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Designing Polices that Stimulate Foreign Investment in Brazil

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Introduction

Foreign Direct Investments (FDI) has come to be recognized over the past decade as a major potential contributor to growth and development. It can bring capital, technology, management know-how and access to new markets. In comparison with other forms of capital flows, it also tends to be more stable, with a longer-term commitment to the host economy.

It is important to consider, however, some of the arguments against foreign investment in general and the activities of Multinational (MNC) or Transnational (TNC) companies in particular, such as[1]:

- ? Although the initial impact of MNC investment is to improve the foreign exchange position of the recipient nation, its long-run impact may be to reduce foreign exchange earnings on both current and capital accounts. The current account may deteriorate as a result of substantial importation of intermediate products and capital goods, and the capital account may worsen because of the overseas repatriation of profits, interests, royalties, management fee, and other funds;
- ? Although MNCs do contribute to public revenue in the form of corporate taxes, their contribution is considerably less than it should be as a result of liberal tax concessions, the practice of transfer pricing, excessive investment allowances, disguised public subsidies , and tariff protection provided by the host government.

The above arguments should catch the government attention to the nature and meaning of the desired economic development, i.e., no question foreign investment can play an important role and also be an important stimulus to economic and social development, but to do so the interest of MNCs and the country government have to coincide in a long run bases.

Brazil has long been an attractive location for FDI. In both absolute amounts and even in proportion to its large economy, it has few equals among developing and transition countries. From its peak of import substitution in the 1950s when in one year it attracted about a third of all the FDI going to developing economies at the time, through its lagging during Latin America's "lost decade" of the 1980s, to regaining its position among the top recipients in the second half of the 1990s with FDI inflows amounting to over US$33 billion in 2000.

Nevertheless, after the record high levels of 2000, global flows declined sharply in 2001 – for the first time in a decade – as a result of the economic slowdown, accentuated by the September 11 events in the United States. World inflows of FDI amounted to US$735 billion, of which US$503 billion went to developed economies, US$205 billion to developing economies and the remaining US$ 27 billion to the transition economies of Central and Eastern Europe (CEE). FDI into Latin America and the Caribbean declined for the second consecutive year, mainly because of a significant drop in FDI to Brazil (US$ 22 billion), where the privatization process of the past few years has almost stopped, and Argentina, where the economic and financial crisis has discouraged any new investments.

It is also necessary to take in account that as more and more countries compete to attract FDI their regulatory framework are becoming similar. For example, in 2001, 208 changes in FDI laws were made by 71 countries in order to make the investment climate more favorable to inward FDI. As a result, the appeal of any particular host country to potential investors is increasingly determined by factors other them FDI regimes. These include the quality of its physical infrastructure among others such as macroeconomic environment, the size and growth of its market and the skill composition of its human resources.

Considering that Brazil has a potential for US$228 billion in investments for the next five years as pointed out in the Estudo dos Eixos Nacionais de Integração e Desenvolvimento (Study of National Integration and Development Zones) in the four basic dimensions for development – infrastructure, social, environmental, information and technology – no foreign experts are required to find that something must be done in order to improve our performance in attracting and maintaining FDI and that is the purpose of this study.

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[1] For more information refer to Smith, Stephen C. and Todaro, Michael P. in Economic Development, Eighth Edition, Chapter 15: Foreign Finance, Investment, and Aid: Controversies and Opportunities.

Given the exploratory nature of this study, the methodology used was based on research of the relevant literature. The results are organized in five sections. After the introduction herein, the next chapter introduces conceptual aspects of FDI and its evolution in the last two decades. Then you find the aspects relating FDI to the macro economic environment as an attempt to predict some trends in the FDI flows for the next years, taking in account the slowdown in the world economy and the impact of the terrorist attacks of September 11, 2001, in the United States. Section III points the main impediments that may be keeping Brazil from realizing its full potential as a location for FDI. Section IV presents the main questions relating to long term funding in Brazil, with focus on infrastructure projects, a situation of uncertainties that make even more difficult the process of attracting both domestic and foreign investors to the infrastructure sector. Finally, the last section with some final remarks.

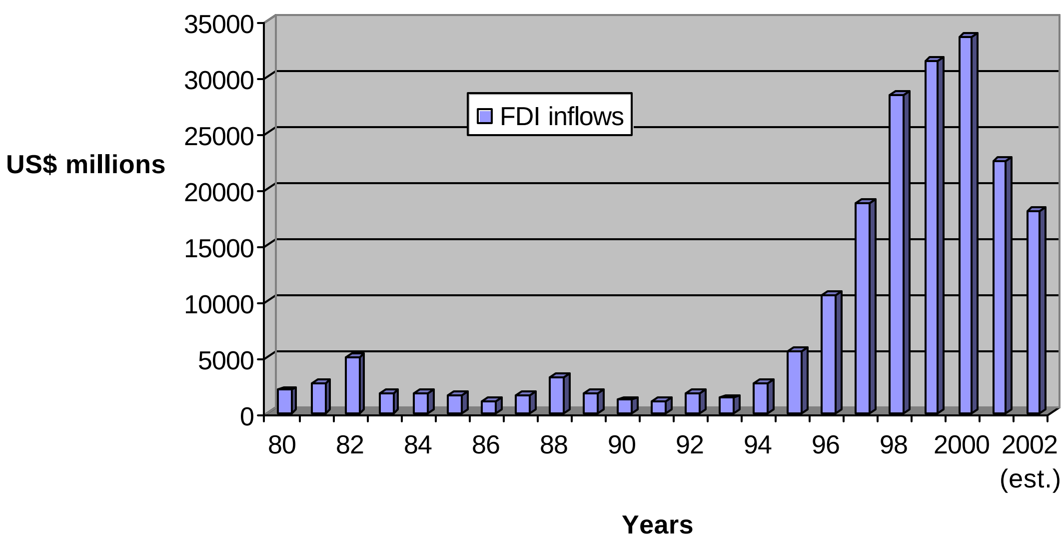
Two appendices complete the paper: the first is a list of bibliographic references and the second, a list of sites of interest.

