquisition to support the restructuring of existing banks. No greenfield foreign banking licences have been issued. Nevertheless, foreign banks had a 25 per cent share in the banking market by 2002.<sup>60</sup> The least open area to FDI entry is in domestic transportation. FDI in rural land requires the approval of INCRA (the National Institute for Colonisation and Agrarian Reform) and is restricted to approved industrial, agricultural and pastoral projects.

Apart from the cases listed in Table II.1., foreign investment does not need prior approval. Under the 1962 Law on Foreign Capital, all FDI must be registered with the Central Bank. Reinvested earnings must also be registered. This is essentially a foreign exchange and taxation control measure rather than an FDI restriction, which would deal with the principles and process of FDI entry, treatment and protection.

<sup>60</sup> Source: TEJ Database, Central Bank, as reported by McKinsey.

Apart from the 1988-1995 interregnum, Brazil's regulatory strategy towards FDI has been to operate a relaxed entry mode but to legislate specific constraints where typical commercial actions of foreign investors might not naturally conform to the national interest. The 1962 Law on Foreign Capital is the lynchpin of this approach. For example, it constrains tax deductibility and foreign remittance of technology royalties to affiliates abroad.

In summary, Brazil is substantially open to FDI; restrictions apply to relatively few activities and even in these cases entry can be achieved by seeking approval.

## **2. Treatment and protection of FDI**

### **(a) National treatment**

The 1995 constitutional amendment removed the grounds for *non*-national treatment. Although it did not make an affirmative statement that national treatment would be accorded to foreign investors, it seems widely accepted that this is the legal position. Thus, provided an enterprise is incorporated in Brazil, it receives national treatment irrespective of the nationality of its owners.<sup>61</sup> Only four departures in law from national treatment were found in this review:

- Listed shares must have voting rights if issued by foreign controlled companies. A similar restriction does not apply to nationally owned enterprises (Law on Foreign Capital).
- A foreign-owned Brazilian company may not remit intellectual property royalties to its parent company (Law on Foreign Capital).
- Access of foreign-controlled Brazilian companies to the domestic capital market may be restricted in times of serious balance of payments conditions.<sup>62</sup>
- A foreign-owned company is limited to a maximum of three permanent visas for its employees. No such limit applies to nationally owned companies.

Notwithstanding these cases,<sup>63</sup> national treatment is the cornerstone of Brazil's official approach to FDI. It is firmly entrenched in administrative and legal practice. Brazil seems to be truly nationality "blind" once the enterprise becomes a Brazilian legal entity. This should not be underestimated as a positive aspect of the investment framework.

Yet this strength also has policy implications due to the rigid and not always practical manner in which the principle is applied. On the one hand, it is applied so that concessions and assistance for small and medium enterprises (SMEs) must also be extended to foreign investors. Many other countries' FDI regimes, including their BITs, allow scope for exclusive assistance to nationally owned SMEs.

An issue which may impact on foreign investment, on the other hand, is that rigorous application of national treatment affects Brazil's willingness to accept international

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<sup>61</sup> Some provisions refer to such enterprises being "headquartered and managed" in Brazil but in practice Brazilian domicile is sufficient to qualify for national treatment even if the controlling shareholders are abroad.

<sup>62</sup> Law No. 4,728 of July 1965.

<sup>63</sup> Indeed, it is conceivable that these four instances of non-national treatment, which pre-date the 1995 constitutional amendment, would not survive a constitutional challenge in court.

arbitration in order to resolve investor-State disputes (see below). It is a factor in the unwillingness of the Congress to ratify BITs (see Box II.1.). It has also prevented Brazil from applying the relevant MERCOSUR protocols on treatment and protection to investors of member states.

### **Box II.1. Brazil's BITs experience**

The number of BITs worldwide has increased substantially in recent years. Brazil has no BITs in force.

In the 1990s Brazil negotiated fourteen BITs. Six of these BITs - with Germany, Chile, France, Portugal, the United States and Switzerland - were sent to the Congress for ratification in the mid-1990s. The Congress expressed concerns on constitutional grounds over some provisions and highlighted the need for amendments. The key concerns expressed in Congress were two-fold:

1. It was argued that it is inappropriate to grant foreign investors the right to settle investor-State dispute through international arbitration whilst this recourse is not available to national investors.
2. The usual provisions on compensation for expropriation did not include Brazil's policy of paying for certain rural land acquisitions in the form of long-term government bonds denominated in domestic currency (see "Expropriation" in this section). Such bonds would fall well short of international standards for the payment of compensation.

The Government at that time decided that the Congressional amendments would render the treaties ineffective and decided not to press for their ratification.

A further eight negotiated BITs - with Venezuela, the Republic of Korea, Cuba, Denmark, Netherlands, Belgium and Luxembourg, Italy and Finland - were not sent to Congress for ratification in view of these difficulties. Since 1999, the Government has signed no new BITs.

*Source:* UNCTAD

#### (b) Other issues of treatment and protection

No legal principles exist in relation to *fair and equitable treatment* or *most-favoured-nation treatment* either in national law or international treaties in force.

*Funds transfer* concerns foreign investors' ability to repatriate dividends, capital and other payments associated with investment. Brazil's 1962 Law on Foreign Capital provides a mechanism for controlling but not guaranteeing such transfers. It is widespread practice in national law and international agreements relating to FDI to provide assurances of ability to transfer funds of these kinds. In many cases these assurances are made subject to balance of payments conditions and/or foreign exchange control regulations.

Funds transfer from Brazil in relation to dividends and capital repatriation require prior registration of the foreign investment and reinvestment with the Central Bank and the approval (usually a *pro forma* registration) of the Central Bank for each remittance. Closer scrutiny is given once remitted capital exceeds the amount of registered investment. In the Law on Foreign Capital, the Central Bank reserves the right to cap the repatriation of profits in cases of "grave imbalance" in the balance of payments. The cap is 10% of the historical value of investment and reinvestment. Capital repatriation

may be restricted or prohibited in less demanding circumstances – i.e. "whenever the exchange situation warrants". In fact, Brazil has never limited or suspended funds transfer over at least the last fifteen years despite several financial crises in this time.

The Law on Foreign Capital forbids a foreign investor from remitting funds for payment of royalties for patents and trademarks to its parent company. This is probably designed to prevent transfer pricing. The public interest issue might be better handled by general provisions in tax law, applying tax expensing limits to all such payments whether or not the parties are connected. The current provision is discriminatory and not helpful to the introduction of proprietary technology to Brazil.

There is a strong tradition of respect for private property rights in Brazil and this is embedded in the Constitution. The Constitution permits *expropriation* in cases of "public necessity" or "social interest" and states that compensation must be fair and paid prior to acquisition. Insofar as it goes, this is a reasonable approach. However, "social interest" includes not just the usual rights to acquire land for public works and environmental conservation but also economic judgements such as the right to acquire underutilised rural land and land for tourism. Several subsidiary laws govern issues such as valuation and compensation. In principle, there is provision for independent valuation and appeal but valuation principles are not necessarily based on market value. Moreover, compensation is not always payable in cash. Compensation for rural land expropriation takes the form partly of cash and partly of ten-year inflation-indexed government bonds (or twenty years where it involves official agrarian reform). All these provisions apply equally to national and foreign investors.

In relation to *dispute resolution*, foreign investors have full and equal access to domestic dispute resolution procedures, including recourse to Brazilian arbitration and to the Brazilian courts. Where an investment gives rise to an investor-State agreement (such as in privatisations, minerals and utility licences and in infrastructure concessions), it appears not to be possible to provide for binding international arbitration to resolve a dispute.

Brazil is not a member of the 1965 International Convention for the Settlement of Investment Disputes (ICSID). It has acceded to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). The New York Convention provides greater latitude to a member State to decline to enforce an award if it is deemed contrary to public policy.

Long-term concessions involving the supply of sensitive public services will inevitably give rise to tensions. This has already been evident in electricity concessions and the new public-private partnerships (PPPs) will expand the scope for foreign investor-State partnerships in public services. Most such tensions have and will be resolved by good faith negotiation. However, investors and their lenders to such projects will be more willing to invest if they have the ultimate right in investment agreements to independent mechanisms to resolve serious differences with the Government. It is understood that the Sao Paulo state law for PPPs will authorise recourse to international arbitration to be included in PPP agreements between investors and that state and that the Sao Paulo authorities are confident that such provisions are permissible under the new federal law.

### 3. Assessment

Although there is a requirement for case-by-case approval in some instances, foreign investors may enter almost all activities available to the private sector. The particular restrictions are scattered in the national laws and in the interest of good governance a consolidated list of activities requiring prior approval should be prepared. Apart from this minor improvement no change in the FDI entry regime is suggested.

National treatment is a firm principle. Other areas of FDI treatment and protection are, objectively, below the *legal* standards offered by many developing countries to foreign investors. In particular:

- Funds transfer, as described above, is not a legal right.
- The provisions for compensation for expropriation do not wholly meet the widespread international "prompt, adequate and effective" practice. .
- International arbitration is not available for investor-State dispute resolution.

Is it either necessary or desirable for Brazil to revise its legal standards on the above matters to improve foreign investor protection either in national law or by international agreements?

There is no compelling case at present for Brazil to enhance these aspects of its legal framework provided two existing and related conditions are maintained. The first is continued good *practice*, which provides confidence in there not being undue risk of currency inconvertibility, expropriation, breach of regulatory contract or unfair treatment by the domestic courts.<sup>64</sup> The second is continued availability of political risk insurance for these key risks, enabling investors to shift them to third parties. A particular issue here is whether the lack of BITs and the absence of investor-State international arbitration is an impediment to providing political risk cover. Several political risk insurers were contacted on this point. For some, the existence of BITs is very important and for others not so. In no case is Brazil cover denied due to an absence of BITs or national law covering key elements of investor protection although premiums charged by some insurers may be higher. Insurers look to the underlying conditions in Brazil, including government and judicial treatment of investors in practice, in deciding whether to extend cover. Thus, once again continued good practice in investor treatment will be important.

At present, outward FDI from Brazil is relatively modest and there is no strong domestic constituency to provide Brazilian overseas investors with BIT protections in foreign countries.

The number of international investment agreements has greatly increased in recent years. So too has the number of investor-State dispute settlement cases under ICSID or other *ad-hoc* arrangements such as UNCITRAL. Investors are increasingly paying attention to the existence of investment agreements and making use of investor-State dispute resolution mechanisms to challenge measures taken by States that adversely

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<sup>64</sup> Although it is widely acknowledged that judicial system is very slow.

affect their investments. This approach has also recently been taken by minority shareholders in several cases involving Argentina.<sup>65</sup>

These developments have been noted by host States. They are leading to the formulation of what can be called "new generation" investment treaties in which the interests of host countries are being clarified and enhanced. Box II.2. provides examples of some of the important developments in potential benefits to host States. Equally, it should be noted that in some areas the "new generation" treaties may restrict the policy space of States.

Brazil has exercised a clear principle in its approach to international investment treaties. It is nevertheless important for Brazil to be actively involved in the discussions that are shaping the new generation of treaties. The benefits and disadvantages of participation in a future generation of treaties should always be considered in weighing its interests in maintaining its current position.

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<sup>65</sup> Indeed, the situation in Argentina has received much attention because the State is the subject of many international arbitration cases brought by foreign investors arising from the extensive privatisation programme executed in the 1990s. At least 23 cases have been initiated under ICSID alone. The underlying issue in many such cases involves Argentina's alleged failure to honour US dollar price indexation in utilities tariff setting when it abandoned its currency peg to the US dollar during its recent economic crisis. Early cases were not necessarily brought by the licensee but by minority foreign investors in the licensee. Such a case involved CMS, a US energy company that is a minority shareholder in a gas transportation company. CMS won the arbitration case, which was brought under the Argentina/US BIT. In general, the underlying issue is not essentially a legal one but of a government's judgement of the risks it would bear to attract the volume of investment it desired. In contrast to Argentina, Brazil did not offer US dollar price indexation in its utility privatisations of the 1990s. Brazil was able, at the time, to achieve its investment objectives while obliging investors to accept exchange rate risk.

## **Box II.2. "New Generation" International Investment Agreements**

Experience gained with the application of "first generation" international investment arrangements is leading many countries to seek to refine and clarify the key provisions. This process is not confined to capital importing countries. The US, Canada, Japan, and Korea have substantially revised their model treaties in the last six months with the aim of clarifying concepts that have led to divergent interpretations in arbitral tribunals. Many such cases arose from NAFTA, involving the US, Canada and Mexico. Until recently European countries tended to view this issue as NAFTA-specific but now are also considering their positions, not least because NAFTA jurisprudence provides an input to customary international law. Some of the issues under review that could benefit host countries include:

### **Fair and equitable treatment**

Attention is being given to achieving greater clarity of this wide and potentially contentious provision. For example, the 2004 US draft model BIT and the Chile-US FTA circumscribe its application to the enjoyment of a minimum standard of treatment and incorporate reference to customary international law. These provisions seek to leave much less room for interpretation of the standard to an arbitral tribunal.

### **Expropriation**

An important issue requiring clarification is the scope of "indirect expropriation". In what circumstances can a regulatory change with an adverse impact on an investment be deemed to be an expropriation? The fundamental issue is to achieve clarity and balance between a state's right to regulate and the reasonable commercial interests of the investor. The emerging trend is to more clearly entrench a host state's right to regulate. This trend is reflected in both the US and Canadian draft model treaties of 2004.

### **Dispute settlement**

Various measures are being considered to strengthen the dispute settlement process. One measure is greater recourse to mediation and reference to an independent expert. This can be especially important in infrastructure investments where, over the long term, circumstances can change in a manner not envisaged in the original regulatory regime. Host countries are also successfully limiting their exposure to frivolous claims (e.g. Chile in its FTA with the US) and providing for a three-year limit on claims.

*Source:* UNCTAD

## **B. General measures**

This review of "general measures" covers tax and regulatory measures, and their administration, that affect *all* business whether foreign or nationally owned. It follows that comments on general measures apply equally to both sets of investors. It is worth noting, too, that foreign investors in many countries find that general measures often have a more critical impact on their business than the FDI specific measures reviewed above. This is also the case in Brazil.

General measures are considered here because of their effects on investment. However, it is clear that policy in these areas will have to take into account myriad national concerns apart from investment. A number of suggestions of possible policy actions are offered here, though policymakers will have to consider whether they are sufficiently practicable and worthwhile given the wider economic and social objectives of the country.

Brazil has a large and sophisticated private business sector and has attracted substantial FDI. Overall the tax and regulatory regime could be more supportive to international competitiveness and growth.

### **1. Taxation**

The principal elements of Brazil's business taxation are summarised in Box II.3.

The current system of business taxation is widely regarded as being more complex than necessary, and the Government has undertaken reforms to align taxation more closely with its strategic goals, taking into account business needs. It is focussing initially on the area of value-added taxation (VAT), which featured in the "fiscal war" between states as they competed to lure automotive FDI. It has also restructured social security taxes such as COFINS. Continued reforms will be needed to build a tax system that is less cumbersome and more competitive for business, and especially for export-oriented investors.



### Box II.3. Summary of Brazilian taxation

#### Taxation of profits and remittances

Business profits are taxed at the Federal level. Corporate profits are subject to income tax, the **IRPJ**. Annual profit up to equivalent of about \$80,000 is taxed at 15% and additional profits at 25%. A social contribution charge (the **CSL**) of 9% is also applied to profits. IRPJ losses can be carried forward indefinitely but cannot reduce taxable income by more than 30% in any year. Depreciation allowances are 2% for buildings, 10% for industrial plant and equipment and 10-20% for other assets. Taxation is generally uniform across sectors. The most prominent incentive is a 75% reduction in the IRPJ for approved agricultural, manufacturing and services industries in the North and Northeast regions.

Dividends are exempt from tax and there is no withholding tax on overseas remittance of dividends. Other overseas remittances are taxed at the following rates:

Interest: 15%

Services' fees: 25%

Technology and know-how related payments: 15%.

Brazil has a well-developed network of 24 double tax treaties. Generally, they do not reduce withholding rates. Technology royalty and service fees paid to affiliates abroad are not a deductible expense.

#### Import duties

Import duties are solely a Federal tax. Since 1 January 1995, Brazil adopted the Common External Tariff, under the regional agreement of MERCOSUR, which sets duty rates for all imports, except for a list of about 400 products. Import duty rates average 10.8% and range up to 35%. The higher rates apply to selected automotive imports. Duty relief can apply to capital goods not produced domestically. Generally, tariff levels escalate by degree of processing and many industries are offered high levels of effective protection for domestic manufacture (see Figure II.3. for more information on nominal and effective tariff rates).

#### VAT and sales taxes

The Constitution permits such taxes in similar forms to be applied at all three levels of government. The Federal and state governments levy VAT known as **IPI** and **ICMS** respectively. IPI is levied at rates of between 2 and 15% on manufactures (with higher rates for luxury items). Broadly it is targeted as an excise tax, but is levied on value-added. ICMS applies on the transportation and sale of goods and on communications services. Rates vary by the type of good or service and by the state of origin and destination. They range from 7% to 25%. For example, in Sao Paulo the general rate is 18% but lower rates apply to transactions with less developed states. Both systems zero-rate exports but defer full credit for input VAT paid on capital goods.

Municipalities levy a sales tax, the **ISS**, on any kind of service performed by companies or by self-employed professionals. ISS varies from 2% to 5% (with a few exceptions), and is assessed on the cost of services (not on value-added). The rate varies by municipality and by type of service. Some state governments impose ceilings on the ISS rate.

#### Other significant taxes and charges on business

- **COFINS**, a social security funding tax, changed in 2004 from a sales tax at 3% to a tax based on a value-added concept at the rate of 7.6%.
- **PIS/PASEP** is a Federal tax to fund unemployment insurance and a bonus for employees earning less than twice the minimum wage. From 2004, it will be charged at 1.65% on the same base as COFINS.
- **IOF** is a charge of up to 2% on the value of financial transactions including loans, securities sales, and foreign exchange and insurance transactions. For example, loans are levied at 1.5% p.a. on the principal. CPMF is levied on customer account transactions in financial institutions.

#### Personal taxation

Personal income above about \$5,000 p.a. is taxed. The highest marginal rate is 27.5%.

Source: UNCTAD

*Tax measures affecting investor competitiveness*

(i) Indirect taxation

An important issue for encouraging exports is the ability to acquire capital and operating inputs at world prices. Indirect taxation can impair this ability whether through import duties, sales taxes or value-added taxes. In common with most countries, Brazil has schemes to neutralise the burden of indirect taxes on exporters but they are subject to limitations.

- Import duty drawback (and IPI suspension) applies on raw materials and supplies for export processing. But local supplies must amount to 40% of such inputs and thus the programme does not fully address the need of exporters to acquire *all* inputs at world prices. The Industrial, Technology and Trade Policy has identified this problem. It proposes that improvements to import duty drawback will be made, with special attention to eight states, but details have yet to be announced.
- The BK/ICT scheme allows reduced import duty (to as low as 0-2%)<sup>66</sup> on capital goods including ICT equipment where the applicant can demonstrate no local supply. This scheme, which applies for a renewable two year term, attracts about 1,500 applicants per year. In 2002, concessions were granted on \$1.2 billion of capital equipment imports compared with a total of such imports of \$11.6 billion. Exporters can also benefit from deferral of import duty payment on capital goods under RECOF.
- RECOF,<sup>67</sup> which was launched in 1997-98, permits certain manufacturing industries to defer payment of IPI and import duty on components, packaging and equipment for one year with possible extension to a second year. As an additional incentive, up to 20% of imports may be sold without additional manufacture on the domestic market. The only eligible industries are currently IT and telecommunications, aerospace and automotive industries. Applicants must commit to export at least \$10 million p.a. of product over the first three years and \$20 million p.a. thereafter. Major foreign investors such as Ericsson, Dell, Hewlett Packard, Motorola, Lucent and Northern Telecom have qualified. The Industrial, Technology and Trade Policy envisages both a simplification of RECOF administration and a lowering of the required export thresholds. Details have yet to be announced.

At present, these measures do not fully respond to competitive needs of export manufacturers. Customs drawback does not give the scope of relief provided in other exporting countries. The BK scheme expressly excludes relief where there may be domestic (and potentially uncompetitive) supply of capital goods. RECOF applies to a narrow range of industries and defers rather than removes duty. Under the Industrial, Technology and Trade Policy enhancements to these measures are being considered. This is encouraging although no details are yet available.

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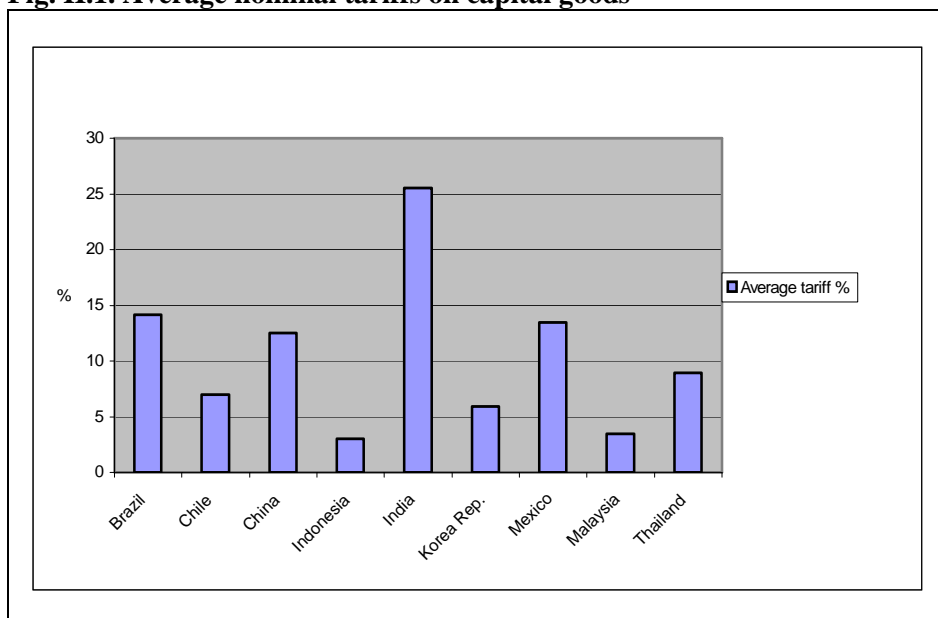
<sup>66</sup> In February 2004 the applicable rate for temporary duty reduction was lowered from 4% to 2%. This measure is contained in the new Industrial, Technology and Trade Policy. According to MERCOSUR decision 34/03, as from 1 January 2006, tariffs may be temporarily reduced to 2 %, in the case of items not produced in Brazil, and to 0% if not produced by a MERCOSUR country.

<sup>67</sup> The Special System of Industrial Depots.

Of course, the underlying rationale of these limitations is a concern to promote and protect local suppliers of operating and capital inputs. In a large economy, such as Brazil's, the local supply industry is extensive. It is thus more difficult to contemplate enabling exporters to have unfettered choice between imports and local supply. For example, Brazil has a more developed capital goods industry. Figure II.1 shows that Brazilian import tariffs on capital goods are about on average with those of other big developing countries, but higher than those of some key competitors for FDI in Asia. The capital goods industry is earmarked for accelerated development as part of the new Industrial, Technology and Trade Policy. The measures adopted therein should be consistent with this goal while ensuring export competitiveness through non-protective measures on capital inputs.

Building the capacity of local suppliers to be internationally competitive is important for creating a dynamic export sector. If export-oriented production is to be encouraged producers should have the ability to buy inputs at world-competitive price and quality.

**Fig. II.1. Average nominal tariffs on capital goods**



Source: TRAINS database. Latest data for each country in 2001-2003 period.

Another scheme to provide competitive arrangements for exporters is export processing zones (EPZs). (See Box II.4.). In many other developing countries, including middle-income and successful countries such as Malaysia, EPZs have served as effective instruments for developing competitiveness. So far 17 EPZs have been permitted to operate in Brazil, and 4 have been developed, but none has become operational. It appears that the Federal Government has not permitted investors to take up the tax and other measures available. This is in part due to the scepticism of successive governments about the effectiveness of EPZs and in part due to the lack of demand.

Is there a case today in Brazil for activating the EPZs and, if so, under what conditions? The key rationale for EPZs is that they deliver to investors acceptable conditions that the economy at large *ought* to provide but is unable to at present. Such conditions include good infrastructure and utilities, liberal foreign exchange arrangements, efficient customs facilities including well-administered drawback or exemption schemes

for import duties on goods processed for export and prompt VAT refunds. To this extent the activation of EPZs is an option to be considered.

This rationale can be extended to suggest that EPZs should also offer a corporate income tax regime that is internationally competitive. This does not mean tax exemption or long tax holidays but reasonable, competitive rates of the kind that ought to be available to *all* comparable investors whether or not they are based in EPZs. If due care is taken in the design of the corporate income tax regime, there is much to recommend EPZs in Brazil today as a means of ameliorating constraints on export investors. Care must also be taken that the corporate income tax regime in EPZs is WTO-compliant.

The regional tax concessions available for the north and northeast regions could make EPZs particularly attractive sites for investors in these regions. Moreover, investors in the zones are exporters and would be able to pay for zone infrastructure and services in foreign currency. Thus EPZs may well be suitable candidates to attract private developers and service providers through public-private partnership (PPP) projects. An element of public subsidy would reflect the national interest in positive measures to accelerate development in the less advantaged regions.

#### **Box II.4. EPZs in Brazil**

The legal basis for Export Processing Zones (EPZs), other than the long-established Manaus zone, was created in 1988. The aim was to provide favourable conditions for investment in less developed areas. Zones had particular appeal to policy makers in the 1980's when import tariffs were higher.

EPZ businesses may import operating and capital inputs free of import duty and are exempt from federal excise (IPI). The general rates of income tax apply but remittances of royalties, fees and interest are exempt. States have agreed to exempt goods bound for zones from state VAT (ICMS). More generally, domestic supplies to zones are treated as exports for tax purposes and zone suppliers can be paid in foreign currency. EPZ businesses are free from exchange control and are permitted to maintain foreign currency accounts abroad. The key conditions are subject to a stability provision in that any change in relevant general law will not apply to EPZ firms unless it is more favourable to them. Two provisions are designed to enhance local supply to EPZ firms (to mitigate the *malquiladora* effect): each investor must procure a minimum of supplies from domestic sources and tax depreciation is only available on domestically produced capital assets.

Some restrictions apply. EPZ firms must export 100% of output. There are no arrangements to permit domestic sale with, for example, appropriate import duty being paid. Exports to MERCOSUR countries are liable to the full rate of CET. Also only manufacturing (and not services) is allowed within EPZs.

Source: UNCTAD, based on information supplied by Prof. H. Braga

Both federal and state level governments have VAT powers and municipalities can apply sales taxes. The scope of each is summarised in Box II.4. Individual elements are poorly designed and the system as a whole lacks coordination, for example on the matter of refunds of excess VAT. The Government is making a comprehensive effort to harmonise and integrate the VAT system.

Additional issues arising from the present system are:

- There is not full zero rating of exports on the federal and state VAT because creditability of input tax on capital purchases is not immediate.

- There is a bias against most services because they are not included in the VAT system and service providers cannot gain relief from VAT on manufactured supplies.

Brazil offers an interesting incentive to encourage R&D in the IT industry (manufacture of semiconductors and related electronics and components, digital equipment and software). To be eligible, an investor must expend at least 4% of its domestic sales revenue on R&D in Brazil (of which about ½ must be invested in an official research institution). The investor is entitled to 95% reduction in federal excise (IPI) in 2001, tapering down to 70% reduction from 2006 to 2019.

Several major foreign investors participate in this scheme, which has generated R&D expenditure of about \$2.5 billion since it was first introduced in 1991. The scheme began as an alternative to the "go-it-alone" model of information technology development that had previously dominated official policy on technology development. The earlier approach clearly entailed risks to Brazil's competitiveness. However, there appears to be no sustained assessment as to whether the incentive has led to cost-effective outcomes. This could be done before the scheme is extended to other activities, as seems to be foreshadowed in the Industrial, Technology and Trade Policy.

New incentives to increase innovative activities are also foreseen by the new Innovation Law of 2 December 2004, discussed in Chapter 1. At the moment of writing, the Law is in the final stage and implementing rules and regulations are being adopted.

(ii) Corporate taxation

The tax comparisons presented in Annex I suggest that Brazil is broadly competitive in its standard regime of corporate taxation but less so when account is taken of:

- the wide-ranging concessions offered to export manufacturing by other countries; and
- the potential for COFINS and related taxes to fall on the income of goods and services providers for the local market. This is a key issue.

Moreover, Brazil imposes high rates of withholding tax on royalties and interest payments (elements that are not captured by the international comparisons shown in the figures in Annex I).

Elements of the tax base are not helpful to investors at start up – in particular the limit on loss carry forward and the modest rates of tax depreciation on fixed assets.

*Assessment of taxation*

Brazil has begun to overhaul business taxation to make it more competitive and, in particular, to make it more supportive of investment in exportable goods and services. Reforms being tackled in federal and state VAT and in COFINS are noteworthy examples. These reforms can be seen as preparing the way for a wider range of Brazilian firms, including foreign affiliates, to link themselves to the world market.

On *import tariffs*, the current schemes of relieving exporters of duty on capital and operating inputs, so that they are available to exporters at world prices, have not gone further because of the conflicting aim of protecting local suppliers. Brazil's manufacturing base is simply too extensive to make the two aims compatible. These schemes have over time become more liberal and this could be accelerated as Brazil pursues its goal of increasing manufactured exports.<sup>68</sup> Thus a first step would be to remove the limitations on the import duty drawback and the BK schemes so that key manufactured inputs can be obtained at world prices. The EPZs could also be activated.

The ultimate goal should be to enhance the competitiveness of local suppliers by increasing exposure to international competition through, for example, across the board tariff reductions. In this way, domestic suppliers of goods and services to all exporting sectors are better able to supply inputs at world prices. The TEC of MERCOSUR now sets most tariffs applied by Brazil to non-member countries. The formation of MERCOSUR in 1991 coincided with a steep reduction in effective protection. An important question is whether MERCOSUR will again be a positive force in creating more competitive tariff levels or entrench the current levels.

Import taxes are not a major element in total revenue collection and thus there is no overriding budgetary obstacle to these reforms.

In relation to *corporate taxation* there are immediate changes that could be made. It should be possible to redesign elements of the corporate tax *base* in order to assist investor early cash flow:

- (i) remove the 30% cap on annual utilisation of loss carry forward; and
- (ii) improve rates of depreciation allowances .

These measures would especially assist large greenfield projects that typically have high levels of debt financing, including the utilities investments and proposed PPP infrastructure projects. From a Budget standpoint these changes would affect only the timing of Budget receipts, and not revenue collections in the medium term.

Two more fundamental matters need attention. The first is that corporate taxation for manufactured exports is less competitive in Brazil than in other leading developing countries, since many provide special fiscal regimes to attract FDI. This gap is stronger when account is taken of Brazil's high withholding rates on technology and interest payments. The second matter is COFINS. It may have a very significant impact on corporate profitability in labour intensive industry and services. Prudence suggests that the rate of tax could be lower.

Clearly, there is a difficult balance to be drawn between reductions in the business tax burden, which affect business costs and international competitiveness, and revenue needs of the Budget. It is possible to argue, however, that although in the short term a reduction in taxes might inevitably lead to a reduction in the fiscal revenue, in the long term, it is likely that by widening economic activity, and potentially narrowing informal business arrangements, fiscal revenue might actually increase.

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<sup>68</sup> Figure II.1. in the textiles and garments industry provides a case that illustrates the severe additional tax burden of applying the full tariff to capital and operating inputs.

One possibility for revenue neutral reform is to shift more of the tax burden to personal income taxation by reducing the personal tax thresholds, though this would of course have to be weighed against other policy goals. At present, about 80% of employees pay no tax because the minimum threshold is set at about 5 times the minimum wage (indeed the minimum tax threshold is probably above average earnings).

## **2. Foreign exchange arrangements**

Brazil has maintained convertibility of the currency for more than a decade despite many financial upheavals including hyperinflation. In 1999 Brazil acceded to the Article VIII of the International Monetary Fund and undertook to maintain current account convertibility.

The Central Bank operates a conventional form of exchange control with comprehensive rules. Overseas remittance of technology-related payments, including royalties and services fees require prior approval by INPI of the underlying technology transfer agreement. Dividend remittance and capital repatriation require prior registration of the inward investment and all subsequent reinvestment with the central bank. Investment registration is not however an approval procedure but one of registration only. Foreign investors seeking to remit dividends abroad must also comply with the procedure - applicable to all companies - that the minutes of the company meeting authorising the dividend should be lodged with the Commercial Registry. The Registrar checks that the dividend has been authorised in conformity with the requirements of the company's charter and any pertinent agreements among the shareholders. The Commercial Registry procedure can take up to 15 days.

The Central Bank has significantly streamlined the administration of these rules at the transactional level, based on the introduction in 2000 of electronic registration. It does not exercise prior approval over remittances to ensure that they conform to the underlying agreements and corporate arrangements but monitors compliance *ex post*. Once registered electronically, a remittance is completed immediately. However, the investor must retain the paperwork for five years. This enables a very timely execution of corporate transactions.

Residents can hold offshore foreign currency accounts, which are important for limited recourse lending to major export projects, with the prior approval of the Central Bank.

It is not common to find a mature economy of Brazil's size and sophistication using exchange controls as an instrument of balance of payments management. This is one area that Brazil should give serious consideration in due course. There are many issues of macroeconomic policy and bank supervision to consider; but from a foreign investor standpoint this step would be a positive signal. It would advance Brazil's profile compared with major alternative locations for FDI, reduce foreign exchange transactional costs and further reduce compliance paperwork undertaken for the Central Bank (such as INPI approval of technology agreements). It is probable that in such a system the Central Bank would retain the electronic registration system, including for foreign investment registration, but utilise it only for statistical purposes.

### **3. Labour**

Brazil has comprehensive labour legislation, primarily in the Consolidated Labour Law (CLT), which governs most occupations. Labour rights and benefits are clear in principle but compliance has presented increasing complications over time.

Wages are freely negotiable and widely set by annual collective agreements. The Federal Government is constitutionally mandated to set a national minimum wage (currently about \$85/month). In 2000, individual states were permitted to set higher, but not lower, wages (for example the minimum wage set by the Rio de Janeiro state is \$98/month). Minimum wages are set on a tripartite basis and are updated annually for inflation. Currently, about 2.3% of employees earn the minimum wage.<sup>69</sup>

In addition to basic pay, employees have a mandatory entitlement to substantial paid benefits, the most significant of which are:

- an annual bonus equal to a month's wage (the "13<sup>th</sup> month");
- employer contribution of 8% of wage to an employment insurance fund known as the FGTS; and
- employer-paid social security contributions.

Employers' social security contributions include a pension fund contribution of 20% of wage to the National Institute for Social Security (INSS) plus contributions to various agencies that promote training, welfare and cultural activities. There are at least 7 such agencies, all obtaining contributions from employers in one or more industries. Payments can easily total another 8% of wages.<sup>70</sup> These contributions are in part designed to provide worker training. However, several schemes appear to have little connection to employees in the workplace and are administered by multiple agencies. Most of these agencies were established in the 1960's and the approach could be revisited.

Employees may be terminated upon notice periods not exceeding 30 days and without recourse to permission by the labour authorities. Brazilian law readily regards the employment relationship as a contract, even if there is no formal contract. Employees terminated for normal commercial reasons are thus regarded as being terminated "without just cause" because a contract has been terminated. There is no stigma attached to the employer as a result of this label; indeed employees wishing to resign will often request to be terminated "without just cause" in order to access 40% of funds accumulated on their behalf in the employment insurance fund (FGTS – see above). Cases of genuinely unfair dismissals or disputes over the leaving entitlements go the labour justice system. Some claim that the prospect of access to a portion of FGTS entitlements stimulates job turnover and reduces employers' motivation to train staff.

Access to the labour justice system is becoming a bottleneck to investment. The Labour Courts are perceived to favour employees and thus employees are motivated to claim

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<sup>69</sup> Ministry of Labour communication, 23 February 2004.

<sup>70</sup> The potential contribution for FGTS plus other social security contributions can be up to 28.8%. TradeNet p. 36.



that entitlements have not been fully paid. The issue has been administratively burdensome for employers.<sup>71</sup>

Pressure on the Labour Courts in respect of all labour matters is increasing. The number of cases received in the 1990s doubled from under 1 million per year to 2 million per year, and the rate has increased further in 2001-2002. Labour court sources estimate that at least 80% of these cases relate to compensation for severance. Conciliation has not worked (in 1998 only 1,090 cases of a total of over a million were resolved at this level). Neither has arbitration. There is no specific labour arbitration regime. The 1996 law on general arbitration provided an opportunity for the employers and unions to establish an arbitration system for labour disputes. The Brazilian Arbitration Association was formed by both investors and unions but it has received a negligible number of labour cases. There is uncertainty as to whether the parties will abide by arbitral awards in the absence of a firm position from the Labour Courts that they will uphold arbitral decisions.

The labour law framework is a reasonable balance between the rights and needs of employers and employees. But certain practices would benefit from rationalisation or improvement:

- Are investors able to hire workers at economic cost or is this affected by setting a minimum wage and levying numerous social charges? There has been unfavourable comment on the question of social charges. However, given the high levels of unemployment in Brazil and the gap between the minimum wage and typical earnings, it is likely that the incidence of social charges is on employees rather than on employers. The basic wage is probably market-adjusted to take into account the social charges, which, therefore, make little difference to total remuneration cost. The issue for investors is the bureaucratic requirement of registering new workers and making payments to multiple agencies. It appears that a high proportion of employers avoid the system altogether by hiring unregistered workers or by characterising employment as a service relationship (at least 1/3<sup>rd</sup> of the work force might be informal).
- Nevertheless, the social charges system could be more rational.
  - Social charges could be combined into a single charge to reduce investor compliance costs.
  - Programmes directly related to the welfare or training of a company's workers should remain. Others could be removed and funded from general budget sources. Otherwise the practice of payroll charges will seem open-ended to employers.
  - Employers could be able to opt out of all schemes if they offer alternatives that can provide similar or better benefits and services to employees. Currently there is an opt-out provision for the INSS if employers offer profit sharing plans.

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<sup>71</sup> An investor who was interviewed for this report said that it retained a full time lawyer in each of its 21 factories in Brazil in order to deal solely with labour severance claims. It currently employs 15,000 staff and has 2,500 claims outstanding from departed workers.

- Is there flexibility to hire and let go of staff? The law affords appropriate flexibility. But, as discussed, the widespread practice of additional settlement claims markedly increases the administrative costs of severance. Clearly, employees must have a means of redress against unfair practices. But claims are routinely made in huge volumes and affect even the most reputable and careful employers. The initiative to encourage arbitrated settlement by utilising the general arbitration act has not worked because of doubts that decisions would be upheld by the Labour Court. An independent arbitration system under the labour law could be introduced and the scope of review of the Labour Courts could be confined to appeals related to legal interpretation and due process.

#### **4. Employment and residence of foreigners**

The employment and residence of non-citizens raise important public policy issues including protection and advancement of the local workforce, immigration and security controls and augmentation of key skills. In all countries, these issues have to be handled within a framework that provides investors with a reasonable ability to hire staff from abroad to provide the skills and corporate controls that they require.

Non-citizens may be employed in Brazil under two schemes:

- A temporary work visa (Visa V). This is issued for two years and renewable for another two years. Dependants and partners have the right to reside but not to work.
- A permanent visa (Visa VIIe).

Prospective employers seeking to hire non-citizens under the temporary work visa must:

- pass a labour market test (i.e. show that there are no suitably qualified citizens available to perform the work); and
- employ at least 2 citizens per foreign employee and maintain the wage bill in the same proportion. The 2:1 ratio derives from a stipulation in the general labour law.

There are two further stipulations – the applicant must have at least 2-3 years experience in the occupation and must be paid in Brazil not less than what was earned abroad.

A person seeking to stay longer than four years must apply for a permanent visa and the position will be subject to a more in-depth labour market test.

Where the employment is part of a services' contract, that contract must be registered with INPI. Where the contractor is a company and the contract is for technical services there must be a Brazilian team to accompany the foreign team and there must be two Brazilian employees for each foreigner.

Permanent visas are available to those proposing to invest a minimum of \$200,000 in Brazil or increase employment equivalent to 240 units of the minimum wage. In 2002, useful flexibility was introduced: since then, investment lower than the threshold can be accepted if the investment has a "relevant social interest" and the project intends to

create at least ten new jobs.<sup>72</sup> An additional permanent visa is available for each increment of investment or job creation with a maximum of three for foreign companies. Permanent visas are suitable for self-employed foreign investors and also larger foreign investors seeking to place executives or directors<sup>73</sup> in key positions. Permanent visas are issued on a provisional basis for two years and confirmed when the investor has fulfilled its proposals on capital investment and national employment. This procedure is sensible to prevent abuse by economic migrants pretending to be investors.