Foreign Direct Investment – FDI

From its modern origin as a colony to about the middle of the 20th century, Brazil has been receiving a large amount of FDI mainly for the country's abundant natural resources and huge infrastructure requirements. Beginning with the forced import substitution of the World War II and continuing with deliberate policy during the 1950s and, really, through today, the main attraction has been its large, often rapidly growing, and protected internal market. In the last decade, infrastructure and financial service sectors have received enormous amounts of FDI as policies shifted to allow it. Protection for manufacturing is much lower now, but still significant.

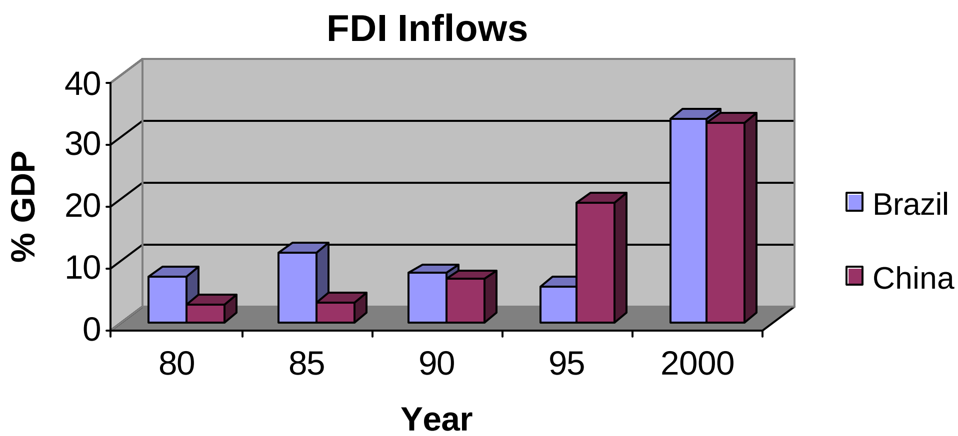
FDI inflows for the period 1980-2002 are summarized in Figure 1 below. The chart shows the enormous inflows of the last few years, unmatched by any developing country except China (Figure 2).

Figure 1: Brazilian FDI Inflows 1980-2002



Sources: UNCTAD, World Investment Report 2002. Central Bank of Brazil.

Figure 2: Brazil x China: FDI Inflows Stocks as a Percentage of GDP



Source: UNCTAD, World Investment Report 2002. Central Bank of Brazil

But FDI is only a means to an end. It is desirable not for its own sake, but for the capital, management skills, jobs, technology, and access to export markets it usually brings. It can also contribute to productivity increases and sustainable growth. In other words, FDI can make Brazil more competitive, and as Brazil becomes more competitive it should attract more (and more productive) FDI.

FDI and Macro-Economic Environment

FDI Prior to 1980

From the end of World War II in 1945, through the early 1980s, Brazil's high tariffs and non-tariff barriers made it difficult to serve the Brazilian internal market through imports, but it was still attractive for foreign companies to locate and produce domestically. FDI was actively sought and welcomed in most parts of manufacturing during much of this period, both as a way of bringing new technologies and as a source of foreign exchange. From World War II to 1962, Brazil achieved the most successful import-substituting industrialization in the less-developed world.

FDI in the 1980s

Foreign investment flows declined sharply in the "lost decade" of the 1980s due to the debt crisis, the very high levels of inflation, political instability and perceptions of a society that sometimes appeared to be hostile to foreigners. In spite of all these problems, new FDI did not disappear during this period. According to UNCTAD – World Investment Report 2000 – FDI stocks, in fact, more than doubled over the decade, from around US$17.5 billion in 1980 to over US$37 billion in 1990. But in these years, the growth momentum of FDI moved elsewhere. For example, foreign investment stocks in Chile increased more than eleven times in the same period (from US$890 million to US$10 billion). The same rate of increase took place in Mexico (from US$2 billion to US$22 billion).

The 1990 – 94 Period

From 1990-94, Brazil continued to experience low rates of growth and high inflation. Some positive steps were taken to improve the investment environment. Foreign investment responded mainly by upgrading existing facilities to meet new levels of competition. There were few major new investors (the automobile industry was an important exception) and inflows remained low. New inflows of FDI remained at essentially the same low levels of the previous decade. At the level of policy, however, a number of important changes were taking place.

Several measures were adopted to reduce somewhat the red tape for investment registration and profit repatriation, to increase transparency, and to reduce the discriminatory treatment against foreign capital in some areas of taxation.

For FDI the most important of the reforms in this period was undoubtedly the decision to reduce tariffs. The reduction in import tariffs actually started in 1988, but a pre-announced and binding schedule of tariff reductions only began in 1990. Also in 1990, Brazil abolished its infamous "Anexo C", a list of around 1,300 products that previously could not be imported at all.

The 1994 – 1999 Period

During the period of the Real Plan from 1994 until the devaluation of 1999, record amounts of FDI came to Brazil, responding generally to price stabilization and improved domestic demand, and specifically to new opportunities in the privatization and opening of service sectors previously closed to private and foreign investors; also to the new "national treatment" policies extended to foreign investors by amending the Constitution; and finally to some continuing import-substitution policies such as the Mercosur Auto Pact. Unfortunately the fiscal side of the Real Plan was not a success, the currency became more and more overvalued, and indicators of short-term Brazilian competitiveness (i.e., relative production costs expressed in dollars) turned sharply in the wrong direction, with corresponding weakness in the trade and current accounts.

FDI inflows surged from US$2.6 billion in 1994 to US$31.3 billion in 1999, further increasing to more than US$33 billion in 2000. In 1999 FDI flows were equal to 5.2% of GDP compared to a mere 0.2% of GDP at the start of the decade. Very few countries received such an amount of FDI in proportion to their GDP.