The permanent visa system seems entirely geared to the foreign skills' needs of new foreign investors. The investment requirements must be fulfilled in hard currency and the sponsor must have been established abroad for at least five years prior to the application. It would be logical to have equivalent provisions to meet the foreign skills needs of national investors.

While it is clearly important to meet the needs of the local workforce, more thought could be given to the foreign staffing needs of new investors. This is not such a problem for established investors (whose companies are already highly localised). The statistics show that Brazil issues a very small number of work and residence permits to non-citizens as shown in Table II.2. Moreover, the number being issued fell sharply in 2003, which tends to confirm investors' views that the authorities are tightening the procedures. One major investor reported that it had been forced to bring in foreign technicians on visitor visas to avoid serious implementation problems with its new project.

**Table II.2. Non-citizen work and residence visas issued**

Country	Temporary work and residence permits issued
Brazil (2002)	2,415
Brazil (2003)	1,458
México (2002)	24,649
Australia (2002/03)	37,859
Canada (2001)	58,860
United Kingdom* (2003)	113,960

\*Top 10 country sources only.

Source: National authorities

Quite apart from *temporary* work visas, it is also the case that Brazil grants relatively few *permanent* visas for businesses. Brazil issued 882 permanent visas in 2002 and 493 in 2003. By comparison Australia, which has a pro-active programme, granted over 40,000 visas of an equivalent kind in 2000/01.

Work and residence permitting arrangements could be designed and administered to achieve the twin objectives of safeguarding the local labour market and ensuring that Brazil avails itself of international skills. A review of policy and a reform of procedures could be considered:

<sup>72</sup> At the time of publication it was reported that this lower investment limit has been formalised at \$50,000.

<sup>73</sup> The legislation refers to positions of administrator, manager, director or officer although other commentary refers to "statutory positions" which is a narrower concept of officers of the company.

(i) Policy goals

Brazil has a comparatively strict policy towards the entry of foreign skills. This is not fully consistent with goals of enhancing competitiveness, moving into the more technical areas of industrial value chains and gaining leadership in knowledge-intensive industries and services. The Government could review whether its policy orientation on work and residence permitting is consistent with current strategic objectives such as those of the new Industrial, Technology and Trade Policy.

(ii) Temporary work visas

Implementation could be considered for improvement in line with practice in some countries:

- a. The Government, not individual employers, could undertake labour market testing. Based on research, the Government could publish a list of skills in short supply in Brazil and designate them as open for foreign recruitment. This relieves employers of the need to "prove" that such skills are in inadequate supply in Brazil by an unsuccessful local search. For example, science skills needed for pharmaceutical R&D and clinical trials could be "open list" candidates.
- b. All employers who hire foreign workers could have training responsibilities to fill the skills' gaps.
- c. The 2:1 employment and payroll ratios do not seem commercially sensible and are unnecessary if a. and b. are implemented. For the same reason, the limit of one renewal per temporary work visa could be removed.
- d. The requirement that INPI vet any technical services contract associated with foreign hire could be reconsidered. Implementation of a government scheme to designate skills in short supply obviates the need for INPI to assess whether foreign supply of the services is warranted.

(iii) Permanent visas

In principle, the scheme is appropriately targeted at the special needs of self-employed smaller foreign investors and at the key worker<sup>74</sup> requirements of larger foreign investors. Improvements could be considered:

- a. Lower the investment thresholds for areas of services that are knowledge-intensive but capital-light. Recently reported changes may have already achieved this (refer footnote 72).
- b. Develop a *pro-active* programme to attract business talent of types which are high priority for Brazil's strategic vision. For example Australia, with

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<sup>74</sup> A "key worker" position is one for which foreign hire is available without the need to pass a labour market test or guarantee localisation. This arrangement is useful for foreign investors in ensuring that key positions such as chief executive and chief financial officer can be filled from headquarters. Many countries explicitly offer key worker schemes to recognise the importance to foreign investors of retaining this level of management control of affiliates.

arguably a higher business skills base than Brazil has such programmes.<sup>75</sup> If implemented properly, a talent programme would increase local employment and skills in Brazil and *not* displace them. It should be noted that such a programme is not designed to import "labour", particularly not low skilled labour, but to target selected business and professional skills to enrich the skills' base of the economy. This programme could be an outcome of the review of Policy Goals proposed in (i) above.

## **5. Land**

Land issues have not been reviewed in detail though independent reports highlight a number of possible issues. Land title is secure and bankable but the transfer of title is slow and bureaucratic and the permits required for planning, development and building approval are extensive and time consuming. Zoning and land registration are underlying problems. Most land title and land use matters fall within state and municipal jurisdiction and details of the process were not investigated for this review. The most comprehensive recent review of such matters<sup>76</sup> (in Sao Paulo and Rio de Janeiro) found that land acquisition takes 90 to 260 days in Brazil – longer than in leading Asian competitors for FDI and longer than in Argentina, Chile and Mexico.

## **6. Commercial law and enforcement of contract**

Given its long private business history, Brazil has a comprehensive and workable set of commercial laws. Recently the civil code has been overhauled. A new bankruptcy law moves Brazil closer to the US Chapter 11 approach of providing more protection from creditors to enable corporate reorganisation.

Contracts are enforceable through the courts but there is a business perception of risk that the courts will be partial and will be unable to give speedy closure to contractual dispute. The concern is that the courts, especially lower courts, tend to be partial to the debtor in credit disputes, partial to employees in labour disputes and partial to government in a dispute between an investor and a public authority. Judges tend to take a social and public interest perspective in addition to ruling on the legal merits of cases. This perception is confirmed by a recent survey from IPEA, which showed that 78% of the judges would rather base their decisions on social concerns than on what is stated in the contracts.<sup>77</sup>

In addition, the judicial system gives many opportunities for appeal to higher level courts and this process can make it difficult to obtain closure on business matters that should be entitled to swifter and less costly settlement.

There appears to be no discriminatory treatment of foreign investors in these matters.

Since 1996 a commercial arbitration system has been established to enable parties to obtain speedier settlement. Recourse to arbitration is still novel in Brazil and there are

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<sup>75</sup> Clearly, Brazil has benefited in historic times from substantial immigration. Now, it is possible that skilled business people from say, Italy, are more likely to be made welcome in Eastern Europe.

<sup>76</sup> FIAS (2001).

<sup>77</sup> As reported in "O Globo", 17 August 2003.

differing views among investors as to how useful it is. The courts still hold themselves available to review arbitral decisions rather than simply enforce them.

## **7. Regulatory design and red tape**

The exceptional complexity and changeability of business regulation was frequently noted (examples abound - e.g. it takes on average 60 days to incorporate a company in Brazil according to one study<sup>78</sup>). It forms part of the additional costs of doing business in Brazil known locally as "custo Brasil". Established investors have learned to manage the regulatory system and have relatively low expectations of improvement. It is, however, a daunting prospect for new investors and for smaller investors.

Some common themes emerge in the Brazilian approach to the design of business regulation:

1. Interlocking regulatory approvals. Processes are established in which one regulatory approval is not possible without other unrelated approvals. Procedures are then sequential and cause delays. For example, obtaining tax registrations for the company and its shareholders is required (from federal and state tax agencies) before the company can be registered.
2. Multiple agency review. More than one agency reviews the same conceptual matter. Examples:
  - a. INPI reviews the rationale for (foreign) technical services agreement and the immigration and labour authorities review again the requirement for foreign professionals and technicians.
  - b. Units of both the Ministry of Finance and the Ministry of Justice investigate potential breaches of competition regulation.
  - c. Environmental permitting is reportedly subject to similar problems (although these were not investigated for this review).
3. Wide view of the public interest. In some cases the nature of the public interest is not discernible. Examples:
  - a. A dividend cannot be remitted abroad until the Commercial Registry confirms the company minutes authorising the dividend. This may be an attempt to protect local or minority shareholders.
  - b. A non-citizen who is a director of a Brazilian company cannot enter Brazil to attend board meetings on a temporary (business) visa.
  - c. A non-citizen company director who holds a permanent residence visa must obtain separate permission from the authorities for each statutory position held in any company in Brazil.
4. Frequent regulatory change without consolidation. Regulations are frequently amended and changes are usually not consolidated so that investors can readily understand the law. Examples:

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<sup>78</sup> For example see FIAS (2001).

- a. The Exporters Association has prepared a list of laws and regulations that affect its members. The list runs to fifty pages, due in part to the lack of consolidation.
- b. The applicable rate of one tax measure appeared to change three times in three working days during an enquiry for this review.
- c. The situation in which labour law is so complex that departing employees can bring Labour Court claims in the knowledge that employers cannot be totally sure that they are in compliance with all regulations.

The costs and delays to business caused by inappropriate regulation often compound, even where one regulatory element is sound. For example, it is, rightly, not possible to wind up a company unless all labour claims are settled. But it can take years to settle all claims and thus a company may have to remain a legal entity (and undertake all the usual filings) for many years after it has ceased to carry out business.

An unfortunate situation in Brazil is that many of the *routine* regulatory procedures are highly bureaucratic. Yet *key* regulatory matters, often those modernised over the last decade, are seriously understaffed (INPI and the competition agencies, as previously noted).

Red tape amounts to a substantial competitive disadvantage for Brazil and will reduce its appeal in particular for high quality FDI from the global integrator companies for whom internal market size is not paramount. In this respect Brazil compares poorly with a number of smaller developing countries in Latin America and Asia although it still has a window of opportunity in relation to India and China. There is little evidence of a systematic attempt to address the problem other than through more extensive use of information technology for routine administration (e.g. the Central Bank external payments system).

If Brazil were to make a comprehensive attempt to reduce regulatory costs and delays it could be transformed into a powerful FDI promotional message along with measures to improve infrastructure and sustained economic stability. It would be far more persuasive than the traditional reliance on tariff policy for manufacturing and would bring collateral benefits in the attraction of FDI in resource industries and services.

Such an attempt can only succeed with active participation and guidance from the highest levels. If these were secured, a strong advocacy function could be installed in a central agency of government with key ministries, networking with private sector advocacy groups such as chambers of commerce (see Chapter III).

An immediate practical step would be to insist that no new regulation is implemented until it is consolidated with all prior regulation.

## **8. Intellectual property protection**

The industrial property law of 1996 markedly changed Brazil's policies on the protection of intellectual property. It followed Brazil's signature of the Marrakech Agreement embodying the results of the Uruguay Round of trade negotiations. The law recognized patents, trademarks, industrial design, geographical indications and introduced new provisions concerning the enforcement of intellectual property rights.

This law was followed by new statutes on plant cultivars (1997), copyright (1998), software protection (1998) and regulation of internet domain names (1998). Brazil is a member of the Paris Convention on industrial property and the Berne Convention for the protection of literary and artistic works.<sup>79</sup>

Registration of intellectual property, other than copyright, is the responsibility of the National Institute for Industrial Property (INPI).

INPI is also involved in the registration of transfer of technology agreements between Brazilian and foreign parties. In part it acts as an agent for other authorities such as the central bank (foreign exchange control), the tax authorities (transfer pricing control) and for the immigration authorities (foreign hire arising from technical services agreements). But there appear to be no public interest criteria set out in applicable law or in published policy.<sup>80</sup> As a minimum, good governance principles suggest that clear principles should be published to guide applicants.

It may be timely for a review to be made of the need to pre-approve transfer of technology agreements. Also, agencies other than INPI could be better placed to handle the key public policy issues in technical agreements. For example, the transfer pricing implications of royalties and services fees payments between affiliates could be handled by the income tax authorities when companies file tax returns. The policy issues of whether foreign hire is justified by national skills shortages could be a matter better assessed by the labour authorities (and measures have been suggested in section B.4 above to assist the administration of national policy in this regard).

Apart from these policy issues, INPI appears to suffer backlogs in its work, probably at least 50,000 applications are outstanding according to industry sources.<sup>81</sup> The backlogs are acute in some sectors, particularly in pharmaceuticals. However, it has been indicated that during 2003, INPI's staff number has increased through both short term and some long term arrangements<sup>82</sup>. Indeed, this is reflected in the rapid increase in the number of patents' applications analysed in 2003 (see Table II.3).

**Table II.3. Administration of intellectual property registration**

Applications	2001	2002	2003
<b>PATENTS</b>			
Applicants	24,572	24,098	24,872
Analysed	12,245	8,089	24,796
<b>TRADEMARKS</b>			
Applicants	103,574	94,957	97,296
Analysed	40,193	26,881	43,314
<b>TRANSFER OF TECHNOLOGY</b>			
Applicants	3,463	3,173	2,794
Registered	3,099	2,981	2,592

Source: INPI Management Report, January to December 2002.

<sup>79</sup> In August 2004, Brazil (with Argentina) proposed to the World Intellectual Property Organisation that it establish a "development agenda" so as to explicitly include developmental issues in its work including in relation to patent protection standards, transfer of technology and enforcement procedures.

<sup>80</sup> INPI interview.

<sup>81</sup> INPI does not provide information on these matters in its public reports.

<sup>82</sup> INPI, *Relatório de Gestão de 2003*, available at: [www.inpi.gov.br](http://www.inpi.gov.br)



Table II.3. shows the current workload of INPI. Despite the recent developments, INPI acknowledges a need for more staff and attention to this is foreshadowed in the new Industrial, Technology and Trade Policy.

## **9. Competition policy**

Enforcement of competition policy is a vital economic function in Brazil, which is struggling to cope with the demands of a large and sophisticated economy. Pro-competition regulation is a fact of life for investors. But they have reasonable concerns that the process be transparent and competent and not subject to unreasonable delay.

The 1994 Antitrust Law<sup>83</sup> covers all competition issues including cartel regulation. The merger provisions are of particular interest to foreign investors. Where investment will result in a company holding 20% or more of the relevant market or where the acquirer has a worldwide turnover of about \$130 million or more per year the competition implications must be assessed by the authorities.

Three agencies are directly involved in competition enforcement. The agencies are the Secretariat for Economic Monitoring (SEAE) of the Ministry of Finance, the Secretariat for Economic Law (SDE) of the Ministry of Justice and the Administrative Council for Economic Defence (CADE), which is an independent administrative tribunal, linked to the Ministry of Justice. These agencies make up the Brazilian System of Competition Defence (SBDC). The public prosecutor is also involved in case referral.

The SEAE is mainly responsible for the economic analysis of merger reviews but also exercises an investigative function. The SDE analyses and investigates cases. Both agencies give their opinions on economic and legal aspects before submitting a case to CADE. CADE decides cases. All merger reviews must be submitted to CADE.

Despite the creation in 2003 of a simplified (fast track) procedure which reduced merger reviews to about 80 days, there exists still a great overlap of functions and many sequential processes which cause, in particular, delays for investors undertaking mergers and acquisitions. Understaffing and budget restraints are also problems. The recent Nestlé acquisition of Garoto has occupied more than two years (see Box II.5.), which is a long time notwithstanding the complexity and importance of the case.

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<sup>83</sup> Law no. 8884 of June 11, 1994.

**Box II.5. The Nestlé /Garoto competition decision**

In March 2002, Nestlé Brazil filed a notification to the SBDC concerning its acquisition of Garoto, a confectionary manufacturer. CADE requested Nestlé to submit a non-integration agreement, undertaking to keep Garoto's operations independent.

In October 2002, SEAE gave its opinion and forwarded the file to SDE. In December 2002 SDE gave its opinion and submitted the matter to CADE.

In February 2003 CADE's legal adviser presented its opinion of the case and in April 2003 the Public Prosecutor gave his legal opinion about the application of the anti-trust act. In February 2004, CADE decided not to permit the acquisition, stating that it would result in undue concentration in the chocolate market.

Nestlé appealed CADE's decision in March 2004 and included a plan to divest 10% of its market share in chocolates. In October 2004, CADE rejected the appeal. It is reported that Nestlé will appeal for a second time.

Source: UNCTAD interviews and Bloomberg report.

The primary solutions required to ensure that competition law is enforced fully in accordance with the public interest, but with greater speed and clarity and at lower cost to investors are:

- i. Amalgamate the current three independent functions into a single or a maximum of two competition authorities able to investigate and adjudicate. A draft new law completed in early 2003 proposes to amalgamate the two investigative secretariats into an independent agency with CADE remaining as an independent tribunal. This seems necessary to eliminate duplication and reduce delays.
- ii. Raise the mandatory investigative threshold of 20% to international norms of at least 40% so as to reduce the investigative burden. The draft of 2003 also proposed the extinction of the market share threshold and a rise in the turnover threshold.
- iii. Improve the budget and staff levels devoted to these issues. The draft of 2003 proposed to hire public employees specialised in competition policy.
- iv. Develop the capacity to issue guidance notes and preliminary findings for investors contemplating acquisitions or mergers. Currently, investors contemplating M&A could have to await the outcome of a potentially lengthy process with little ability to forecast the result. The draft of 2003 proposed to adopt a pre-merger review.

Another area that will soon need greater attention is the shared jurisdiction on competition matters in the newly liberalised utilities sectors. This is a matter of working out cooperative protocols between the sector regulators and the competition authorities. It is quite possible that a period of consolidation may now take place in the newly privatised industries.

## 10. Sectoral regulation in utilities and infrastructure

The 1990's privatisation programmes dominate the modern history of sectoral regulation. These opened many sectors to private investment and resulted in new regulatory regimes in telecommunications, electricity, oil and gas, and transportation. The privatisations themselves were widespread and massive. Between 1991 and 2000 130 state enterprises were privatised and in aggregate realised \$100 billion in sales proceeds and debt transfer. By comparison, all privatisations in all the OECD countries up to 1997 realised a total of \$153.5 billion.<sup>84</sup> FDI accounts for approximately 49% of this total.

In the utilities, telecommunications and electricity generation and transmission are federal responsibilities. Electricity distribution and gas distribution are the key areas of state responsibility. Along with municipalities, the states have responsibilities for non-interstate roads. Both claim responsibility for water and sewerage and the absence of an agreed regulatory regime is one of the reasons that little progress has been made in opening up this sector to private investment.

The results of liberalisation have been very mixed. The attraction of private investment in telecommunications privatisation is regarded largely as a success whilst electricity privatisation has been controversial and litigious. The management of liberalisation of these two sectors is reviewed below to see what lessons can be drawn for the new thrust to attract private investment in infrastructure through public-private partnerships.

### 10.1. Telecommunications

Telecommunications is widely, and rightly, regarded as a success story in liberalisation and privatisation. Significant proceeds were raised from sales, some competition was introduced at the outset and new entrants undertook significant obligations to expand services. The regulatory regime is summarised in the box below.

#### **Box II.6. The telecommunications investment regime**

Network expansion (termed "universalisation") was the most important government objective in telecommunications privatisation but attention was also given to the creation of competition.

The regulatory regime was installed first (culminating in the General Telecommunications Law and the creation of the regulator, ANATEL, in 1997). Then followed the privatisation of Telebras, the holding company of 28 state providers of local services, and of Embratel the monopoly long distance company. Telebras/Embratel were reorganised into three regional providers of local and intra-regional fixed-line services and one long distance/international carrier. The four entities were sold at auction with strong network development obligations and foreign investors acquired control of three. Local call competition was provided by selling licences to regional competitors (so called "mirror companies"). A framework for long-distance and international competition was created by permitting the regional companies to expand into these services once they had met their network coverage obligations. A similar duopoly structure was created in mobile services through the creation of 8-10 regional licences.

Data and Internet services are fully open to private investment.

Source: UNCTAD

<sup>84</sup> Augusto Castelar Pinheiro, *The Brazilian Privatisation Experience: What's Next?*, Paper Presented at the Second Annual Global Development Conference, Tokyo, December 10-13, 2000. p. 26.

This regulatory model has made significant progress towards government objectives:

- In the first two years following privatisation, fixed lines installed grew from 15.3 million to 35 million and mobile subscribers grew from 4 million to 21.5 million.<sup>85</sup>
- Competition is still weak but should improve. The mirror companies in local fixed line services have only 7% of the market. They have no access to the incumbents' "last mile" to subscribers and at least two mirror companies are relying on wireless local loop. Greater competition is possible in the long-distance and international segments from 2004 as the regional operators qualify to provide services.
- Significant sales proceeds were achieved.

Some of the private investors in fixed line and mobile telephony report that they have made losses or very low returns on capital invested. This seems to be a result of the authorities creating highly competitive privatisation conditions, including an initial pricing regime that was not US dollar-linked.

ANATEL has honoured the tariff regime on which the privatisations were based despite consumer pressures not to pass on inflation adjustments. Investors place great importance on the continued independence of this and other regulatory bodies.