Three main policies can be associated with this extraordinary foreign investment response. First, the Real Plan, introduced in June 1994, linked the nominal value of Brazil's currency to the dollar, restored price stability, moving the economy rapidly from triple to single-digit inflation. Secondly, in 1995, constitutional amendments and legislative changes (Amendments 5-8 of 1995 and Law 8987 of the same year) opened up to private capital, and by extension to FDI, public-service concessions and certain other activities previously reserved for federally owned and controlled entities. In addition, Constitutional Amendment 6 revoked Article 171 of the 1988 Constitution, thereby establishing the principle of equal treatment between companies controlled by Brazilian nationals and Brazilian entities that are subsidiaries of foreign entities or that are controlled by foreign investors. Finally, the Auto Pact between Brazil and Argentina, effective in January 1996, established conditions that would essentially compel foreign manufacturers to locate production in the two countries if they wished to maintain or increase their share of the Mercosur market.

1999 to the Present

From 1999 to the present, the combination of a large devaluation, a floating exchange rate and domestic inflation targets which have increased expectations for a more stable real exchange rate, and good progress in reducing the government's primary fiscal deficit have started to restore this loss in short-term competitiveness.[2] FDI inflows reached US$31 billion in 1999. But after the record high level of 2000, over US$ 33 billion, global flows declined sharply in 2001 – for the first time in a decade – and Brazil achieved US$22 billion in 2001. This was mainly the result of the weakening of the global economy, notably in the world's largest economy, which fell into recession.

As a result, the decline in FDI was mainly concentrated in developed economies, in which FDI inflows shrank by 59 per cent, compared to 14 per cent in developing economies.[3] It could be argued that 2001 saw a return of FDI to "normal" levels after the hectic Merge and Acquisition – M&A activity of the previous two years. In developing countries and economies in transition, FDI proved fairly resilient despite the global economic downturn and the events of September 11 in the United States.

[2] Major challenges remain, however, in the area of unfunded government pension liabilities. World Bank, "Brazil: Critical Issues in Social Security," Brazil Country Management Unit, June 2000.
[3] The UNCTAD World Investment Report 2002,

Trends in FDI flows

The decline in FDI in 2001 reflects a slowdown in the world economy. More than a dozen countries – including the world's largest economies – fell into recession in 2001 (United Nations Department of Economic and Social Affairs and UNCTAD 2002). To the extent that the events of September 11, 2001, exacerbated this slowdown, they may also have contributed to the further decline in FDI.

The effects of the terrorist attacks of September 11, 2001, on FDI flows are difficult to gauge. Company surveys suggest that they were limited. In October/November 2001, a survey by UNCTAD, the Agence Française pour les Investissements Internationaux and Andersen Consulting revisited a number of firms they had surveyed before 9/11. The finding was that few expected to change their investment plans in the light of the attacks. Similarly, a survey by the Japan External Trade Organization (JETRO) found in October 2001 that nearly half the Japanese firms surveyed did not expect to change their FDI plans. These findings are consistent with a survey by A.T. Kearney in September/October 2001: two-thirds of corporate executives of the world's 1,000 largest firms said that they intended to invest abroad at more or less the levels already planned, 16 per cent said that their FDI in 2001 would increase, and 20 per cent that it would decline. A survey of 643 firms by Multilateral Investment Guarantee Agency (MIGA) in October 2001 found that there was no effect on the expansion plans of 64 per cent of respondents (MIGA, 2002). Virtually none of the respondents intended to cancel their FDI projects.

On the other hand, the higher level of uncertainty created by September 11 events, including higher perceived political risk (associated with war and terrorism), may have induced some companies to adopt a "wait-and-see" attitude. Firms may have placed planned investments on hold until they had a clearer picture of economic developments and the long-term impact of the events on the United States.

In spite of the substantial liberalizing measures of the past decade, developing countries still attract less than a third of world FDI flows. The ratio of FDI inflows to GDP in both developed and developing countries fell, from 5.1 per cent in 2000 to 2.1 per cent in 2001 in the former, and from 3.7 per cent to 3.0 per cent in the latter.

The medium-term (three-year) prospects for FDI are promising. Major transnational corporations (TNC), according to the UNCTAD survey, plan to continue their international expansion. The preferred mode of expansion will continue to be cross-border M&A in developed countries and green field investment in developing countries. More specifically, the survey suggest that the preferred destinations will be the United States among developed countries as whole; Germany, the United Kingdom and France in Europe; China in Asia; Brazil in Latin America; Poland in Eastern Europe; and South Africa in Africa. A survey by the Japan Bank for International Cooperation (JBIC) in July/August 2001 presents similar results. As many as 72 per cent of the Japanese TNCs surveyed said that they would strengthen and expand their foreign operations, a jump of 55 per cent compared to the previous year (JBIC, 2002). A MIGA 2001 survey show similar trends: nearly 80 per cent of the respondents plan to expand FDI in both developed and developing countries in the next three years (MIGA, 2002).

The potential for FDI remains large in many developing countries. In Latin America, according to the UNCTAD Inward FDI Potential Index, it is the smaller, middle-income economies that have the greatest potential in the region, while those with the lowest GDP per capita have the least.

According to the UNCTAD/Andersen survey, FDI prospects for Latin America and the Caribbean over the next three years are likely to improve, although not as much as in East Asia or Central and Eastern Europe. By sector, the MIGA survey shows that Brazil is attracting interest in both manufacturing and services, while Mexico is considered a top destination only for manufacturing, and Chile and Argentina only for services.

The main barriers to attract FDI

Brazil is one of the most attractive investment options in the world. Few others developing nations offers such a large domestic market with such growth potential, backed up by diversified modern industry and services, a sophisticated financial sector and a focused, results-oriented western management class.