## *10.2. Electricity*

In contrast to telecommunications, electricity sector liberalisation has been controversial and litigious. A privatisation programme, initiated in the mid-1990s, attracted substantial FDI from leading TNCs in the sector, especially in distribution. These investments have been loss-making amid recurring issues concerning electricity pricing and payments. Further investments in the sector, including those by industrial users, have been put on hold, as reforms are made to the electricity regime, some of which may reduce the regulatory scope of ANEEL, the electricity regulator.

A number of reasons may have contributed to lack of full success in the process.

A driving objective was to raise budget revenues to meet pressing fiscal needs of the time. BNDES was mandated to privatise the electricity assets of heavily indebted state governments as well as the businesses of Eletrobras. Privatisation began prior to the development of a full-fledged regulatory regime (or even the establishment of a regulator) and in the absence of a well-organised wholesale energy market. It was conducted under the 1995 concession law (see below) and the key regulatory conditions were set out in the concession contracts. In the focus on revenue maximisation the key commercial terms were highly favourable - a generous price indexation regime and modest conditions on network expansion and other social objectives. Moreover, BNDES provided 23% of the financing by in effect taking some of the distributors' debts to government onto its own books.

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<sup>85</sup> Pinheiro (2000), p. 23.

The privatisations have been likened to a gold rush. Investors in electricity distribution accepted three risks to acquire incumbency positions in underperforming companies in large markets:

- Foreign exchange rate risk (the price setting formula was not \$-indexed unlike most contemporary transactions in other countries).
- That (government-owned) generators would honour supply contracts in which they were obliged to compensate distributors for reductions in supply.
- That new investment – including private investment – would be forthcoming to meet fast-growing power generation needs.

Meanwhile prospective investors in new thermal generation capacity (utilising imported natural gas) were inhibited by the prospect of competing with lower marginal cost hydro production and thus being relegated to the role of swing producers.

This fragile approach to attracting private investment was undone by the 2001 currency devaluation and by a severe drought that led to reduced hydropower output and power rationing. Investors' decisions to forgo dollar indexation of tariffs proved to be a poor one. The Government-controlled generators were unwilling to compensate distributors for reduced supply until a compromise settlement was eventually negotiated. An early privatisation entity, the Rio de Janeiro utility LIGHT, had to be bailed out by its investors and by BNDES.

Current issues are the basis of a new tariff regime for the distributors and the recent reformulation of the wholesale market. The 5-year re-setting of the tariff regime for distributors has become controversial because it is proposed that the capital base be replacement value rather than the (much higher) price paid for the assets by investors. It has been argued that the original tariff basis - which is the key driver of investment value and underpinned the original sales price - should be retained.

Recently, the creation of a wholesale market has been abandoned in favour of more direct government control over wholesale prices in which distributors and industrial users will be required to buy power with a blend of (higher priced) thermal power and (lower priced) hydropower. Distributors will be obliged to bid for thermal power and take it on long-term agreements. Private investment will be sought in new thermal plants and it appears that hydro plants will not be privatised.

### *10.3. Concessions and public-private partnerships*

In 1995, the first serious attempt was made to create an overarching legal framework for the concessioning of public infrastructure and services to private investors.<sup>86</sup> At a time of severe fiscal constraints at all levels of government, private concessions were seen as a means of injecting private finance into much needed public infrastructure and service improvements. New laws imposed a requirement for competitive bidding, set out the essential rights and obligations to be required of concessionaires and provided for enforcement obligations on the part of the awarding authority (which could be a Federal, state or municipal government or a public entity) to safeguard the public interest. A wide range of public services could be concessioned – telecommunications

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<sup>86</sup> Law 8.987 of 13 February 1995 and Law 9.074 of 7 July 1995.

was the only significant exception. No FDI restrictions were imposed. Full details of investment arising from the 1995 law were not obtained. But it appears that investment was realised in 11 railways projects, 24 port projects and at least 6 highways projects.<sup>87</sup>

The authorities have been disappointed with the results. They believe that the poor private investment response arose from their inability, due to fiscal responsibility laws, to provide long-term subsidies to projects that are justifiable on socio-economic grounds but cannot generate adequate financial returns for commercial investors. A new public/private partnerships (PPP) law has been enacted to overcome this. Once again, the strong motivation is to improve public infrastructure and services with the aid of private investment in an era of government budget austerity.

What is a realistic set of expectations and lessons based on the experiences in utility privatisation?

- Investment in Brazil may increasingly require a foreign currency related element in the price regime, guarantees on foreign currency availability and independent means of dispute resolution. Interest worldwide in utilities and infrastructure investment is currently much less than in the golden days of privatisation in the 1990's. It will tend to favour projects that have the imbedded ability to price and charge in foreign currency (such as international airport and seaport concessions). Fortunately, Brazil is able to offer a number of such projects.<sup>88</sup> Where PPP project sales are in domestic currency it may be difficult to generate investor competition; thus bargaining dynamics currently favour the investor. Brazil government sponsors will be asked to accept more project risk on pricing and foreign currency availability. The government sponsors must be prepared not to consummate PPP projects where the commercial terms or the level of risk borne by public authority are disproportionate to the project benefits. The Argentine cases now in dispute show the dangers of poor risk assessment. The Brazil electricity privatisations show the dangers of allowing short-term fiscal constraints to influence the structuring of projects for important public services.
- Long-term contracts will almost always give rise to circumstances not clearly addressed by the foundation regulatory or contractual regime. Consideration should be given to the use of independent expert procedures and, as Sao Paulo state is contemplating, providing for arbitration to resolve unforeseen issues which disadvantage either the government or investors.
- Greater certainty will be required as to the long-term pricing/subsidy regime. The problem for government is that bids in current conditions will reflect current Brazil risk and cost of capital. The pricing regime could contain some inbuilt flexibility to accommodate changing Brazil risk, otherwise the concessions will generate windfall gains or losses.
- The uncompetitive elements of "custo Brasil" may be built into the commercial terms offered by investors. This would inhibit the provision of infrastructure at

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<sup>87</sup> Electricity privatisation was also conducted under the concession law.

<sup>88</sup> The development of EPZ facilities should also be considered for PPP projects. EPZ tenants are exporters and can be charged fees in foreign currency. The public subsidy component of PPPs is a useful tool for encouraging the private sector development and operation of zone infrastructure in remote areas.

internationally competitive prices or raise the element of public subsidy required.

## **11. Assessment**

The main suggestions on policy options emerging from the review of "general measures" are the following:

### Taxation

- Amend corporate tax legislation to increase depreciation allowances and remove the loss carry forward limit so as to improve investor's early cash flow.
- Improve and activate existing schemes to remove indirect tax disadvantages of export-oriented investment. Measures could include removing the local supply limit on customs duty drawback, the "no local supply" limitation on capital goods tariff relief (the BK scheme) and the deferral of VAT credit on capital purchases. Provide a proper mechanism to refund promptly input VAT incurred on zero rated exports.
- Consider a reduced rate of COFINS and PIS/PASEP taxes. The recent restructuring of COFINS to fall not on sales but on value-added, and the relief given to exports, is an important initiative. However, these taxes can become a significant tax on income where they cannot be fully passed on to the final consumer and prudence suggests that these taxes should be applied at lower rates.

### Labour

- Prune from social charges on payroll those levies not directly connected to the training welfare of company employees. Permit companies with approved schemes to opt out into self managed programmes. For other companies, combine all the social charges into a single payment to reduce investor paperwork.

### Export Processing Zones

- Activate the EPZ schemes and include them as PPP candidates to stimulate private development of zones, with preference to less developed areas.

### Foreign skills

- Establish Government research-based labour market testing to establish occupations open for foreign hire and thus facilitate rather than restrict employers needs to augment national skills in short supply with qualified foreign personnel.
- Develop the permanent visa scheme into a pro-active programme to attract foreign business talent.

### Intellectual property

- Replace INPI review of technical services contracts by appropriate safeguards against transfer pricing in the tax code.
- Despite the recent efforts to increase the staffing of INPI, there is still need to boost the institute's staff for other matters.

### Competition

- Combine the three competition bodies into one or a maximum of two agencies.
- Increase the threshold for merger review and develop guidelines and a pre-merger advisory capacity.
- Boost staffing of the agency to a level commensurate with the scale of matters it must address.

### Foreign exchange controls

- Keep under review the need for foreign exchange controls. Remittances under the present controls have been simplified by electronic registration plus the declaratory system for transactions. Apart from the confidence building benefits of abolishing controls, currency exchange costs would fall and there would be reduced need for approval of underlying agreements such as for technology transfer.

## **C. Findings and recommendations**

An impressive number of modernising elements was introduced to the investment framework in the 1990s. These included reductions in import tariffs, updated legal regimes for intellectual property and competition, the induction of private investment to the utilities' sectors, the widening of access for FDI and the removal of non-national treatment from the Constitution. Chapter 1 records the substantial response of FDI to these initiatives, especially in backbone services.

The extent to which these reforms were truly entrenched was opened to question by claw-backs that occurred - including, for example, the resort to increased tariffs in the late 1990's to stimulate hand-picked industries such as the automotive sector and the sidelining of ANEEL. Also, Congress expressed concerns on constitutional grounds over the BITs in the form in which they had been negotiated.

It is also encouraging to note that recently, the Government announced that the new focus for the Brazilian Government after the period of macroeconomic stabilization would be to carry out a Microeconomic Reform Agenda. The measures contained in the Agenda, which is receiving the financial support of the World Bank, include the reduction of business logistic costs (reducing customs' clearance times, container handling costs and road transport costs), the enhancement of the business environment (simplifying SMEs registration, adopting the new Bankruptcy, enabling PPPs) and the improvement of financial sector efficiency.



It is important, however, that the effort spent on legal reforms is matched by comparable improvement in the resources devoted to administration of the new laws. For example, the intellectual property and competition regimes are not staffed in a manner commensurate with the scale of business activity in Brazil's large and sophisticated economy. Indeed electricity privatisation began before an independent regulator was even established. To a degree, Brazil's historic record of administrative over-attention to routine matters (the famous "custo Brasil") has now been joined by administrative underperformance on matters of vital regulatory concern for investment.

Brazil is open to FDI and accords national treatment to foreign investors. There is no compelling case at present to provide stronger legal provisions in the key areas of foreign investment treatment and protection. Brazil could, however, involve itself actively in the work that is enhancing host country interests in the formulation of international investment treaties. As this work develops it may always keep under review the benefits of participating in a future generation of such treaties.

Undoubtedly the most important focus for enhancement of the investment framework is the reform of the general tax and regulatory regime for business.

Brazil could consider adopting a global competitiveness agenda so as to facilitate investment— foreign and national - willing to develop Brazil operations into world-class providers of goods and services to domestic, regional and global markets. The reforms of the last ten years are a significant step towards a more competitive environment. There is still much to be done. The first step is to engender debate and consensus on the importance of reform for long-term prospects for investment, growth and living standards.



### III. FDI STRATEGY

As Chapter I records, the end of the recent boom raises questions about the sustainability of the *quantity* of future FDI inflows. Moreover, important questions have been raised about the *quality* of FDI being received - in terms of the benefits it brings in relation to national development goals. This chapter highlights **five key elements of a new FDI strategy**. They are addressing strategic gaps that Brazil should close in order to enhance the attraction and impact of FDI. They are:

- Promoting a higher level of competitiveness of the national economy
- Extending market-seeking FDI into export-oriented FDI
- Facilitating access to demanding markets
- Promoting more FDI in poorer regions
- Organising institutions to better promote, facilitate and champion FDI.

The ultimate objective of the new strategy is to ensure that FDI contributes more to Brazil's development goals.

#### A. Promoting higher levels of competitiveness of the national economy

Foreign affiliates in manufacturing have a higher export propensity, on average, than domestic firms but their export performance is well short of expectations. The success of Brazil's new focus on export-oriented FDI will depend largely on the progress that is made in improving competitiveness, both on a firm and the national level. Export-oriented and efficiency-seeking investments are exposed to global competition and are dependent upon an operating environment that allows for world-class production conditions. This is more so today, than for the foreign affiliates that came to Brazil in the past for market-seeking reasons. Thus, policies promoting competitiveness at the national and the firm level are crucial. It means that FDI strategy must be embedded in a national competitiveness agenda.

As part of its efforts to create a more competitive business environment, the Brazilian Government has been undertaking, so far with partial success, a serious and difficult effort to reform taxation and business laws and practices, of which a recent and encouraging development was the adoption of a modern Bankruptcy Act. Among other objectives of national interest, such as creating a fairer tax system, there is also the goal of improving the tax and regulatory prerequisites of a better competitive situation for the export sector, both national and foreign. This requires the gradual expansion of Brazil's national competitiveness agenda which, building on the recently announced Industrial, Technology and Trade Policy (Box III.1), must include continued restructuring of taxes that impinge on international competitiveness, redesign of business regulation, and appropriate staffing of key business regulatory agencies.

### **Box III.1. The New Brazilian Industrial Policy**

Early in 2004 the Brazilian Government announced its new Industrial, Technology and Trade Policy.<sup>89</sup> The policy comprises a set of measures formulated at a generic level. Many of them aim at improving competitiveness, including enhancing innovation capabilities of Brazilian manufacturing. Most of the proposed measures are horizontal, that is, they target competitiveness of firms across industries through modernizing equipment, improving the efficiency of supply and distribution networks, enhancing infrastructure and strengthening innovation capabilities. They also aim to improve export competitiveness of the manufacturing sector. Vertical measures target four innovation-intensive activities singled out as strategic options: microelectronics, software, pharmaceuticals and capital goods, although concrete programmes have not yet been formulated. They have been earmarked as long-term priorities because of their knowledge intensity, their role as diffusion poles of innovation for a wide range of industries branches and because of their importance for the trade balance.

It is expected that, at some point, horizontal initiatives will be articulated in more industry-specific vertical measures to improve competitiveness of selected value chains. There is a strong belief in Brazil, that promoting externalities provides a strong argument in favour of actions targeting specific clusters and/or value-chains, since potential benefits of such proposed actions would result in spillovers to the economy as a whole.

Given the large number of government agencies involved in the implementation of broadly defined horizontal measures, the success of the policy will heavily depend on policy coordination. With this in mind, the Brazilian Government is in the process of creating an Industrial Development Agency, which will coordinate policy actions in this area. Another task of the agency will be to formulate the programme of strengthening of innovation activities in the four priority areas. So far the Government has conducted studies and assembled expertise both from public and private sectors to assess opportunities and needs in those areas.

Policy documents emphasize the importance of cooperation not only between government agencies but also with and within the private sector. Cooperation within the private sector is considered important in the case of clusters, where a number of small producers needs to build externalities in order to improve competitiveness, and in the case of value-chains where interaction between suppliers, producers and distributors is important to improve efficiency.

As part of the new policy, the National Economic and Social Development Bank (BNDES) has already implemented financial support schemes to promote software development (Prosoft Program) and increase the quality of locally produced generic pharmaceutical products (Profarma Program). The Bank has also completed feasibility studies on the design and production of custom-made integrated circuits (ASICs), including the identification of potential foreign investors.

The new policy expects also important contributions from foreign investors, especially to enhancing competitiveness. First, it is expected that in most manufacturing industries, Brazilian affiliates of TNCs will play a leading role in increasing efficiency and developing capabilities that would increase competitiveness and improve trade performance. In this regard official documents explicitly state that the new policy aims to obtain more contributions to development from foreign investors already in the country, maximizing especially positive spillovers from their activities. Second, the new policy selectively aims to attract new FDI in some industries where foreign firms could provide required resources for developing targeted activities. A case in point is microelectronics, where FDI is targeted to develop capabilities for design and manufacturing of custom made integrated circuits (ASICs). The Brazilian government is currently considering the creation of a new agency, at the highest level of the executive branch to coordinate negotiations with potential new foreign investors.

*Source:* UNCTAD

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<sup>89</sup> See "Diretrizes de Política Industrial, Tecnológica e de Comércio Exterior", in [www.mdic.gov.br](http://www.mdic.gov.br).

During the interviews with representatives of the public and private sectors conducted in the preparatory stage of this report, key measures concerning various regulatory policies have been frequently highlighted and a series of actions have been proposed to deal with immediate problems. They relate in particular to taxation, improving further infrastructure, labour and skills issues, commercial law, red tape, intellectual property protection and competition policy. Those perceptions of the main obstacles should be seen as useful inputs to shape the competitiveness agenda and FDI strategy. Such measures are predominantly "horizontal" as the term is used in Brazil. That is, they impact all investors in a non-selective manner.

Key measures concerning various regulatory policies have been examined in Chapter II and a series of actions have been proposed to deal with immediate problems. They relate in particular to taxation, improving further infrastructure, labour and skills issues, commercial law, red tape, intellectual property protection and competition policy. All of them are indispensable parts of the competitiveness agenda and FDI strategy.

Measures discussed in Chapter II are predominantly "horizontal" as the term is used in Brazil. That is, they impact all investors in a non-selective manner.

"Vertical" measures target individual industries, groups of industries or even individual firms. Brazil, as many other countries, has had a long tradition of using these measures although recently there has been a growing "horizontalization" of Brazil's policies.<sup>90</sup> But the right to use "vertical" policies, as well as their scope, including in industries dominated by foreign investors, is still at the centre of the current debate in Brazil on industrial policy.

The key issue as regards vertical measures is that they be applied in a way supporting, or at least not harming, competitiveness (and of course in ways consistent with Brazil's international obligations). For almost each issue to be solved, there is a choice between pro- or anti-competitive instruments. To give one example, non-competitive domestic suppliers of intermediate goods in an industry threatened by liberalized imports can be kept alive by high tariffs, public purchases and local content requirements. Alternatively, they could be helped by measures promoting their efficiency and encouraging (but not imposing) linkages between foreign affiliates and local suppliers – the policy which Brazil may not have sufficiently developed or coordinated yet, as will be discussed below. And a final caveat should be made. Moving from low to world-class competitiveness is painful and politically difficult, not only in Brazil, but also in other countries. Therefore, the temptation to use vertical measures to reduce pain is always there, but the result can be little or no progress in competitiveness across sectors. This should also be kept in mind when using them.

## **B. Extend market-seeking FDI into export-oriented FDI**

One of the key benefits Brazil expects from FDI is raising national export performance, especially in manufacturing. Although foreign affiliates have increased their shares of exports considerably, their contribution is not yet considered sufficient.

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<sup>90</sup> da Motta Veiga, P., 2004, p.5

The depreciation of the Real has improved price competitiveness and helped the recent export performance. In addition, weak domestic demand forced many companies to look abroad for new markets. Most analysts agree that without a strong productivity growth, Brazil has little chance to sustain this.<sup>91</sup> Foreign firms have contributed to this performance, but FDI in manufacturing remains oriented towards the domestic market.

To make a breakthrough, a new paradigm is needed to change the nature of FDI in Brazil from market-seeking to efficiency-seeking and thus export-oriented. This is needed not only to increase productivity and dynamize exports but also to change its composition. While world trade patterns have shifted towards more technology-intensive products, Brazil's exports remain concentrated on commodities and low technology-intensive products. Brazil has lost market share in high-technology products and, as a result, its overall share of world exports had stagnated until the recent improvement over the last two to three years. On the other hand, the share of high- and medium-technology products in Brazil's imports is very high.

This paradigm has to be based on an understanding of companies – “global integrators” – pursuing efficiency-seeking strategies, based increasingly on regional and global integrated production networks (Box III.2.). To achieve a change, one must first identify the needs of global integrators and introduce measures that will encourage them to become efficiency-seeking investors.

It is in the arena of the international networks of supply and the resulting efficiency-seeking FDI, that the competition among countries is fierce. This permits TNCs to be highly selective in where to locate their efficiency-seeking assets. Brazil may be seen as more competitive as a location than say, Argentina, but that is no longer the appropriate test, as competition is today increasingly global rather than regional in nature.

But Brazil's problem is specific. While many countries are struggling to attract global integrators, many of them have been in Brazil for a long time. In fact, over 400 of the Fortune 500 firms are present in Brazil. But typically, those in manufacturing (and of course in services) have entered Brazil in a market-seeking mode. Paradoxically, this insulates Brazil from massive divestment of the type which has taken place in Mexico. But at the same time, it limits benefits from FDI. TNCs in Brazil often retain separate operations designed for local supply only and not linked to the global supply network. Sometimes sheltered by tariffs, these operations are not efficient enough by global standards. The challenge and the opportunity for Brazil is to utilize the presence of so many leading international companies to foster an investment climate of competence building and continuous improvement in internationally calculated efficiencies.

Thus the development of efficiency should be regarded as the essential prerequisite for incorporating Brazil into an increasingly integrated network of global supply leading to increasing gains in export performance as well as investment.