Nevertheless, Brazil is very much aware that today's world is increasingly competitive. It's not enough to provide free entry and repatriation of FDI and profits, world-class investment promotion legislation and constitutional guarantees for a level playing field. No foreign experts are required to find that taxes, a difficult bureaucracy, and violent crime against persons are some of the main weaknesses of the investment climate in Brazil. Various aspects of the labor force and labor laws have also been discussed for many years; issues there include labor laws, taxes and regulations that combine to raise the total labor cost to the employer to perhaps excessive levels, as well as weaknesses in education, infrastructure including especially ports, and other legal/administrative aspects. Discussions of the "*custo Brasil*" (cost Brazil), which includes all these and other problems such as transferring and employing the most advanced technology, go back ten years or more.

An even more basic problem, which is especially relevant to exporters, is instability and lack of predictability. This occurs in laws and administration of regulations, as well as in important economic polices such as taxation, intellectual property, and exchange rate management. Some of this instability is a direct result of deliberate policy changes and some of it is the accidental result of failed policies. It is worse in Brazil than in many other countries, specially the Asian countries, which have been so successful in attracting globalizing, strategic-exporting FDI. Comparisons of Brazil to Argentina, Colombia, Mexico, and some other Latin American countries already show Brazil as needing to improve in this dimension, but comparison to the entire world is needed to show just how far behind Brazil is in providing the stable framework needed to attract world-competitive investments.

If Brazil wants to benefit from an increased globalization, it needs to strengthen its competitiveness. Export-oriented FDI, i.e., investments with long term strategic exporting orientation that will serve a broader market rather than the domestic, may serve as a central tool in this process. But in order to get this different type of FDI, Brazil would need to improve key parts of its current investment climate. According to the Foreign Investment Advisory Service - FIAS 2001 survey, Brazil needs some urgent reforms, and the most important ones are:

The Bureaucracy, Public Administration and Regulation in General

Brazil has a cultural legacy that includes the supposition that in general private activity should be regulated closely by the government, and a legal tradition that to an extent is more concerned with legal form than with content. On top of this legacy, Brazil has a federal form of government where, as is the rule in federal states, the division of powers and responsibilities between the center and the states is often in flux and in some respects leads to overlap and duplication.

In common with many countries around the world, the Brazilian government has undergone a major transition from being a dominant actor in the economy to becoming regulator/ controller for functions that are now lodged in the private sector.

Today the government, and many states, have established regulatory-normative agencies for a number of economic sectors, such as in petroleum (ANP), electric power (ANEEL), telecom (ANATEL), road transport (ANT), civil aviation (ANAC), water (ANA), sanitary surveillance (ANVIS), or consumer protection (ANC). However, since they are for the most part staffed by the same bureaucrats who performed related policy-making functions in the traditional line ministries, the new regulatory agencies are often said to lack not only the expertise but also the culture required for this changed government policy. The transparency of decision-making processes has not been high and, fairly or not, agencies have found themselves under criticism at one moment from the industries they regulate, for being too strict, and at another from consumer groups and the public at large for being excessively generous in allowing tariff increases and for not requiring higher standards of service. The bureaucratic perspective and lack of professionalism said to characterize many of the regulatory agencies is part of the "c*usto Brasil*". Although investment flows into the privatized service sectors do not seem to have been much affected to date, regulatory performance has the potential to be a major deterrent to FDI. Scrupulously apolitical appointments made on the basis of technical expertise rather than affiliations, and establishing terms of service that do not coincide with a particular administration's term of office are two measures, among others, that have been shown to strengthen public and investor confidence in the regulatory process.

In addition to the regulatory agencies, certain other branches of government pose specific problems to investors in general and foreign investors in particular. One of them is the environmental area of public policy, not so much because of the strict regulations (and costly sanctions) embodied in the 1999 environmental law but rather owing to the limited administrative and technical capacity, compounded by an inadequate budget, of the operational federal environmental agency (IBAMA) to cope with the mass of projects requiring environmental impact assessments.

In sum the recently enacted strong legislation promoting competitiveness, as well as those mentioned above for protecting the environment are welcome additions, but when the public agencies entrusted with the implementation and enforcement of these statutes lack the minimum resources, budgetary and technical, to carry out their responsibilities, the net effects can be negative, acting as disincentives to business in general and export-oriented FDI in particular.

The Judicial System

Seems to be an universal agreement that the judicial system in Brazil is archaic and needs urgent reform. Not only are the basic statutes, including the civil and commercial codes, out of date, but also the complex civil procedures, leading to seemingly endless appeals, make the system cumbersome and outcomes uncertain. To begin with, there are two parallel systems, at the federal and State levels. Outcomes in one jurisdiction do not bind or even necessarily act as admissible precedents for outcomes in another. Thus exactly the same case can be tried in different parts of the country and lead to opposite court decisions. Labor courts are perceived as strongly biased in favor of employees. Lawsuits are often brought for the sole purpose of delaying the implementation of public policy, e.g., in fiscal matters or in respect of privatization. Many judges are young, inexperienced and poorly paid. The administrative system servicing the courts is inefficient and rife with petty corruption. Criminal impunity is rampant even though prisons are full and overcrowded.

Instability of laws and regulations is a pervasive problem. The passage from the military government to a democratic government with true division of powers has reduced this instability considerably, but by no means sufficiently. It is an adage of business that executives can deal much more easily with imperfect but stable systems, than with unstable and therefore unpredictable systems. Yet again, for a company serving the Brazilian market, everybody in the market is subject to the same situation, but for world-competitive investments, instability in policy, laws, regulations, and administrative practices can be a killer.

Brazil offers several successful examples of reform advocacy initiated by the business community. Among the best known is the work of the Investment Committee of the American Chamber of Commerce of São Paulo. The Committee's work went well beyond simply documenting problems: it proposed, and in some cases helped to pay for solutions aimed reducing costs to business in ways that were also mindful of the legitimate needs of the State. The joint development with the Central Bank of Brazil of an electronic system to expedite foreign-exchange payment approvals illustrates what can be achieved under this cooperative model.