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<sup>91</sup> M. M. Moreira (2004). “Brazil's Trade Liberalization and Growth: Has it Failed?”, Inter-American Development Bank, Occasional Paper 24, p. 14.

### **Box III.2. The “global integrators”- who are they and what they are looking for?**

Global integrators are companies that have developed a complex pattern of specialization among affiliates located in different countries, thus creating regional or global production networks in a dramatic strategic change as compared to earlier business models.

Until recently, the bulk of FDI in manufacturing was in the form of “transplanting” an entire producing organization into a host country. Thus, Du Pont, for example, used to reproduce its complete value chain from purchasing to after-sales service in individual host countries. Its affiliates operated as stand-alone affiliates with weak connections with the parent company and no connections with foreign affiliates in other host countries. This was also a predominant FDI model in Brazil under import-substitution strategies, which in many aspects has survived until today under market-seeking strategies.

Today, Du Pont, like so many others across almost every industry, is increasingly specializing its activities in different countries. There are several types of specialization. One type of specialization takes the form of allocating part of the product range to a particular country or subsidiary and then cross shipping finished goods to provide customers with a full line of offerings. GM, for example, has allocated the Chevrolet Trailblazer to its Dayton, Ohio plant and the Pontiac Aztec to its plant in Mexico. Trade resulting from this type of specialization is in finished parts. A second type is where the value chain is split into its components -- each allocated to a different location. The resulting trade is in both components and in finished goods. Further, activities such as R&D and other tradable corporate services may be divided among countries. In the pharmaceutical industry, for example, GlaxoSmithKline has specialized its research by class of therapy and located different specializations in countries that are the leaders for a particular therapy class.

Although industries vary considerably in their progress towards dis-integrating their value chains, there are certain common requirements to be met by countries wishing to be part of integrated production networks:

- The networks are created to achieve economies of scale that are greater than national scale and to lower total system cost. They can be justified only where the foreign subsidiaries are capable of working at world-class levels and at exchange-rate adjusted costs that equal (or approximate) the best in class available.
- Increasing attention is paid to transferring to foreign affiliates operating procedures and processes to provide uniformity of practice, regardless of location and wage rates. The goal is to achieve international levels of productivity, especially in low-wage countries.
- The networks of complex cross-trade require detailed control over both intermediate and final goods as well as the flow of information.
- The networks must be capable of rapid adaptation to changing need. Moreover, managers, in seeking to control the dynamics of the links between the local operation and the global network, demand a high degree of freedom to adjust output and trade flows rapidly.
- If the location fails to meet both the cost and the adaptability requirements, the parent company is unlikely to take the risk of including it in the network.

The requirements of global integrators vis à vis host countries are higher than other investors, but their presence is more beneficial. Countries that have managed to attract foreign affiliates with a regional or global intra-company mandate for the production of a particular product or part thereof may benefit from increased technologically advanced exports meeting the test of international markets and, occasionally, also more R&D activities.

Source: UNCTAD

Even under present circumstances, there are some indications that Brazil has the potential to succeed in this endeavour. Some "global integrators" that are present in Brazil, such as for instance Daimler-Chrysler, have moved to link at least parts of their Brazilian operations to their global supply chain. Also, Brazil has attracted some investors that established regional export platforms in Brazil, in particular within the

MERCOSUR context (but this was - by no small measure - due to the deterioration of the investment conditions in the neighbouring countries as much as to improvements in Brazil's own business climate). Furthermore, IBM has recently announced that it will include Brazil in its list of Emerging Business Opportunity countries, alongside China, India and Russia. Moreover, IBM has also decided to limit the number of hard disk plants to four, globally. It closed its European facility and transferred it to Brazil. Similarly, Nokia has concentrated its manufacture of telephone handsets to three locations and decided to include Brazil as one of the three. Dell is another recent arrival in Brazil, whose output is for both domestic market and exports.

The results of UNCTAD's survey of foreign affiliates in Brazil,<sup>92</sup> distinguishing affiliates that have internationally integrated operations from other affiliates, show that the former are by far more bullish in their investment intentions for Brazil (Table III.1). In terms of investment, sales, employment and exports they have clearly more expansionary plans than non-integrated affiliates. In terms of R&D, the picture is less obvious. But still, this is a positive sign confirming that the "global integrators" are capable and willing to contribute more to the Brazilian economy than other investors. The reason for this is that they have, to an important degree, insulated themselves from current instabilities and concerns that affect operations of other investors.

**Table III.1. Plans of future activities of global integrators and other foreign affiliates in Brazil, 2004**

		Reduction	Standstill	Moderate increase	Significant increase
Investment	Integrators		xx		xxxxxx
	Others		xx	xxxx	xx
Sales	Integrators			xx	xxxxxx
	Others		xx	xxxx	xx
Employment	Integrators		xxxx	xx	xx
	Others		xxxx	xxx	x
Exports	Integrators		x	x	xxxxxx
	Others		x	xxxxx	xx
R&D	Integrators	xxxxxx			xx
	Others		xxxx	xx	

Source: UNCTAD Investors' Perceptions Survey, 2004.

But the challenge is to turn isolated cases (among 40 interviewed firms only 12 integrators were identified) into a pattern of behaviour, by providing conditions that meet the twin test of world-class flexible and transparent operations and low cost. Many of the Fortune 500 firms in Brazil have only very small "toehold" operations in the country. The survey suggests that turning those firms into "global integrators" that are ready to develop their Brazilian affiliates into an export platform for certain products or parts thereof would substantially boost the development contribution FDI can make. But the planned reduction of R&D expenditures is less promising and should be a subject to further investigation to find the reasons and ways to deal with this problem.

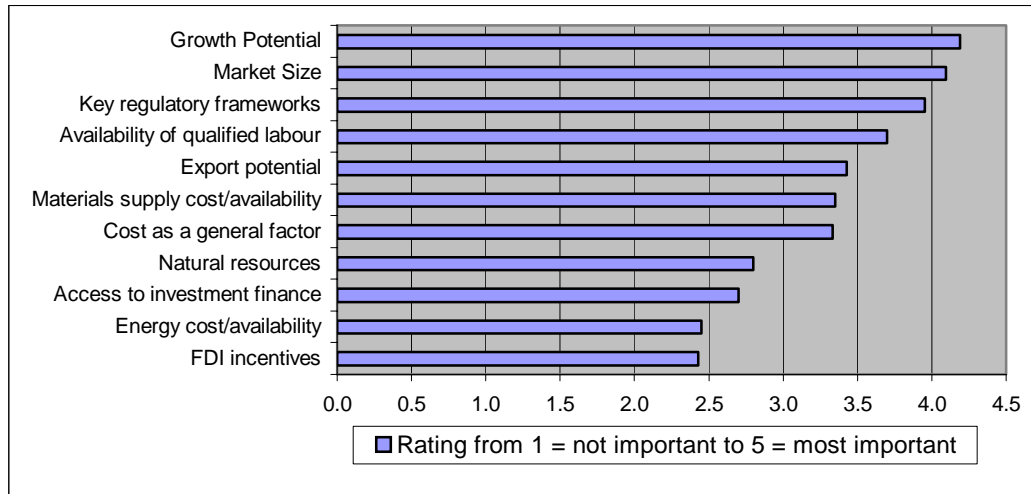
How to do it? The special needs of global integrators must be understood and addressed. Figure III.1, from the survey, shows the familiar results that for *all investors* the most attractive factors in Brazil as a site for either investment or re-investment are the size

<sup>92</sup> In support of the analysis for the report, UNCTAD carried out an Investors' Perceptions Survey among foreign investors, polling executive opinion on Brazil both at Headquarters and local affiliate levels. The poll was based on two small samples, "global integrators" and "others", for a total of 40 TNCs.



and growth potential of the domestic market. The data also show that incentives are regarded as the least important. Indeed, as one investor said “the incentives were important for our initial entry, but have little bearing on our investment decision now”. But there is also considerable divergence in individual responses depending on their experience and strategic needs.

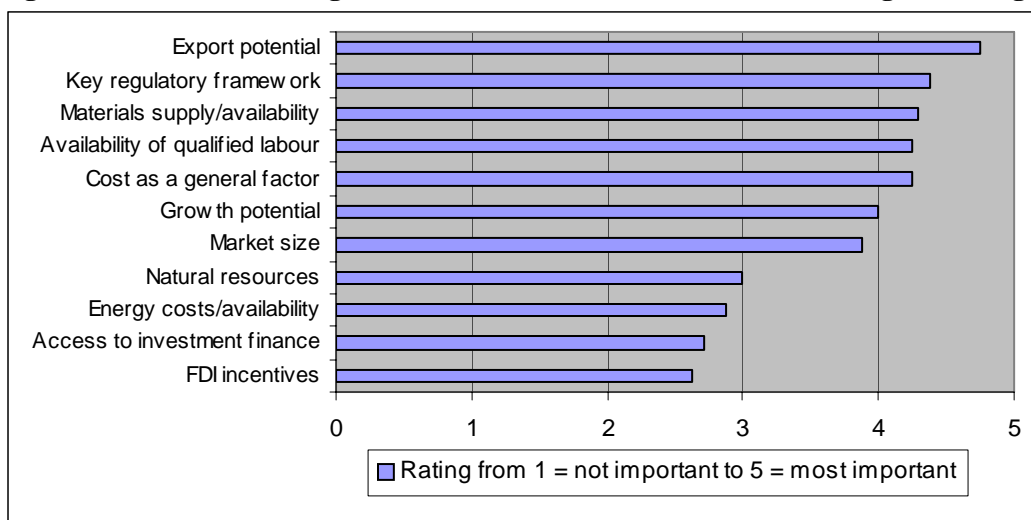
**Fig. III.1. Factors affecting the decision to invest in Brazil: all investors**



Source: UNCTAD Investors' Perceptions Survey, 2004

This familiar pattern of expectations changes dramatically when the “*global integrators*” are examined separately (Figure III.2). Collectively, they pay the greatest attention to export potential, followed by the key regulatory frameworks and cost/quality issues in the supply of inputs and resources. The issues of Brazil’s market size and growth potential is of much lesser concern. This ordering of priority is entirely consistent with a business perspective that emphasises the need to integrate with the global market. Many investors reported their interest in expanding in Brazil because of their ability to harness the skills and co-operation of the work force. Scale for them was being measured on an international basis and the attractiveness of Brazil was its ability to be or become an equal member of the globally competitive system.

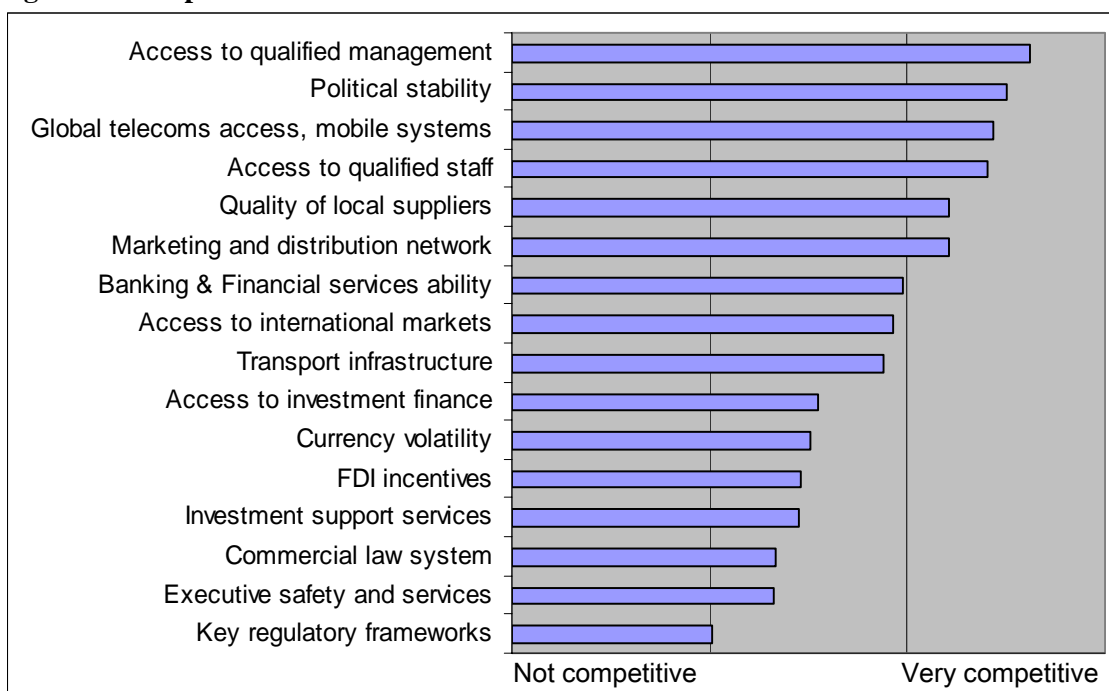
**Fig. III.2. Factors affecting the decision to invest in Brazil: the case of global integrators**



Source: UNCTAD Investors' Perceptions Survey, 2004

Global integrators were also asked to compare Brazil’s attractiveness relative to that of other countries in Latin America and Asia, most particularly China, on some 17 factors determining competitiveness. Here the results showed with striking clarity the nature of the challenge. In many categories, Brazil's main worldwide competitors are regarded as more favourable to investment than Brazil. In general, the key regulatory frameworks were perceived as the category where the differences are very great (see Figure III.3).

**Fig. III.3. Competitiveness of Brazil relative to other countries in Latin America and Asia**



Source: UNCTAD Investors' Perceptions Survey, 2004

Among other global integrators' perceptions, one investor representing the prevailing views stated:

“Brazil is not a good location to compete worldwide. It is a good location to compete in Latin America. The freight charges to import components are very high, so ... it will be very expensive ... to export to Europe and the US. It will not be competitive in comparison to buying from Malaysia or China”

Another stated:

“Brazil is not competitive in Asia because the volume produced in Asia is higher. Furthermore, there are more incentives in Asia”

Global investors are acutely conscious of the inter-country cost comparisons. As one executive stated:

“We measure ourselves against competitors and all other units in (our company) on a monthly basis. We pass on this data to everyone in the company. They and we know we must develop constantly to earn our place in the sun. Where we have failed to do this, we have outsourced to (company X) which has developed a global competence in this activity”

As shown earlier, some projects in Brazil, but not too many, have been designed to be global source points, competing on equal terms with other locations. But on other projects, including research projects, Brazil is losing out. Two years ago, Siemens, which has a strong presence in Brazil, announced that it intended to increase the number of its research technicians in India from 3,000 to 10,000, with no mention of Brazil. Everyone is aware of the lower costs of Asian software engineers. Siemens has calculated that the cost of its software engineers in 2002 ranged from €6.5/hour in Germany to €5.5/hour in Brazil to €6.8/hour in India – and China is even lower.<sup>93</sup>

The results of the survey, supplemented by a selection of more in-depth interviews, signpost critical issues that require closer attention in developing an FDI strategy:

- Improving national competitiveness (as discussed above) becomes a more acute need to attract efficiency-seeking, export-oriented FDI. Low export propensity is part of the overall problem of competitiveness. Although foreign manufacturing firms export more than nationally owned ones, it would be unrealistic to expect that they will forge way ahead of the entire economy under present circumstances. The attraction profile of a large and growing market cannot be relied upon to create the dynamic export-oriented FDI that Brazil requires.
- The issue of market access has to be examined with a view to ensuring that it would stimulate the type of export-oriented FDI that *must* meet international standards of competitiveness. Only by meeting the sternest tests will such FDI bring maximum sustainable benefits. This is discussed in section C. below.
- The institutions involved in FDI promotion must strengthen two functions, namely: targeting (to identify those among more than 11,000 of foreign affiliates in Brazil, which hold the greatest promise in terms of international integration of their activities) and policy advocacy (to pay particular attention to policy measures critical to investors-exporters). The institutional implications are discussed as sections D. and E. below.

### **C. Facilitate access to large and demanding international markets**

As shown in chapter I, Brazil, enjoying the advantage of possessing a relatively large domestic market, with considerable growth potential, as its GDP increases and real wages go up, has attracted mainly market-oriented FDI not only in non-tradable services but also in tradable manufacturing goods. Although the share of foreign investors in Brazil's manufacturing exports is high and growing, their export propensity lags behind that in other Latin American countries, including those with comparable market size. Given this, one of the declared objectives of Brazil's policy has become to change the orientation of manufacturing FDI from market-seeking to export-oriented and, in the process, to encourage foreign firms to contribute to upgrading the composition of exports towards high-technology and high value-added products.

In this context, access to international markets becomes one of the critical issues. First, the size of the Brazilian market is admittedly not sufficient for the production of some sophisticated and/or high-technology products. Second, access to international markets

<sup>93</sup> The data include incidental costs. Source: Siemens Press release *Wirtschaft und Politik*, Mar 2002.

is one of the determinants of the type and sophistication of products produced by foreign investors, including also traditional products.<sup>94</sup> Third, as indicated earlier, TNCs increasingly organize international production in an integrated chain of production and distribution of components and products manufactured by TNCs affiliates established in different countries. Regional integration groupings such as the European Union and NAFTA has been instrumental in boosting regional production networks by TNCs, often stimulating exports from less to more developed members of these groupings. International production networks are also organized on a global basis, although still less frequently so than within integrating regions. And, of course, progressing liberalization of world trade has stimulated traditional exports by both foreign and domestic firms.

Brazil has not been a stranger to regional production networks by TNCs. The first Montevideo Treaty establishing ALALC (Latin America Free Trade Association) in the early 1960s, facilitating member countries to negotiate and sign so-called "sectoral integration agreements" prompted TNCs such as IBM, Olivetti, Burroughs and others to integrate their production chains, mainly in Argentina, Brazil and Mexico. In later years, with the second Montevideo Treaty (1980) and the establishment of ALADI (Latin America Development Integration Association) and more ambitious schemes like MERCOSUR, this trend was reinforced, leading to impressive results in, for example, integrating internationally the automobile industry.

MERCOSUR in particular has played an important role in speeding up trade liberalization, increasing market access for Brazilian exporters and expanding intra-regional trade. It occupies one of the top priorities on Brazil's trade agenda. But it has not been free of problems as a consequence of asynchronous economic crises in Brazil (1998/1999) and Argentina (2001/2002), with sharp variations in the level of trade and the accumulation of trade imbalances, undermining the stability of market access. The positive impact of MERCOSUR -- aspiring to become a full customs union in the near future -- has been so far felt much more in the area of trade rather than cross-border investment among the partners. FDI which took place – in oil, banking, breweries and some food industries – has been mostly of a traditional, domestic market-seeking nature. It can be safely suggested that MERCOSUR potential to foster cross-border investment by firms from the participating countries remains under-utilized and it is one of the challenges that deserves close scrutiny in the follow-up to this preliminary discussion. By contrast, TNCs from outside the region, such as the automobile assemblers have been faster in taking advantage of the enlarged market than local companies with a rather national horizon, replicating the historical experience of ALALC.

Apart from this experience with regional and sub-regional integration, partly historic, partly recent, the diversified geographical character of Brazilian foreign trade is a relevant consideration concerning its market access. In distinction from many countries in the region, for which the United States is the main or even dominant trade partner, Brazil's trade is relatively well balanced among important destinations. For example, Mexico's trade has been dominated by the United States (about 80%) even before NAFTA. Many Caribbean, Central American or northern South American countries

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<sup>94</sup> To illustrate this with one example, Mexico's auto industry catering to the demanding North American market produces cars with an average wholesale value above \$16,000, while Brazil's industry, catering to the domestic market and the markets of MERCOSUR and other Latin American countries sells for some \$6,000 (ECLAC, 2004, p. 121).

also post high levels of trade concentration – close to 50% – with the United States. By contrast, the EU taken as whole is the largest trade partner of Brazil, accounting, after its enlargement, for some 26-27 % of Brazilian exports. In recent years, the share of the United States has oscillated between 18 % and a quarter of Brazil's exports. Asia as a whole, including China and Japan, represents about 15% of Brazil's exports and Latin America is not very far from that level. Imports pattern is not much different. In addition, recently Brazilian trade with new markets (Eastern Europe, Russia, Africa, the Middle East) has been growing fast.

Therefore, it is not surprising that Brazil has tried to optimise the multilateral approach to trade negotiations and to follow a "tous azimuts" aggressive market access policy to open markets everywhere. This is indeed an apt description of Brazil's current foreign trade strategy: a pro-active and leading role in multilateral liberalization of farm trade in WTO talks and bilateral trade agreements with countries such as Mexico, South Africa and, together with MERCOSUR, with India, the Andean countries and others. A significant step in market expansion was the launching of the third round of negotiations among developing countries member of GSTP, during UNCTAD XI, in Sao Paulo, in June 2004.

Brazil is also engaged in trade negotiations involving developed countries, including in the region, aimed, among others, at improving market access for Brazil to these countries. In the context of these negotiations, some studies and simulations have been undertaken to analyse the economic impact of the potential negotiation outcomes. These simulations are usually based on static comparative advantages. Given the right conditions and assuming that regional free trade agreements negotiations would be able to effectively deal with non-tariff barriers – the main obstacles to traditional Brazilian exports to these markets – especially as regards agricultural and sensitive products such as footwear, leather, textiles and steel (where anti-dumping measures are the main obstacle), Brazil could gain, including through attracting export-oriented FDI into areas with traditional comparative advantages.

Given the right conditions, FDI can also contribute to changing Brazil's configuration of comparative advantages, moving it upwards on the ladder of dynamic comparative advantages through linking it to international production chains. These conditions include long-term access to large and demanding international markets, regional and/or global, competitive exchange rate, healthy macroeconomic conditions, a strong profit-reinvestment link, high emphasis on human resources development, special attention to science and technology, to name a few.

In many developing countries that gained world export market shares during 1985-2000, led by China, Malaysia, Taiwan Province of China, Singapore, Thailand and Mexico as well as in countries of Central and Eastern Europe (especially those which joined the European Union), TNCs were instrumental in boosting export competitiveness.<sup>95</sup> There is no reason why Brazil, with a strong presence of global/regional integrators in high-value added industries (such as the auto industry, consumer electronics, telecommunication equipment, informatics and pharmaceuticals), could not join the club of successful countries, provided it pursues with determination the current trade strategy both in multilateral fora and in bilateral or regional

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<sup>95</sup> *World Investment Report 2002: Transnational Corporations and Export Competitiveness*, United Nations 2002, New York and Geneva, p. 144.

agreements, as a complement to the constant improvement of the most decisive factors underlying export competitiveness.

#### **D. Promote more FDI in less developed regions**

Alleviating regional imbalances and accelerating the economic development of poorer regions is a policy priority for Brazil. Consequently, it merits specific attention in the country's FDI strategy.

Chapter I notes that less than 15% of FDI is located outside the southeast region. The north, north-eastern and central west regions in particular attract a small share of total FDI and strikingly less than their share of overall economic activity. Thus FDI is not contributing to a reduction in economic inequalities among regions.

For a variety of commercial reasons, foreign investment - both market and efficiency seeking - tends to cluster in the most developed areas of a country. Only resource-seeking foreign investors will be intrinsically attracted to less developed areas. Nevertheless, an FDI strategy that is responsive to national development needs must consider what can be done within a sound pro-competitive environment to facilitate greater FDI in poorer regions. Even though one has to acknowledge the limitations of policy to influence tendencies of FDI towards clustering, several aspects need to be taken up. In this respect, under defined conditions, the WTO Agreement on Subsidies and Countervailing Measures identifies assistance to disadvantaged regions pursuant to a general framework of regional development as non-actionable subsidies.<sup>96</sup>

The fiscal concessions for the north and northeast regions are quite powerful and provide competitive conditions for export manufacturing, compared with the incentive regimes of key competitors for export manufacturing FDI. These measures could be supplemented with initiatives already well-advanced:

- Activation of export processing zones with high quality regulatory administration in line with their intended goal of supporting less developed regions.
- Utilisation of the PPP framework with federal government support to encourage private sector zone development. Inadequate infrastructure is a prime constraint to private investment in poor and remote areas and warrants the public subsidy that can be provided through PPPs.
- Focus in SME and linkage promotion programmes on less developed regions. Competitive suppliers are an important factor in attracting export-oriented TNCs to a certain location. By increasing the number of "linkage-ready" firms in these regions, the chances of attracting TNCs increase. One example for this approach is the UNCTAD-supported project on: "Promotion of inter-firm cooperation for the North-East of Brazil", which aims at establishing and deepening demand oriented-business linkages between TNCs and local SMEs, in particular in the North-Eastern regions of Brazil. Companies that already pledged their cooperation for project include Accor, Bosch, DaimlerChrysler, Nestlé and Unilever.

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<sup>96</sup> See: WTO Agreement on Subsidies and Countervailing measures, Part IV, art. 8 and Part I, art. 1.

- Specific technical assistance in FDI promotion from the federal level to less developed regions in their marketing efforts (Box III.3.).

### **Box III.3. Promoting regional Australia**

In Australia as in Brazil, balanced regional development is of high priority. Consequently, InvestAustralia, the country's federal investment promotion agency (IPA) has put particular emphasis on promoting FDI into the more rural or poorer regions and communities of the country. In all its marketing activities, InvestAustralia ensures that the advantages of locations in these regions are prominently reflected. It also helps regional communities in their own marketing efforts. One very practical example for this is the development of the "Inside Intelligence: Building an Investors' Guide" toolkit. It essentially provides regions with "a practical, low-cost process" to enable them to collect and appropriately present valuable information about their investment environment. In the process, the regional and community authorities are encouraged to ask relevant federal authorities for assistance. As of August 2002, 35 regions within Australia were using the toolkit.

*Source:* UNCTAD, based on InvestAustralia, 2002.

There is scope for considering other federal/state programmes that support FDI in these regions within a pro-competitive agenda.

Better institutional arrangements for FDI promotion should also form part of an FDI strategy. There needs to be developed a partnership between federal and state levels to promote Brazil to foreign investors and ensure that all regions are adequately presented as investment locations. Less developed regions need more support to be strong partners and better competitors for FDI. On the other hand, the "fiscal wars" between the states provide examples of excessive and probably wasteful competition between states that should be pre-empted in future by closer coordination. These matters form part of the discussion below of FDI promotion.

Notwithstanding the special arrangements in Manaus, there does not appear to be a federal government concept on how it can best support poorer regions to attract and benefit from FDI. A strategic review should be commissioned that draws on worldwide experience, especially in countries with federal systems or substantial regional autonomy.

## **E. Organise institutions to enhance FDI performance**

### **What needs to be done?**

#### **a. Development of a focussed and coordinated campaign**

Even the most competitive countries accept that a measure of Government-sponsored promotion is needed to optimise the quantity and quality of FDI that is attracted. Lack of competitiveness may inhibit investment but it does not follow that competitiveness alone will attract FDI.

There is a case for Brazil to enhance its efforts to encourage FDI of a kind and amount that suits its goals. A properly resourced and fully integrated marketing campaign has yet to be developed. Four special factors should be reflected in the upgrading of Brazil's FDI marketing capability:

- The priority to be attached to the export re-orientation of FDI to Brazil, most notably in manufacturing.
- The lesser need, compared with most countries, to carry out *generic* image building abroad of the country. Brazil is well known and already hosts many of the world's largest TNCs. Relatively more attention is needed to improving headquarters perceptions of investors already present in Brazil.
- In stepping up the present low levels of pro-active investor targeting relatively more emphasis, at least in manufacturing, should be devoted to internal lead generation versus external generation. Internal lead generation promotes investment upgrading by established companies, especially where it maximises exports and contributes to Brazil's technological development.
- Following from the above, well-resourced and coordinated state investment agencies as these will typically provide the aftercare services that can serve as a platform for more pro-active lead generation.

The promotion campaign should consist of a number of key elements:

*i) Targeting*

Successful promotion of FDI is an expensive undertaking. Thus priorities must be established as between sectors, industries and marketing methods. Apart from helping to use scarce resources more efficiently, targeting is required to attract FDI that is more beneficial to the host country's development.

Up to now, Brazil does not have a comprehensive targeting approach at the federal level. For example, the Industrial, Technology and Trade policy identifies four strategic industries and suggests that FDI will be actively sought in these areas. All four industries – capital goods (machinery and equipment), information technology (semiconductors, etc), pharmaceuticals and software – are knowledge-intensive and fulfil all or at least some of the following criteria:

- Dynamic development;
- Significant shares of international investment in R&D;
- Potential for opening new business opportunities;
- Direct link to innovation of processes, products and uses;
- Contribution to the strengthening of production chains;
- Importance for the future of the country and potential for the development of dynamic competitive advantage.

The objectives spelled out in this overall development strategy need to be integrated into a research-based FDI targeting exercise. In the course of this exercise a number of factors in additions to those mentioned above have to be taken into account: it is not sufficient to target on the basis of an assessment of country benefits or the dynamism of a certain sector. Industry- and firm target selection must also take into account TNC strategies, the country's potential and conditions in alternative locations (Box III.4).



#### **Box III.4. The targeting approach of Thailand**

While Thailand's economic profile differs significantly from Brazil's there are nonetheless parallels between the two countries when it comes to investment promotion. Thailand as an advanced developing country is facing competition for FDI from low cost locations and had to revamp its FDI promotion policy in order to compete. A cornerstone of this reform spearheaded by the Board of Investment (BOI) as the country's IPA was the adoption of a targeting approach so as to promote FDI more efficiently.

The five target industries (which are the agro, automotive, fashion, electronics and high-value-added service industries) had been identified based on their long-term growth potential, their need to be strengthened to be able to compete effectively in the global marketplace, or their need to be expanded and extended to take advantage of their competitiveness.

For each target industry, policies, measures and marketing specific to each industry was developed, taking into consideration their needs, based on factors such as competitiveness, market potential and levels of technology. In addition, the BOI adopted a geographical focus for its targeting. Three selected regions were earmarked for higher priority in investment missions from Thailand. Also the number of overseas offices was stepped up in these regions.

The targeting efforts were complemented by measures to improve the overall competitiveness of the Thai economy, especially with regard to SMEs.

*Source: UNCTAD, based on UNCTAD World Investment Report 2002.*

Targeting should also involve consultations with relevant stakeholders, in particular with the private sector (see Box III.5.).

#### **Box III.5. Formation of ad-hoc expert teams to identify new target industries: the example of Sweden**

In Sweden it is the task of the national investment promotion agency – InvestinSweden Agency (ISA) to identify new niche industries for attracting FDI. The process starts out by ISA analysing the potential for an FDI cluster in a given industry where IAS's research point to a specific Swedish strength. In a recent case, for instance, this was the system design function of leading semiconductor makers.

In a subsequent step, IAS invites partners in academia, the private sector, and relevant public agencies to participate in its efforts to build up an industry cluster. The partners then finance jointly feasibility studies to further review the potential of the Swedish offer. At this stage – before actual promotion work starts – ISA also secures long-term commitment of the government. In the case of the systems design for the semiconductors, ISA developed a partnership with three universities that would start offering specialised training courses in chip design. The targeting of firms, mainly in Asia in this case, was based on extensive market research. The targeting approached these firms on the basis that Sweden, with its highly developed telecommunications networks and especially wireless technology, was best suited to host the companies' chip design activities where they were not as competitive as their European or American rivals. The marketing campaign also included regular visits to the targeted companies in Asia, Europe and North America.

*Source: UNCTAD, World Investment Report 2002.*

Targeting should result in the setting of specific outcomes. This facilitates a regular monitoring process so as to assess the success or failure and modify targets and methods as required.

In this critical juncture of manufacturing in Brazil, special attention must be given to internal lead generation. It is common to view the process of lead generation as the

solicitation of *new* foreign investors. For reasons explained above, for Brazil, a key aspect of targeting is to identify global integrators *already present in Brazil but whose operations are not linked to their global production network* to develop pro-active campaigns to induce their headquarters to select Brazil as a global platform. In this process, there are definable roles of federal and state agencies (as explained later).

### *ii) Delivery*

Pro-active promotion does not end with targeting but rather starts from there. Subsequent promotion and marketing efforts would use the targeting strategy as a basis to actively communicate with investors. Typical promotion instruments include a careful blend of promotional literature, advertising, events and proactive-in-market generation of investment leads.

In Australia, for example, InvestAustralia uses a two-pronged approach to target companies and generate investment leads. The first step is the onshore identification of the characteristics of potential foreign investors that match the country's priority industries. This also includes the liaison with already established subsidiaries of TNCs so as to motivate further investments. The onshore approach is paired with an offshore approach through which the agency's staff abroad identify overseas companies that match the targeting profile. This information is reported back to Australia where it would be disseminated to the regional promotion agencies. The regional agencies then have about a week to follow-up on the lead if interested.

### *iii) Image-building*

Brazil does not need to expend heavily on generic image building so as to place itself on the global investment map. It is obviously well known to the corporate world.

A central part of image shaping will be assisting local affiliates to win more export-oriented investment from their headquarters. UNCTAD's investor survey shows that the image of Brazil as an investment location is considerably worse among headquarters management as opposed to the management of the Brazilian subsidiaries. Executives who do not know Brazil well are more fearful of the risks and less cognisant of the strengths.

One CEO commented:

"I know that (the local manager) has a more optimistic view than mine, but he has to convince me he is right".

This has implications also for communication methods. Internal investment lead generation will require targeted communication to specific executives and companies. Overall, image building will rely rather less on broad-based branding and image-building campaigns via, for instance, TV commercials. In other areas such as tourism or export-promotion – for which the Industrial, Technology and Trade Policy foresees the development of a "branding" initiative – such campaigns might be more appropriate.

## **b. Better organising the federal-state relationship in FDI matters**

Brazil has not benefited optimally from intense competition among the regions for specific investment projects. Competition among regions is *per se* not a bad thing but unless regional investment promotion activities are coordinated, this competition can be damaging. There is little doubt, for instance, that the amount of the subsidies promised to investors during the fiscal wars "[...] was in excess of the additional efficiency gains from relocation plants within Brazil [...]" or were considered to "[...] exceed the benefits even from a narrowly local perspective [...]".<sup>97</sup> Therefore, Brazil needs to develop a system in which:

- All states are equipped to present, and have the fair access to, opportunities to bid for foreign investment seeking to locate in Brazil.
- The states' attractions to investors are properly presented and add to the overall profile of the nation as an attractive location for FDI. Special support should be given to poorer states that have less well-equipped agencies and, in many respects, a more difficult task in attracting investors.
- Brazil speaks with a single voice at the point of investor attraction when Brazil as a *country* is being compared with other countries by investors.

Brazil must develop protocols of cooperation among federal and state investment promotion agencies to limit *damaging* competition and serve the national interest. Experience from countries where this approach has been tried, such as within the United States, Canada and the United Kingdom demonstrates that with hard work and good will these agreements can be made to have some positive impact. Of course, they will never entirely remove the temptations to engage in damaging competition but do help to contain it.

## **c. Strengthening linkages between TNCs and local companies**

More and deeper linkages of TNCs to local suppliers, most notably regarding export-oriented TNCs, is fundamental to increasing the development impact of FDI. Also, there is ample evidence that the more TNCs are intertwined with local companies through supplier or other linkages the more likely they are to maintain their operations in the country.

Particularly for Brazil this is of key importance. With its large number of resident TNC affiliates Brazil possess a much bigger potential than other countries to create additional linkages. At the same time, many of the long-established TNCs have already built up links to suppliers and other local firms. These existing linkages represent a huge potential for further deepening and expanding, in particular in terms of the technology-intensity.

Few other countries have this potential readily at hand. Thus, the systematic exploration of linkages must play a central role in Brazil's efforts to extract more development impacts from FDI.

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<sup>97</sup> Christansen, H., C. Oman, A. Charlton, *Incentives-based competition for Foreign Direct Investment: The Case of Brazil*, OECD WP Number 2003/1, March 2003.

### **Box III.6. Transnationalisation of local suppliers - the example of Ireland**

The example of the Irish electronics industry is particularly interesting as it illustrates a successful approach for not just closer integration of TNCs' affiliates and local suppliers but also of the suppliers becoming TNCs themselves in the process. This situation resembles the one in at least some of Brazil's industries. Enterprise Ireland, the Government's SME development agency, created an "International Business Linkages Division" partly as a response to the demands of many electronics TNCs present in Ireland. They required their Irish suppliers to be able to supply not just the local affiliate but the TNCs worldwide network. Thus, many Irish companies faced the loss of their TNC clients if they were not able to internationalise their own businesses. Together with the National Export Board the Linkages Division designed a strategy to help local suppliers transnationalise their business operations. This included:

- Assisting local suppliers engaged in electronics sub-supply to find international markets, often piggy-backing on the parents of affiliates who source locally;
- Assisting internationally successful Irish suppliers in finding cheaper sources of inputs in Central and Eastern Europe, in areas in which the Irish cost base is threatened; and
- Assisting successful local companies in transforming themselves from being sub-suppliers to being sub-assemblers.

While the electronics industry might not necessarily be a relevant example for Brazil the initiative as such can be easily adapted to other sectors.

*Source: UNCTAD, based on UNCTAD World Investment Report 2002.*

Since many spill-over effects to the local economy in the form of technology transfer, increasing of skill levels and access to foreign markets can only materialise through linkages, an export-oriented FDI strategy has to include a linkages programme, which in turn should be run in collaboration between the federal and the state agencies. Scotland, Singapore but also Ireland (Box III.6) are examples of how an export-oriented FDI strategy can be combined with an effective linkages-creation approach.

There are already initiatives in place to promote linkage creation, such as the "Buy in Minas" programme. The programme was developed jointly by the Industrial Development Institute of Minas Gerais (INDI) and Italian carmaker FIAT, in 1989. Future INDI plans foresee a similar programme with Daimler Chrysler. It is also planned to use the same approach in the agro- and machinery and equipment industries.

However, successful as individual programmes such as these might be, they often appear to remain rather isolated initiatives. What is still missing is a systematic approach to the creation of linkages to exploit Brazil's full potential.<sup>98</sup> This should also include a regular exchange of experiences between state agencies. Policies to increase linkages have to be an integral part of any policy geared towards increasing the competitiveness of local SMEs, on the federal as well as on the state level.

It should be noted that many of the linkage programmes, including the one cited above, involved TNCs mainly serving the local market. Linkage programmes aimed at export-oriented TNCs have to live up to even higher standards, as TNCs competing on the world market will accept only those firms as suppliers that can match the quality and the prices of the best competitors in the industry worldwide. This in turn implies a more sophisticated approach going beyond mere matchmaking, sometimes even including the development of specialized training centers or other institutions (Box III.7).

### **Box III.7. The Penang Skills Development Centre in Malaysia**

A classic and often –cited example for a successful linkages programme in an export-oriented industry is the Penang Skills Development Centre (PSDC) in Malaysia. The one-stop human resource development center was founded in 1989 as a result of a strategic alliance between the State Government, industry (TNCs and local firms) and academia. At the time, the government wanted to upgrade the local electronics industry which consisted mainly of the final- assembly of imported electronic components which were exported by the foreign affiliates present to the world-market. The development of the industry towards higher value-added activities was, however, hampered by a shortage of sufficiently skilled manpower in the local industry. Therefore, the PSDC was conceived to provide specialised training course and degrees , in particular to stall of local companies.

A key ingredient in this effort was, and still is, the PSDC-inspired linkages-building global supplier programme. The objective of the programme is to develop and upgrade capacities of local companies through training and linkages with TNCs. The programme is a joint effort whereas the Government provides certain financial incentives, industry shares resources and expertise and the SMEs make a commitment to undertake transformation. The programme has two parts: basic training and linkages. Manufacturing and material suppliers are trained in critical skills and to acquire competencies to adopt and use new technologies. The focus is on quality and productivity.

In the second part of the programme TNCs adopt local companies and "hand-hold" them for upgrading in leadership skills and technology. This initiative calls for investment of time and commitment of both the large corporations and SMEs. The success of this mentoring or coaching becomes apparent when suppliers have attained the level of competency to become global players themselves. An important part of the linkage programme is the periodic assessment and review of the SME by the TNC and benchmarking to remain on track.

For many SMEs the sharing of knowledge with TNCs about market trends was crucial for helping them keep in step with their partners. Also TNCs had helped SMEs develop other business opportunities outside of the linkage programme. The State Government in particular encouraged TNCs to engage in business match-making and to broker strategic alliances. SMEs said that it was important for TNCs to allow the SMEs to support TNC operations elsewhere outside the host country in order to go global.

With 60,000 trained workers from TNCs and SMEs since 1989, it appears that this blueprint for growing competitive SMEs has done well over the past then years. Governments have provided the basic educational and logistic infrastructure. Government, TNCs, SMEs and academia have entered an alliance to bridge the gap between formal education and the skills needed by the market place by creating the PSDC. The Centre has developed specific programmes for getting SMEs partnership ready and TNCs have nurtured and mentored SMEs in this programme. Finally, the host country has harvested additional benefits when the SMEs have gone global.

*Source:* UNCTAD.