Labor

Labor costs in Brazil may be high. What matters to a prospective investor is the sum of what he will have to pay. The division between what the worker gets and what goes to various taxes and funds is only of secondary importance to the investor, although it may well have other implications for national social policies. According to the World Bank's World Development Indicators, manufacturing labor costs in Brazil historically have been the highest in the Latin America and Caribbean region, and that they remain high when adjusted for productivity.

Besides having high labor costs, Brazil is also well known for having complex and difficult labor relations. The rules governing labor relations in Brazil are principally based on statute, rather than collective bargaining agreements, as is mainly the case in the United States and many other industrialized countries. Much of Brazil's labor law and institutional framework can be traced back to the legal regime established in the 1930s. Two of the current focal points for labor-related reforms -- the public pension system, and to a lesser degree, the Labor Courts, concern institutions and practices that date from this period.[4]

Over the years the labor laws became increasingly complex, and impose a costly burden of mandatory benefits, payable by employers, including paid vacations of 30 calendar days annually after a year of service, with a bonus of 30% of one month's base pay when the vacation is taken; six national holidays (not counting Carnival) and three religious holidays; some state holidays; full sick pay for the first 15 days of an employee's illness; mandatory maternity leaves of four months; mandatory year-end bonus of one month's salary (the so-called thirteenth salary); mandatory contribution of 8% of wages to each worker's Length of Service Guarantee Fund (FGTS); 20% of salaries to the Social Security Fund (INSS); a monthly family wage allowance of 5% of the minimum wage for each child under 14; a social service tax of 1.5% to finance cultural and educational facilities for workers; a one percent tax on wages to support industrial and commercial apprenticeship services (Senai, Senac); a transport subsidy for transportation costs in excess of 6% of gross salaries; and various other taxes and charges.

What to do about the labor dimension? Significant reform of the taxes and regulations seems unlikely, everyone hopes that the current macro policy means that no more drastic devaluations will cut the real value of workers' wages. What remains is what should be the first priority anyway: increase productivity.

[4] Reform of the pension system is usually viewed as the most important single measure for achieving sustainable reductions in the government's fiscal deficit. World Bank, "Critical Issues in Social Security" Brazil Country Management Unit, June 2000.

In spite of the need for more empirical evidence[5], FDI may bring world-class management and technology, which could make critical contributions to labor productivity. But difficulties in the areas of obtaining visas and work permits for foreign workers, technicians and executives, as well as weaknesses in intellectual property protection, are barriers that can keep foreign investment out or reduce its contribution to productivity if it does come.

Taxation

The worst aspect of the Brazilian tax system from the standpoint of a foreign investor is probably its extreme complexity. There are approximately 52 separate taxes, imposts, duties, compulsory loans, withholdings and other charges and fees imposed by federal and municipal governments. Instability with respect to the applicability of different taxes and their rates has also been a problem, although the frequent changes of the recent past seem to be abating.

The corporate income tax, exclusively levied by the federal government, has undergone a series of reforms in recent years. Other federal levies include a social contribution tax on profit (CSL), a social contribution on gross revenues (CONFINS) and a federal profit participation program (PIS) tax on gross revenues. There is a provisional contribution on financial transactions (CPMF) and a further tax on financial transactions (IOF) is also levied on credit, exchange transactions, insurance, securities and inter-company loans and loans between companies and individuals.

As in many other aspects of the policy and legal environment, Brazil's business corporate tax burden is not awful, but it is somewhat worse than that found in many other countries. Again, for an investment aimed at selling to the local market, the tax system would not keep it out of Brazil. For an export-oriented investment, the tax system would probably not be bad enough to keep Brazil off the "short list" of countries being considered, but it would probably be one of the significant negative factors in the score for the final decision.

[5] There is little evidence of any horizontal spillovers of knowledge from MNCs to local producers of the same type of product according to Dani Rodrik in Smith, Stephen C.,Economic Development, cited, Chapter 15, pg644

There are many other taxes in Brazil that, although they normally do not bear on an investor's financial returns, add to complexity and the generally more-irritating-than-necessary tax system:

> *Value-Added Taxes (VATs)*: Brazil is one of the few countries in the world with VATs at both the federal and state level. The federal VAT (IPI) applies to manufactured products with much higher rates on cigarettes, beverages and cosmetics. The state level VAT (ICMS), applies to the production and distribution of goods and interstate and intercity transportation and communication services. Rates vary across states and goods.
>
> *Municipal Taxes*: Services supplied in a municipality, not subject to state tax assessment, are subject to a tax on services (ISS) at a rate established by a municipality. Municipalities also collect a tax on urban buildings and land and property transfers.
>
> *Social Security Taxes (INSS)*: Social security taxes on payroll are paid by employers and employees.

The VAT and some of the other taxes could be problems for exporters if the system for refunding them does not work promptly and fully, and there are some indications that this is, in fact, a problem in Brazil.

Not only is the state ICMS in need of repair but also so should the federal VAT be improved, perhaps, even more urgently. The current federal VAT is very narrowly applied at the manufacturing level so that it can have a significant impact on the competitiveness of other sectors buying manufacturing inputs.

Technology Transfer

Survey on the research and technological innovation expenditures of 85 foreign companies operating in Brazil showed that companies in the sample spent nearly three times as much in the category as the average for national companies. Seventy-five percent of the foreign company sample considered themselves to have more up-to-date products compared to their national competition. However, 40% of the sample said that they did not employ their most advanced technology and processes in their Brazilian-based operations.[6] The pattern for using technology by FDI in Brazil is thus essentially the same as the export propensity of FDI, i.e., considerably better than the national average but still below an international standard.

The general climate for transferring technology and protecting intellectual property to Brazil is far better today than only a few years ago. But there are still some anomalies. FDI will be more likely to employ its latest technology in Brazil, and thus contribute more to Brazil's competitiveness, if the remaining impediments in this area can be eliminated.