It is suggested that linkages programmes become a vehicle for integrating many of measures geared towards increasing the development impact of FDI, which include:

- Information and match-making
- Programmes aimed at upgrading domestic supplier's technological capability
- Promotion of the establishment of supplier associations
- Training
- Enhancement of suppliers' access to finance

As linkages between domestic and foreign affiliates occur more frequently when both are located in the same spatial and industrial area, the numerous efforts in Brazil to build up industrial clusters would have also to be coordinated with the linkages programmes.

## Recommendations:

- Ensure that "linkages" is part of SME support policies on the federal as well as on the state level.
- Ensure that all measures on the federal or regional level promoting specific development impacts are integrated into or coordinated with linkage programmes
- Create an inventory of existing linkages programmes on the federal and state level and ensure better coordination between them

## Who does it?

### 1. The need for a federal promotion agency

There is no universal practice on this matter among countries with federal or strong regional systems. Some countries, where there exist strong investment promotion agencies at the state level, such as the United States and Germany (until very recently) decided not to have federal investment promotion agencies. Others including Australia, Sweden and the United Kingdom have found it useful to establish them.

Brazil needs a federal investment promotion agency. Many of the tasks highlighted in the preceding section as crucial for a successful FDI strategy can only be carried out or coordinated by a central agency. This agency should, however, work in close collaboration with its counterparts on the state level. A clear-cut division of tasks between the different actors is needed and can be developed so as to avoid duplication of efforts and maximise efficiency in investment promotion.

The tasks of the federal promotion agency should include:<sup>99</sup>

- **Investment generation:** in Brazil *internal* lead generation, i.e. efforts to convince already established investors to extend their operations in Brazil, in particular in the form of global integration of their operations, is key. Most definitely the federal agency should take the lead in *external* lead generation, i.e. in the communication with investors not yet present in Brazil. In this capacity, it leads the efforts to target specific sectors and companies with a view to creating investment leads. The federal agency can also assist states in internal lead generation, including in cases where TNCs have affiliates in more than one state.
- **Investor facilitation:** The federal agency should play a supporting role to the state agencies, as many of the issues to be dealt with are local in nature. Its activities should be confined to helping solving problems on the federal level.
- **Policy advocacy:** Research suggests that policy advocacy is one of the most important functions of investment promotion agencies. Brazil appears to lack an "investors' champion" agency that would take a lead in putting certain issues that represent important impediments to FDI on the agenda (see Box III.8.).

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<sup>99</sup> This list of classic IPA functions is based on the Morisset, J. and Andrews-Johnson, K. *The Effectiveness of Promotion Agencies at Attracting Foreign Direct Investment* FIAS Occasional Paper 16, Worldbank: Washington, D.C., 2002

Trade policies should be also feature on the advocacy agenda, in particular with the new focus on export-oriented FDI.

As part of its responsibilities the agency should systematically benchmark Brazil's competitiveness with that of other countries, identify weaknesses and ensure that these issues, as well as potential solutions, are brought to the attention of policy makers in government and parliament. This agency should be the driver behind the aforementioned "competitiveness agenda".

- **Image building:** The key task here is coordination of federal and state activities in this area to ensure consistent messages and branding on a cost-effective basis. Activities commonly associated with image-building include focused advertising, public relations events, the generation of favourable news stories by cultivating journalists, and so on. The Federal agency should elaborate in cooperation with state agencies the basic messages about Brazil as an investment location. It should ensure that state campaigns are embedded within federal promotion efforts and should act as an information exchange so as to keep state agencies up-to-date regarding the image-building activities of their peers in the other states. It should also keep contact with government agencies that are involved in image-building in other areas (tourism, export promotion, etc).

### **Box III.8. Policy Advocacy - Establishing an "FDI champion"**

Brazil is in need of an FDI champion. This should not mean the creation of yet another institution. Rather an existing institution dealing with FDI issues should be entrusted with this role. Typically, a country's investment promotion agency assumes this responsibility but different models exist across developed and developing countries. There are, however, some features that all effective champions have in common:

1. A brief to promote FDI into the country.
2. Access to resources so as to allow regular competitiveness benchmarking analysis.
3. Close link with investors so as to receive swift feedback from investors on issues impeding FDI and on the effectiveness of reforms.
4. Direct access to key policy makers in the governments and parliaments – both at the federal and regional levels - so as to feed in the FDI angle in ongoing policy-making processes. The agency has to be consulted by other government institutions on all political and legal initiatives affecting FDI.
5. The agency should also make use of the media to promote the discussion of important FDI-related issues in the public domain. This would include regular reporting on the contributions of FDI to the Brazilian economy so as to foster the acceptance of FDI not only among policy makers but also among the public at large. In Sweden, for instance, the InvestinSweden Agency organises a major press conference every year, where the work of the agency and the latest FDI figures for the country are presented. This high-profile event receives a lot of attention in the Swedish media and serves to highlight pressing policy issues that need to be resolved in order to improve the country's FDI performance.

The champion agency should also work in close contact with regional promotion agencies so as to ensure that also region-specific issues receive the attention they deserve.

*Source:* UNCTAD

In addition to the core-tasks, the federal agency can also assume additional responsibilities. Most importantly, it can organise and coordinate training activities for state agency personnel. In addition, it should be a focal point for the state agencies for industry expertise and research-based tasks such as industry and investor targeting.

A national agency must be properly funded and have a clear mandate to carry out adequately these roles. It appears that InvesteBrasil, the country's federal investment promotion agency that operated until October 2004, was not well equipped by these standards. Neither did it get a clear mandate in a number of the above roles. In fact, it was possibly competing with other agencies (Box III.9.).

**Box III.9. Investe Brasil, an effective but short-lived investment promotion agency**

Investe Brasil, created in 2002, was Brazil's Federal Investment Promotion Agency until October 2004. As a non-profit organization with the mission to attract and retain FDI, Investe Brasil was funded jointly by the Federal Government and the private sector. Although it was a small agency, with a staff of around 20 people, Investe Brasil was very active in investment promotion and networking activities with all government entities connected with the FDI process and with the State Governments. The agency ceased all operations as "the financial and organizational model on which it was based – as a Public and Private Partnership – (appeared) to be no longer viable".

Despite its short life, Investe Brasil was responsible for several accomplishments, including:

- 27 missions to foreign countries, with the objective of attracting potential investors;
- Direct attraction of FDI projects for an estimated \$1.4 billion;
- Development of a bi-lingual web site including information on the Brazilian economy, opportunities for investment, newsletters, market analysis and information on investment procedures;
- Creation of an "Investor Support Network", constituted of 106 representatives of 22 Ministries and 37 related entities involved in the investment process, all assigned to support investors in the decision and implementation of their investment projects;
- Partnerships with 26 States of the Federation with the objective to obtain socio-economic information and concrete information on investment opportunities at the State level to include on the website.

A recent development in investment promotion in Brazil is the announcement, on December 2004, of the creation of a new division within the hospices of APEX, the federal export promotion agency, which will be in charge of investment promotion at the federal level, starting in 2005. The experience of Investe Brasil, as well as its operational problems shall be instructive for the Government in setting up the new investment promotion institution.

*Source:* interviews by UNCTAD

These are sensitive issues and it is important to underline that a federal agency should be a facilitator and a coordinator on behalf of the states, as well as a service provider to them. It is not an overlord.

In summary it is recommended that Brazil:

- Ensure that the federal promotion agency is properly mandated and funded to do its job.
- Ensure that the agency is strongly mandated and equipped to lead and coordinate investment generation activities especially where these involve marketing the country to new investors. The brief of the agency should also include policy advocacy and image building.
- Require the federal agency to coordinate and support the promotion efforts of the state agencies.
- Mandate the federal agency to be a focal point for training of state agency personnel.



## 2. The need for strong state agencies

Brazil's biggest source of investment potential, in particular for export-oriented FDI, is additional investments of the firms already established in the country. State agencies are the key to effective delivery of investment promotion as they are the natural counterparts of the TNCs located in their state. They provide the hands-on facilitation needed to make investors comfortable in selecting an investment location. Moreover, state agencies are responsible for aftercare for investors. In that capacity, they have a pro-active role to play in what could be called 'dynamic aftercare'.

'Dynamic aftercare' could include:

- regular meetings with investors in order to identify investment impediments and discuss potential solutions;
- Systematic dialogue with TNCs affiliates and, if required, the federal promotion agency;
- joint effort with the federal IPA to encourage match-making between TNCs and local suppliers; and
- joint initiatives with affiliates' company management to explore expansion potential of local affiliates in the framework of the overall strategy of the TNCs (Box III.10.).

### **Box III.10. Helping an affiliate to expand exports: the case of Black&Decker in the United Kingdom**

There are many examples of how a competent and pro-active local IPA and the management of a TNCs' local affiliate can successfully team up to influence strategic decision-making at headquarters. In 1998, for instance, US-based Black&Decker considered closing down its plant in North-east England. The Northern Development Company, i.e. the region's IPA, together with the local management of the company prepared a business plan detailing cost-cutting plans by a more efficient use of the supply chain which was submitted to Black&Decker's headquarter. In the plan, local authorities also committed themselves to the creation of a supplier village at the plant with a view to attract quality international firms. The company's management found the plan so convincing that the plant was, in fact, turned into a design an R&D centre to develop products specifically for the European market. The subsequent expansion of the Black&Decker's facilities in Spennymore, County Durham, involved additional investment of £17 million and the creation of 350 new jobs in addition to 775 which were safeguarded. The expansion has turned the affiliate into the largest in the Black&Decker network.

*Source:* UNCTAD, WIR 2002.

At the moment, however, it appears that many state agencies are not in a position to assume these tasks. In fact, only 14 out of 27 states have agencies promoting FDI at all (Table III.2.). Some of these are located in the more well off states that have already attracted substantial FDI. In addition, many of these agencies are not specialised in FDI promotion but are covering regional economic development in general. While it may make sense to group investment promotion activities together with other economic development functions in one agency, it is not clear whether they possess the specific expertise nor dedicate sufficient funds to investment promotion.

**Table III.2. State-level investment promotion agencies**

Name of Agency
State of Acre Development Agency (ANAC)
Economic Development Unit of the State of Alagoas
State of Amapa Development Agency (ADAP)
Promotion Agency of the state of Amazonas (AFEAM)
Promo, State of Bahia Trade and Investment Promotion Agency
Distrito Federal Development and Foreign Trade Agency , Brasilia
Official Development Agency of the State of Espírito Santo (ADERES)
Promotion Agency of the state of Goias (GOIASFOMENTO)
Economic Development Agency, State of Pernambuco (ADIPER)
Promotion Agency of the State of Rio Grande do Norte (AGN)
State of Minas Gerais Industrial Development Institute (INDI)
State Industrial Development Company, State of Rio de Janeiro
Promotion Agency of the State of Roraima (AFERR)
Promotion Agency of the State of Santa Catarina
Promotion Agency of the State of Parana (AFPR)

Source: UNCTAD, based on information provided by InvesteBrasil.

State agencies were not interviewed for this report and thus no assessment has been made as to how many are adequately equipped to fulfil these important functions. In a follow-up phase to the Investment Policy Review, UNCTAD and UNDP will collaborate directly with selected states so as to provide them with concrete advice on how to strengthen their capacities (Box III.11.).

#### **Box III.11. The IPR in Practice: Strengthening Investment Promotion at the State level**

Following the UNDP/UNCTAD National Workshop that introduced the main findings and recommendations of the IPR of Brazil to the national stakeholders (30 August 2004), and the opening of UNDP State offices in several Brazilian States, UNDP and UNCTAD decided to launch a "Joint Project to Strengthen Regional Investment Promotion". The project responds to the recommendations included in sections D. and E. of this report and its objective is to help build capacity at state level to attract and benefit from foreign direct investment, in collaboration with the Federal Government.

The Project is expected to be implemented in six states within two years. The State of Bahia was selected to operate as a pilot project. The Bahia project, beginning in early 2005, will have the following components:

- A. Embedding an FDI strategy within Bahia's state development strategy
- B. Creating a "stand-out" state investment climate
- C. Diagnosing the state FDI promotion effort
- D. Implementing the GTZ/UNCTAD Linkages Programme in the State of Bahia

It is expected that this work will lead to implementable recommendations. UNDP and UNCTAD will offer assistance in implementing selected recommendations as a second phase of the project.

Source: UNCTAD

As a response to the regional imbalances in terms of FDI, the federal government should assist each state to establish a strong investment promotion agency with special attention to the needs of less developed states. States that host already a larger number of TNCs should focus their efforts on dynamic aftercare services to those companies. Finally, states that do not yet host many foreign companies should work closely with the federal agency in their lead generation efforts, in particular abroad.

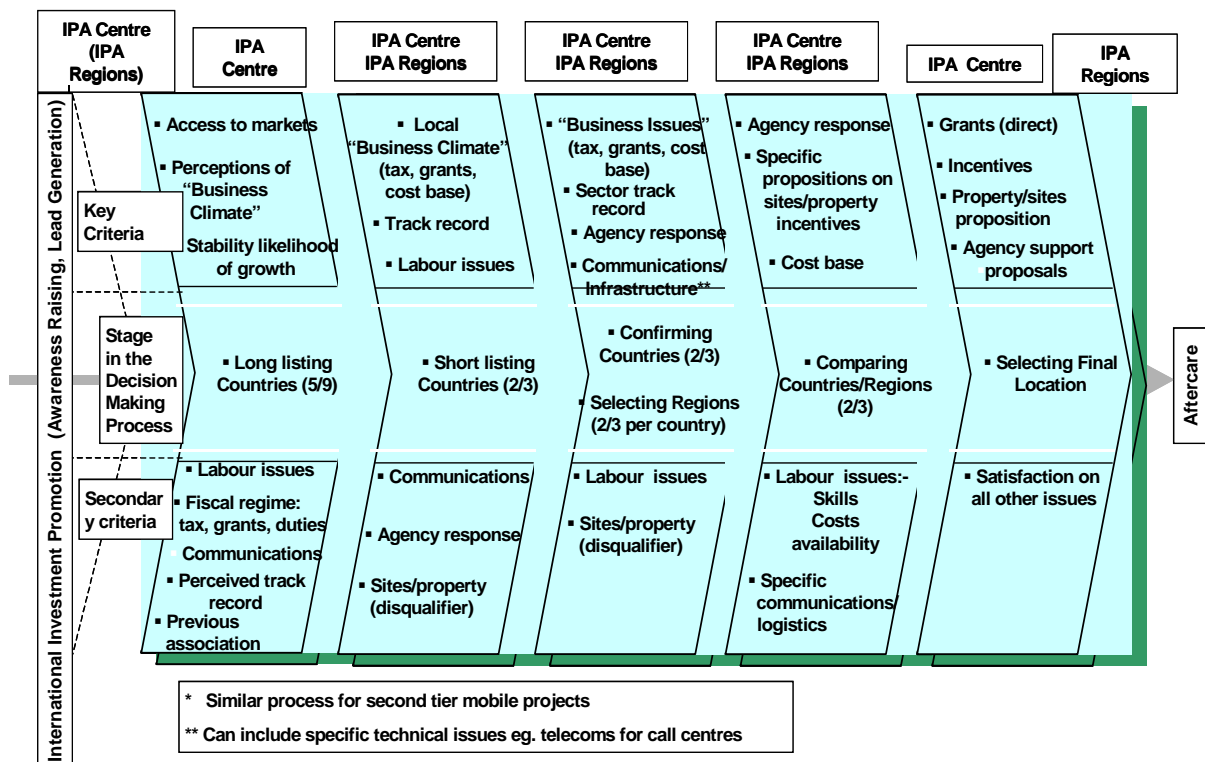
### 3. Coordinating delivery through federal-state partnership

Delivery of FDI, from initial contact through to investor decision, start up and re-investment in due course involves many government agencies. Two essential components should be built into the delivery system:

- A promotion partnership between the federal and state dedicated investment promotion agencies; and
- Streamlined service from the sectoral ministries and agencies that are involved in regulatory approvals and permits.

The *promotion partnership* requires the federal and state agencies to work out detailed protocols as to their contribution to achieving positive investor decisions. Whilst they are different agencies, they should provide a seamless service to the client – the prospective investor. Developing the partnership arrangements is complex. An example, derived from work on a UK partnership, illustrates how roles should be considered at each step of the investor solicitation process (Figure III.4).

Figure III.4. An example of promotion partnership in the United Kingdom



Source: UNCTAD

The *streamlined service* in the most advanced systems attempts to go beyond the "one-stop shop" approach in which one makes itself responsible for procuring required regulatory approvals. The best approach is one of "Team Brazil" in which each of the regulatory agencies sees itself as part of a team effort to deal expeditiously with investor approvals. In such an approach, each regulatory agency works to client charters that indicate to applicants the standards of service quality that they can expect and each

agency monitors and reports its performance against service standards on a regular basis.

Recommendation:

- Adopt a "Team Brazil" approach in facilitating investment by creating a seamless cooperation between federal and state level agencies and integrating the regulatory agencies into a team approach.

#### **4. Designing an effective policy steering mechanism**

In addition to entrusting a specific agency with such a "FDI champion" role, a consultation process is needed to institutionalize regular exchange between the "champion" and the various parts of the government. This process would make sure that the "FDI perspective" is considered when crucial policy decisions affecting FDI are taken.

In Australia, for example, InvestAustralia chairs the National Investment Framework Inter-Departmental Committee (NIFIDC). The NIFIDC meets approximately every six months with InvestAustralia, assuming a secretariat function as well as the role of an advisor to relevant Government agencies on potential FDI impediments.

Brazil has made a step in the right direction with the 'investment room' project. Its objective is to bring together decision makers from important related areas in Federal Government and make them ready and available to get in touch with anyone willing to invest in Brazil. It should also facilitate the formulation of 'Fast track policies to overcome bureaucracy'. The 'investment room' offices are located in the Presidency - underlining the importance the Government attaches to this issue - and the management is directly responsible to the Minister of Development, Industry and Foreign Trade.

For the 'investment room' initiative to be successful it is important that it is coordinated with reforms in all of the other areas mentioned above. In particular, it is important that the federal investment promotion agency as outlined above plays a central role in managing the 'investment room'.

Recommendation:

- Initiate a standing procedure within the federal government, which ensures that – on a regular basis – the federal promotion agency's advice is taken into account regarding all policy initiatives with a bearing on FDI.

## IV. MAIN CONCLUSIONS AND RECOMMENDATIONS

Brazil has long been a leading destination for FDI among the developing countries. A period of severe domestic economic problems in the 1980s deterred investors. Thereafter, FDI has made an impressive comeback aided by expanded opportunities in services and, more recently, resilience in manufacturing despite the global slowdown in FDI flows. Most of the leading TNCs have affiliates in Brazil.

Foreign affiliates have had positive impact on capital inflows, investment and production in some industries. And sustained FDI in infrastructure and intermediate services should improve national competitiveness. But FDI remains oriented towards the domestic market and, until recently, has not met Brazil's expectations of a greater contribution to export competitiveness and shift of production and export towards more technology intensive products. It is also the case that FDI does not have an affirmative impact on regional disparities. FDI remains heavily concentrated in the southeast, although some regions have increased their share recently.

This review pinpoints *five strategic gaps* that Brazil could address to obtain outcomes in the quality and quantity of FDI that better meet its development goals. These are:

1. Promote higher levels of competitiveness of the national economy

FDI to Brazil remains predominantly market-seeking. For long, in fact, FDI has been attracted by the size of a market in which internationally competitive taxation and business regulation have not been prerequisites for commercial viability. These conditions must undergo fundamental change if investors are to successfully export to competitive world markets and FDI is to better meet Brazil's goals. This requires the adoption by Brazil of policies that promote competitiveness at the national and firm level. The FDI strategy must be embedded in a national competitiveness agenda which, building on the recently announced Industrial, Technology and Trade Policy, must continue the restructuring of taxes that impinge on international competitiveness, the redesign of business regulation, and appropriate staffing of key business regulatory agencies.

Many immediate measures can be implemented, as detailed in Chapter II.

2. Extend market-seeking FDI into export-oriented FDI

Greater export orientation of foreign investors requires retaining and attracting efficiency seeking TNCs. Among them are the global integrators, who operate beyond national scale and require efficiencies calculated in world terms. A key goal is for Brazil to understand and cater for their needs and introduce measures that will encourage them to incorporate their Brazilian operations into an increasingly integrated network of global supply. This entails a new focus in strategy – on national competitiveness and access to demanding export markets – and in better organised FDI promotion as summarised below.

3. Facilitate access to large and demanding international markets

Brazil has made distinct progress in trade liberalisation. MERCOSUR has played a role in opening new opportunities for Brazil's international production. Joining the club of winners with the global integrators to aid the shift to the production and export of more technology-intensive goods and services requires that Brazil's trade policies pursue with determination the current strategy of aggressive market access policy. Allied to this is the need to promote the underlying factors determining export competitiveness. These include, among others, healthy macroeconomic conditions, high emphasis on human resources development, competitive exchange rate and a special attention to science and technology.

4. Promote more FDI in less developed regions

FDI to Brazil is concentrated in the more developed regions, and this has not changed with the recent boom in FDI inflows. The Government can deploy better policy options to improve FDI inflows to less developed regions and help to avoid resort to damaging state "fiscal wars". The PPPs can, with federal support, provide appropriately targeted subsidies for infrastructural development. In this light, the EPZs should be activated and their development offered to private investors as PPP opportunities.

The less developed states should receive more support in building their institutional capabilities to identify the local comparative advantages and promote them in cooperation with the federal investment promotion agency.

5. Organise institutions to better foster FDI

The promotion of FDI matched to Brazil's potential and development goals has unique challenges and prospects. The long history of FDI attraction has left a rich resource of established affiliates of leading TNCs and, unlike many countries, Brazil is firmly "on the map". An integral task of promotion should be to facilitate a greater export orientation of established firms. This requires a process of dynamic aftercare by the state agencies with quality support from the federal level. The federal lead agency must be strengthened to not only to assist in the delivery of new opportunities but to achieve greater federal-state coordination in investment promotion in the overall interests of Brazil. The federal agency must be a stronger champion of the competitiveness agenda. It should be capable of supporting state agencies in key tasks and lending particular support to state agencies in the poorer regions. A structure of this kind is not in place.

It is suggested that Brazil's approach to FDI strategy evolve in the following manner:

	<b>Current Status</b>	<b>Suggested Change in an FDI strategy</b>
1.	Over-reliance on market seeking investment	Give greater prominence to efficiency seeking manufacturing in marketing strategy
2.	Investment framework unsuited to export orientation	Adopt a competitiveness agenda as a key strategic initiative
3.	Focus on regional and commodity issues in market access.	Extend market access focus to the most demanding markets for exporting firms, in particular in the area of more technology-intensive goods and services
4.	Under-contribution of FDI to reducing regional disparities	Explicitly improve policy and FDI promotion measures to assist regional development.
5.	FDI promotion institutions not strategically focussed as highlighted below:	Develop a focussed and coordinated FDI promotion strategy involving strong federal and state agencies, as highlighted below.
5a.	Insufficiently focussed marketing goals	Research-based targeting of industries and investors linked to strategic goals
5b.	Development contribution of FDI insufficiently leveraged	Utilise "linkages" programmes as conduits of government support for building world class capacity in local suppliers.
5c.	Underutilised reservoir of existing investors – a key Brazilian advantage	Develop a dynamic after-care strategy for internal lead generation
5d.	A new federal investment promotion agency will start operating in 2005	Ensure that the agency is well-mandated and resourced.
5e.	States not linked in to a comprehensive FDI strategy	Recognise key role in facilitating export oriented FDI, including by the global integrators, through dynamic after care
5f.	Potentially damaging state competition in investment promotion	Develop federal-state investment promotion partnerships with negotiated "protocols" to solve role conflicts
5g.	Patchy FDI promotion capacity on the state level	Federal government to help establish state IPAs and assist the capacity-building process in the existing ones, especially in less developed states.





## ANNEX I. International tax comparisons

### Methodology

The Comparative Taxation Survey presented in Figure Annex 1.1. and Figure Annex 1.2. compares taxation on investment in several sectors in Brazil with taxation in other selected countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. These comparisons enable Brazil to assess the competitiveness of its taxation.

Taxation affects the cost of investment and its profitability, and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed, rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends among other things. Moreover, customs tariff and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner that facilitates comparison between countries. The tax variables included in the analysis are:

- Corporate income tax
- Rate of tax including tax holidays, if any
- Loss-carry-forward provisions
- Capital allowances, investment allowances and investment credits
- Tax on dividends
- Customs import duties and excise duties on business inputs

VAT and sales tax are not considered in this analysis.

Financial models of project investment and financing, revenues and expenses are utilised for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Brazil and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor assuming that the company pays out all residual profits after tax (100 per cent dividend pay out) and that the investor gains the residual value of the company which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the *Present value of tax (PV Tax %)*. PV Tax % is the total of taxes and duties collected by government over the 10 years as a

percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10 per cent per annum. PV tax % thus measures how much of an investor's potential project return is taken by the government in taxes and duties. The higher the PV Tax %, the more the fiscal regime burdens investors and reduces the incentive to invest.

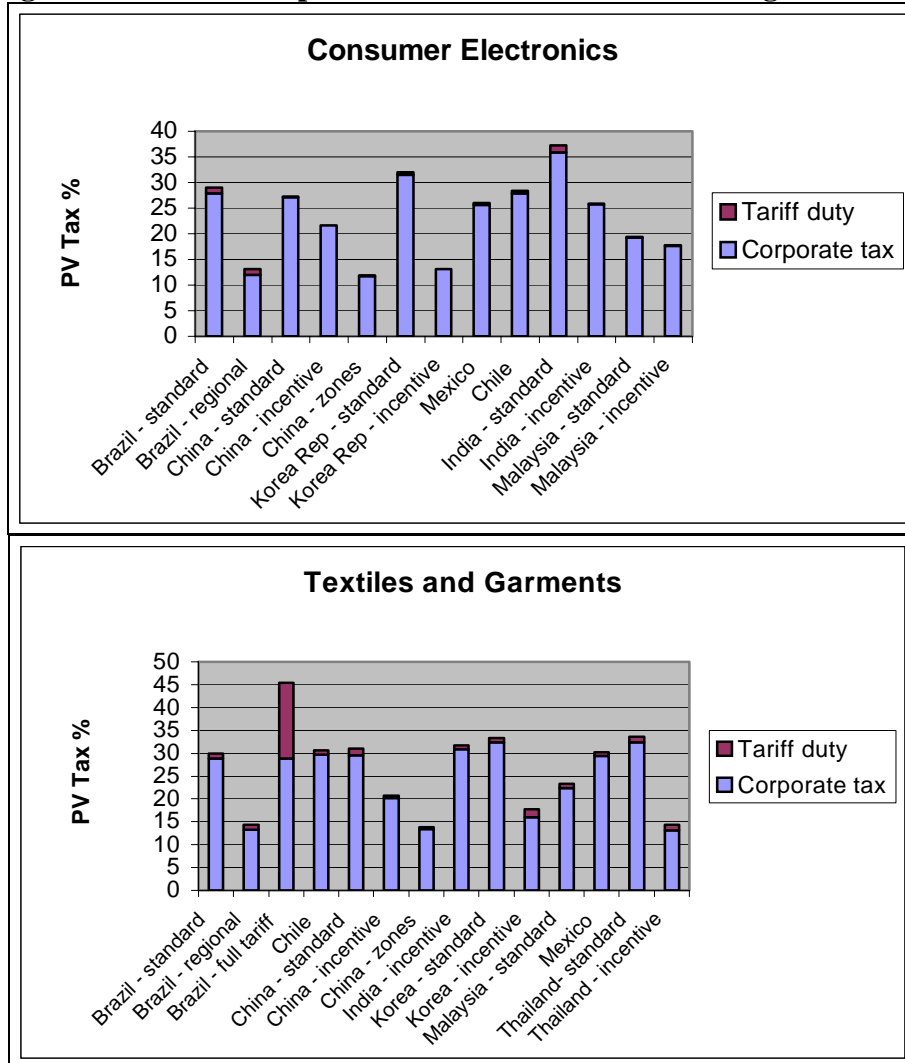
### **International comparisons with Brazil's taxation of investment**

The industries selected for comparison in the Figures below include two export manufacturing cases and three service industries. The impact of both corporate and indirect taxes is shown. The "regional" case as shown in some of the figures represents the case where approved industries in the north and northeast regions are eligible for a 75% reduction in corporate tax. The impact of withholding taxes on interest, royalties and services' fees is not considered. Clearly, these are high in Brazil and obtain no relief in the double tax treaties.

The corporate tax burden shown in the Figures includes IRPJ and CSL. The impact on firm profitability of COFINS and PIS/PASEP is a complicated matter as to whether the incidence of these taxes is on corporate profitability or on final consumers. In the case of exports it is clear – export sales are exempt. In the case of domestic sales, if the market does not permit these taxes to be fully passed on, the impact on firm profitability could be very great. The potential impact is reflected in cases shown for the three services industries in Figure Annex I.2.

Indirect taxation, as shown in the Figures, includes import duties only. In the "standard" cases for the export manufacturing industries (Figure Annex I.1.), the results assume that full import duty drawback is available on imported raw materials and semi-finished inputs and that the cost of capital goods reflects full import duty. As discussed below, Brazil places limits on duty drawback so that the actual burden may be somewhat higher. The "full tariff" case assumes that no import duty drawback applies in order to show the upper limit of the tax burden.

Figure Annex I.1 Comparative taxation of manufacturing



Source: UNCTAD Tax Compass

The results in the figures suggest several issues in Brazil's taxation of investors:

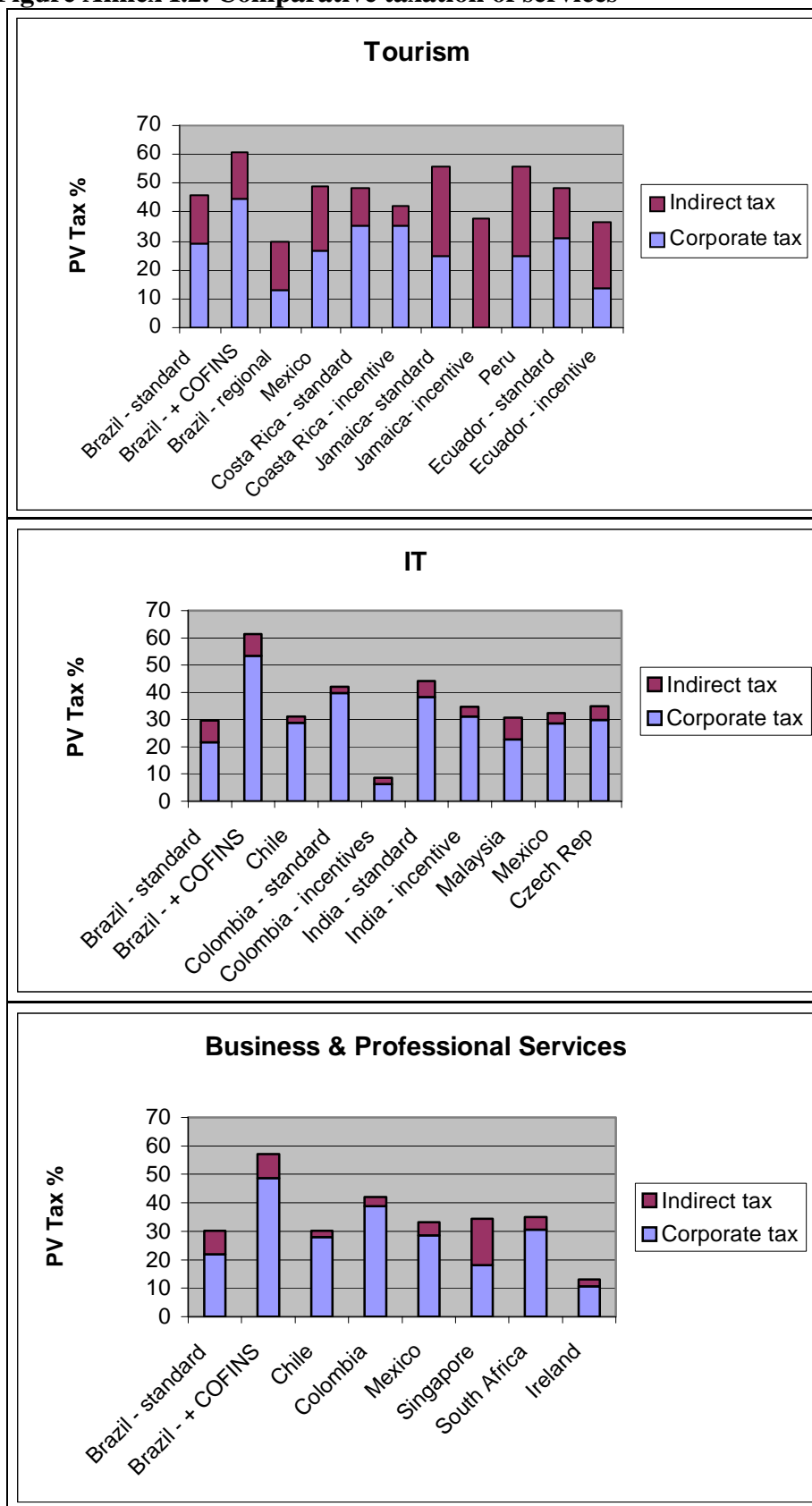
- Brazil's *standard* taxation regime for **export manufacturing** is competitive with Latin American comparators and broadly comparable with the standard regimes of leading Asian manufacturers. But two special factors mean that Brazil's tax regime may often be uncompetitive with Asia:
  - Asian countries offer more widely and readily available special fiscal regimes to attract export manufacturing and Brazil is not competitive with these. Brazil's programmes are confined to regional development incentives, focussed on the north and northeast regions.
  - Brazil assists domestic suppliers of raw materials and semi-finished goods by limiting the scope of import duty drawback. These limitations could impair the competitiveness of exporters (Figure Annex I.1. shows the potential maximum burden to illustrate the issue – see "Brazil-full tariff" in the case of textiles and garments).

- Brazil's *standard* taxation of **services** is broadly competitive. Of course, some countries strongly promote particular service industries, often as export candidates, and may offer exceptionally low taxes (e.g. IT or business services). Brazil would need to review its position if neighbours aggressively sought to become regional service hubs.
- Brazil's corporate tax incentives for investors in the north and northeast regions are quite powerful.
- No conclusions about the *indirect tax* burden on **import-substitution manufacturing** can be drawn for the Figures because they rely on standard output prices. The actual indirect tax impact depends on rates of effective, not nominal, import duty as discussed below. Figure Annex I.3 shows nominal and effective rates of tariff protection in Brazil. All manufacturing industries reported in Figure Annex I.3 receive substantial effective protection, led by the automotive industry<sup>100</sup> (by contrast the **commodity sectors**, except for pulp and paper, suffer the competitive disadvantage of negative effective protection). The *corporate tax* burden depends in Brazil on the incidence of COFINS/PIS/PASEP (CPP) as discussed below.
- The recent restructuring of CPP from a tax on sales to a tax on value-added (effectively labour + profit) removed an important burden from *exporters*, because the tax in its new form does not apply to them. But CPP could have serious competitive implications for local manufacturing or service providers where market conditions mean that CPP cannot be fully passed on. This can include the tourism industry, for example, which competes internationally for visitors. CPP can be an especially strong burden on, and impediment to investment, in *labour intensive industries*. The tax profiles of the three services industries, as depicted in Figure Annex I.2., illustrate this in various ways. The standard cases assume full pass on and the "+COFINS" cases assume no pass on. The potential effect of CCP is striking.

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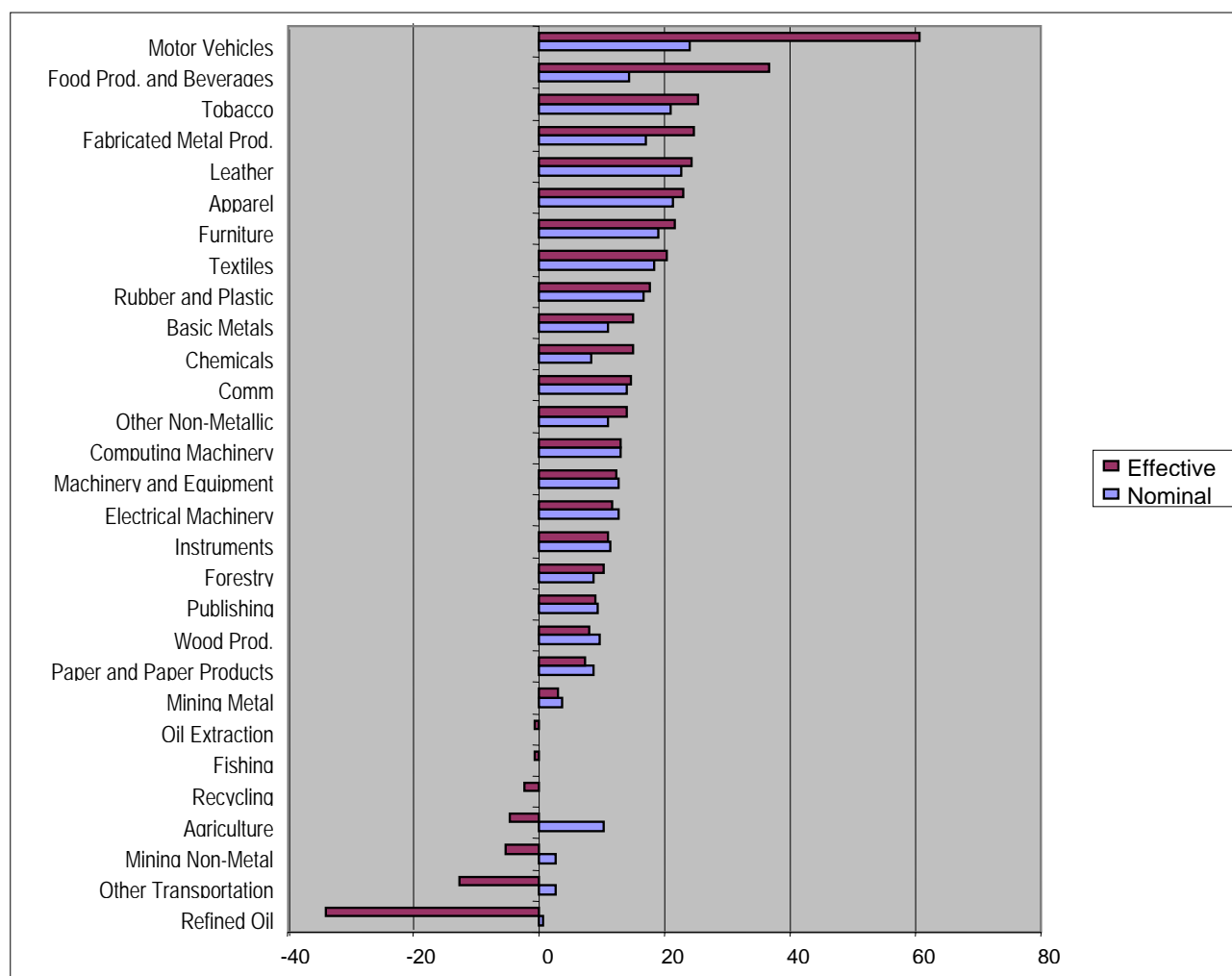
<sup>100</sup> Indeed, even higher levels (over 200% in 1996<sup>100</sup>) were offered to automotive investors during the big development push of the "New Automotive Regime" started in 1995.

Figure Annex I.2. Comparative taxation of services



Source: UNCTAD Tax Compass.

**Figure Annex I.3 Nominal and effective tariff protection in Brazil, 2002**  
(Percentage)



Source: Moreira (2002)

## ANNEX II. UNCTAD's Investors' Perceptions Survey

Investors' perceptions of the investment climate are an important influence on the actual decision processes the TNCs use for investment decisions. Executives have to make judgments about future outcomes and to weigh the prospects of any one country with alternative opportunities elsewhere in the world. Accordingly, executive opinion was polled at both Headquarters and local affiliate levels. The purpose was to test whether decision makers share the generalizations made elsewhere in this report.

The poll was based on two small samples (for a total of 40 TNCs) and cannot therefore be regarded as statistically significant. However, the firms represent a significant proportion of the FDI in Brazil and therefore provide some important insights that need to be taken into consideration in any policy review. Senior executives in twenty-seven Brazilian affiliates were interviewed, and CEOs or senior officials at headquarters of a further 13 TNCs were interviewed.

Though they agreed on many issues, their opinions varied widely on many other issues, as might be expected from the diversity of the sectors where they operated and their widely different qualities of knowledge and experience of Brazil. To control for some of the causes of such differences, the affiliate firms were separated into two groups: *global integrators* and *others*. The *global integrator* category of firms represented a particular development (as discussed in this report). These were all experienced investors who had begun to integrate their Brazilian operations closely, in whole or in part, into their global supply systems. Their calculations of the investment climate differed somewhat from the others in that they required continuous and improving cost competitiveness for their export streams and ease of handling imports to which they added value in Brazil. The *other* category was a random mix of firms that are not global integrators.