Brazil's law regarding patents was recently codified and clarified by the new Industrial Property Code (Law 9279). Foreign investors with patents or patent applications in Brazil were cheered by the extension of patent protection to such previously unprotected areas as pharmaceuticals, food, chemicals and biotechnology. Since enactment of the new law, over 3,000 patent applications have been filed for medicine alone, of which 97% were by foreigners. Applications in all fields totaled 10,000 for the first six months of 2000 alone. The patent office (INPI) is, however, seriously understaffed, and INPI currently predicts that the time period from application to final issuance of a patent may be eight years or more.

INPI is also responsible for approving the terms of transferring unpatented industrial technology. In this area, INPI's administrative practices have changed too often. During the decade of the 1980s, applying the precepts of its Normative Act No. 15, INPI examined contracts for the transfer of foreign technology in great detail. With the opening of Brazil's economy in the 1990s, INPI, on December 17, 1993, revoked Normative Act No. 15 and adopted in its place Normative Act No. 120. This document opened with a declaration that the negotiation of contracts would be governed by a regime of "contractual freedom." It further stated that INPI's review would be limited to the verification of the licensed trademarks and patents, and that "price, payment conditions, type and conditions of technology transfer, contract term, limitations on use, applicable law, and choice of forum, and other clauses" would no longer be considered

[6] SOBEET, Vol. III, No. 14, Edição Bimestral 2000, "O Comportamento Tecnológico das Empresas Transnacionais em Operação no Brasil."

by INPI. Subsequently a separate law lifted the restriction on payments of royalties to parent companies.

On April 15, 1997, INPI's pendulum swung back. Normative Act No. 120 was revoked and replaced by Normative Act No. 135. This document states that "the principal objective of INPI is to enforce the rules which regulate industrial property, in view of its economic, social, juridical and technical function." The document contains no reference to freedom of contract. Investors report that INPI again feels free to question almost any provision of contracts submitted for its review, including royalty rates and compensation for technical services. Once again, capitalization of technology has become difficult due to valuation issues raised by INPI.

Multinational corporations that bring with them their own sophisticated technology have made the bulk of recent FDI in Brazil. They cannot be expected to license third parties unless the research and development underlying their technologies are adequately compensated. Thus, the all-important technology diffusion effects and backward linkages to domestic industry that countries seek from FDI can be seriously constrained as a result of these interventions by INPI. Unless INPI takes these factors more fully into account, it is likely that its policies are creating serious obstacles to the acquisition by Brazilian-owned firms – small, medium and large alike – of cutting-edge technology from abroad, and damage their ability to increase exports and compete in the world economy. By comparison, foreign-owned firms, which have developed their own technology rather than having to obtain it from third parties, would presumably be less affected. In other words, INPI practices that supposedly are designed to promote the nationalization of technology, may have just the opposite effect. In the light of government objectives to increase the share of national output that enters into trade, whether from national enterprises or from FDI, these technology-restricting practices seems especially perverse.

Enforceability of Contracts

In any country, contractual and statutory rights are, of course, valuable only to the extent that they are enforceable. Perhaps even more important from the standpoint of FDI is the extent to which such rights are perceived to be enforceable.

A major factor in the perception of foreign investors relates to the stability and predictability of applicable norms. As noted earlier, foreign investors are often prepared to live with generally applicable rules they do not like, so long as they are not constantly changing. In Brazil, during the period of military government, the frequency of legal change – whether by regulation, decree, decree-law, law, institutional act or even constitutional change (most of which occurred by fiat) was extreme. Since the reestablishment of democratic government, the frequency of change of law has fallen dramatically, leaving foreign investors better able to engage in long-term planning.

Serious problems remain, however, in the perceived enforceability of statutory and contractual rights. Whatever the actual situation may be, the courts are widely perceived as slow, inefficient and bureaucratic; judges are often perceived as young, inexperienced, lazy, and frequently corrupt; court cases are viewed as going on for many years, in which countless appeals may be taken from almost any kind of decision by the lower courts. (There is no "final judgment" rule to block interlocutory appeals in most cases in Brazil.) The issue from the standpoint of attracting foreign investment is less whether these criticisms are true, but whether they are believed to be true.

A further question relates to whether the judiciary is taking any actions to improve itself. Many Brazilian and foreign investors apparently believe that government officials (including judges) are immune from prosecution for corruption or other crimes, and that the judiciary is doing little, if anything, to improve itself. As one Brazilian Professor observed, "the justice system in Brazil is not credible. It is slow, inefficient, oligarchic and incompetent."[7] In the same spirit, a study by a well-known authority, Armando Castelar, concluded that the Brazilian economy suffers a 20 percent reduction in its economic rate of growth as the direct result of judicial inefficiency.[8] On the other hand, a U.S. district judge, who is familiar with Brazil, reports that the Brazilian judiciary is engaged in a significant reform effort. Regardless of which view is accurate – they both may be – the above-quoted criticism, set out in a nationally

[7] Isto e Dinheiro (undated).
[8] IDESP, 2000, Judiciário E Economia No Brasil, Editora Sumaré.

circulating news magazine can scarcely improve the perception of foreign investors with respect to the Brazilian court system, and the safety of their investments in the country.

One technique employed by foreign investors (particularly banks) and their lawyers is to flee the jurisdiction of the Brazilian courts, and to specify contractually that disputes will be decided exclusively in the courts of New York, London, or some other foreign jurisdiction. This solution requires, of course, the agreement of both parties. (In the past the INPI refused to approve contractual designation of a foreign jurisdiction for the settlement of disputes in technology license agreements.) Moreover, if the contract is to be performed in Brazil, common sense may require that Brazilian law govern it. While a New York court may decide questions of Brazilian law, foreign law must be proved as a fact. This complicates matters, and generally results in increased costs. In short, the appointment of a foreign court as the exclusive forum for the determination of contractual disputes is not fool-proof (although from the viewpoint of foreign investors, perhaps better than other available solutions).

Many countries have found a solution to the enforcement problem in arbitration. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) is generally viewed as the most effective treaty on arbitration awards and their enforcement. Brazil has neither signed nor ratified the New York Convention. It has signed and ratified the Panama Convention, the effectiveness of which is limited to parties in Latin American countries, which are parties to the Convention, but this does not include the United States. Under the terms of the New York Convention, courts of a member state must (subject to limited exceptions) enforce arbitration awards entered in another member state, regardless of the nationality of the parties, and without the need for reducing the award resulting from judgments in the courts of the foreign state.

On September 23, 1996, Brazil adopted a modern arbitration law (Law 9307). Almost immediately, however, the constitutionality of the law was called into question, on the ground that the Constitution guarantees all Brazilians access to the courts. The question has yet to be resolved by the Supreme Court; meanwhile the new law has not been used. Ratification of the law would provide a reasonably neutral forum for the resolution of investment disputes.

Although ratification by Brazil of the New York Convention might be even more widely welcomed by foreign investors, approval of the new law by the Supreme Court would undoubtedly be perceived as a major step toward promoting a reasonable mechanism for the resolution of investment disputes in or with Brazil.

As noted earlier, the comfort of foreign investors regarding investment in Brazil depends as much on their perception of the enforceability of contracts, rules, laws and other legal instruments as on the effectiveness of those instruments themselves. For example, Brazil's notorious failure to enforce criminal laws against wealthy Brazilian bankers and businessmen may well leave foreign investors concerned over the risk that they could become victims of white-collar crime. In the end the reform of the judiciary and the public prosecutor's offices depends on the judges and the prosecutors themselves, with the support of the government.

International Agreements

There are a significant number of international agreements bearing directly or indirectly on FDI to which Brazil is not a party. Some of the more important ones are the following:

Brazil already has bilateral investment treaties – BIT with other countries, and a number are currently under preparation. But no such agreement has been reached with the US (which has signed 31 other BITs with countries around the world).

Brazil has tax treaties with 22 industrialized countries, including most countries in Western Europe, but there is no bilateral double-taxation treaty in force between Brazil and the United States. A treaty was signed in 1967, and ratified by the U.S. Senate in 1968 subject to two reservations.[9] The Brazilian Government, not unreasonably, objected to these reservations and did not even submit this treaty to the Senate for ratification. Unfortunately there is still no treaty.

[9] The Senate rejected the Treaty provision, which extended a then-existing 7% investment tax credit to investments, made in Brazil, and also rejected the extension of charitable deduction treatment to charitable contributions to Brazilian non-profit organizations.

Brazil is a party neither to the Inter-American Convention Against Corruption, nor to the similar OECD Convention. (It has signed but not ratified the former; it has not signed the latter.) These Agreements are modeled on the United States Foreign Corrupt Practices Act (FCPA), which makes U.S. investors criminally liable for corrupt practices carried out by them in a foreign country. If Brazil were a party to the treaties, they would be applicable to Brazilian investors investing abroad, but would not apply to domestic corruption involving, say, a Brazilian investor paying a bribe to a Brazilian judge.

The Convention also defines acts of corruption, but establishment of sanctions is left to the member states, under local law. The treaties appear to have little applicability to foreign direct investors in Brazil, although the FCPA does apply to American investors there. In any case, Brazil is party to neither.

Brazil is not a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards to which 116 countries, including the United States are members. With very few exceptions, the Convention requires each contracting state to honor private arbitration agreements, to recognize foreign arbitral awards as binding, and to enforce them in accordance with local rules of procedure. The Convention is unquestionably the most important international agreement applicable to the enforcement of foreign arbitral awards. But, as noted above, Brazil is not a party.

No question that Brazil has been one of the most successful countries in the world in attracting FDI, without adhering to these treaties. Perhaps the more operative question, however, is whether the higher competitive standard Brazil needs to achieve for the future has a counterpart in a higher level of adherence to international and bilateral treaties and conventions, what would need some empirical evidence to be determined.

Long Term Funding in Brazil: Infrastructure Projects

Due to their strategic importance in the dynamics of the economic system, investments in economic infrastructure – that is, in sectors of transport, energy and communications – play a leading role in the economic development process of nations. Given their peculiarities, such as many requirements for capital, long maturation time, whether in the building stage or in the financial recovery of investments during operation, turn these projects feasible has been a constant concern of the collectives for centuries, and becomes a key item in any development strategy.

For a long time the State, the main provider of resources and/or executor of the projects in infrastructure, was practically everywhere in the world, involving building and operation. But the growing number of new investments and generalization of tax crises, diminishing the financial capacity of governments to channel resources into the infrastructure, make the traditional model of financing infrastructure investment, characterized by a strong participation of the public sector, unsustainable.

In the new model, the State fully re-plays its role of granting authority, performing renewed strategic functions in regulation and also in planning and mobilizing resources and partnerships, enjoying its high synergic and catalyzing capacity. From main provider and executor, the State is now regulator and leverages resources; planning is indicative and more decentralized, and not regulatory and centralized as in the past.

Generally involving heavy investments and fairly long terms, the infrastructure projects imply the need to mobilize large amounts of capital in the long term and mitigate high risks. These conditions, particularly critical in developing countries, eventually attract the intervention of special agents, such as the public sector and multilateral organizations.

In the so-called developed world, where credibility of the economic policy and stability of rules of the game set the tone of the macroeconomic scenario, the financial and capital markets encounter conditions to channel considerable savings required to fund these projects.

Recently, the international financial market has been prodigal in managing innovative instruments, which prove to be useful to leverage resources on a large scale and, at the same time, mitigate the risks associated with these operations. The change in attitude of the multilateral organizations towards the infrastructure financing is also interesting. Called to play an increasing role before the growing number of projects and tax difficulties assailing the public sectors, these agencies have endeavored to leverage their resources by changing their attitude, moving from primary providers of credit and equity to suppliers of guaranties, pledges, insurance bonds and correlated instruments.

In the developing countries, however, the supply of long-term resources is very scarce, either due to the insufficiency of domestic saving, or to the instability characterizing the macroeconomic scenario. Moreover, the financial and capital markets are, as a rule, fairly undeveloped, finding it difficult to provide the intermediary service suitable for this situation.

In general, in these countries, domestic savings is complemented by the use of foreign savings – that is, generating a deficit in current transactions of the balance of payments, whose financing eventually involves some type of public guaranty. In this context, the involvement of multilateral institutions and development and official credit agencies, such as IDB, IBRD and Eximbanks, whose stance has also been moving towards incorporating the partnership with the private sector in financial structuring of large infrastructure projects. Among other advantages, the presence of these organizations with strong technical and financial credibility gives comfort to investors and virtually ensures, through specialized bodies such as MIGA or OPIC, coverage of political risks, the most important and volatile components of sovereign risk.

The background of investments in infrastructure in Brazil has, until recently, been marked by a massive Government intervention at all levels. In this context, the public sector has played multiple roles, combining that of a granting authority with those as main provider of resources, executor of projects and also operator of the relevant services. This operating model was one of the basic elements of the development strategy then adopted by the country – to accelerate industrialization by promoting the substitution of imports, a process implemented under the leadership of the public sector.

Since the crises in the 1980s, as a result of the fiscal crisis and fragile financial situation of the State, the development model under the Government leadership is shown to be exhausted, and requires major changes, which marked the advent of drastic structural reforms in the role of the State. The process began as early as the end of the 1980s, but gathered speed since 1991, when the privatization program was launched, and again in 1994, by widening the planning horizons principally offered by the stable economic environment.

The reforms are currently still in progress, thus characterizing the present time as a (long) transition to a new environment, redefining the State's role by outlining a new model of its inclusion in the economic domain, where the following should be mentioned: the adoption of indicative planning, review of the new regulatory benchmarks and appearance of newcomers on the scene.

The new ways of operating in the public sector consider, then, the reinforcement of their regulatory and inspection duties, as well as attracting private enterprise. In the field of economic infrastructure, in particular, in addition to the complete review of the relevant legislation and creation of regulatory agencies, such development occurred principally by adopting privatization and public-private partnerships – PPP[10].

The outlook is that from now on the effort to invest in infrastructure can count on a reduced, clearly insufficient, amount of resources from government. Moreover, the agreement between the Brazilian Federal Government and the IMF – International Monetary Fund, imposes narrow limits on public spending for investments at the three levels of government – Federal, State and Municipalities.

[10] Concepts already included in the Multiyear Plan (PPA) of the Brazilian Federal Government for 2000-2003.

The feasibility of the projects of infrastructure in demand by the economic growth thereby passes through the attraction of different sources of financing and investing agents, from the private and/or foreign sector.

The new model, dictated by this reality, imposes a set of new contours and conditioning factors, once minimized or even non-existent due to the almost omnipotent presence of the State in the scene. In fact, further participation from private enterprise, in executing and financing infrastructure investments, increases the importance of the questions relating to reducing uncertainties and mitigating risks, requiring the implementation of proper– possibly new - mechanisms and instruments focusing on this matter.

In this context, Project Finance, a financial arrangement resulting from financial engineering – designed for the specific purpose of changing the risk profile of a project – appears as a suitable alternative. This financial instrument has been used successfully elsewhere in the world, and is now being considered in Brazil only very recently, with the better macroeconomic environment. In fact, until 1995, when the *Real Plan* was still taking its first shaky steps, the *Infrastructure Finance Directory,* published by IDB, had not one mention of a Brazilian project.

Yet, the increase in private participation in the infrastructure field did not eliminate Government participation, which, in addition to the regulation and fiscal inspection duties, is reserved a major strategic and catalyzing role. Primarily in the current state of institution transition, the public sector has an important space to operate, which in a consolidated scenario would be perfectly dispensable. In this context, the Brazilian development bank - BNDES[11] will still play a relevant role, practically the only domestic source of long term financing available during the past few decades.

In this period, the participation of disbursements for the infrastructure area in all disbursements from BNDES has been around 25%-30% (with some growth in the years of

[11] With total assets of US$ 48.6 billion on December 31, 2001, and disbursements of US$ 10.9 billion during the year, the Brazilian Development Bank - BNDES is the chief federal agency for long-term funding which aims to promote the Brazilian development. It has been a key player in all phases of the country's development effort since it was created, in 1952. Web site: www.bndes.gov.br/english/

concentrating operations associated with privatization). Disbursements from the bank in Project Finance operations in infrastructure have soared recently but the volume is still at quite a modest level.

Although relatively substantial, by any standard of comparison, the available resources in BNDES prove insufficient, given the number of requirements. In fact, according to the Multiyear Plan of the Federal Government for the 2000-2003 period, the predicted economic infrastructure investment requirements are over US$100 billion – an annual average of US$ 25 billion – only in national projects in the sectors of transport, energy and telecommunications – without considering, therefore, the regional and local projects and those of sectors which have micro-location characteristics, such as urban transport, sanitation and electricity distribution.

This ratio reinforces the need to undertake changes in the attitude of the development bank towards an action more aligned with what is seen in the rest of the world, taking project risks and making the requirements more flexible for granting credit. This trend, somehow already included in its new Strategic Plan[12], imprints on BNDES a role much more as a guarantor, mobilizer and giving leverage of resources available in other sectors and spheres, mostly in the private sector.

A more stable currency is, undoubtedly, a necessary condition for a significant reduction in the macroeconomic uncertainty, given the outline for a minimum planning horizon, consistent with the deadlines required by the infrastructure projects.

However, although a necessary condition *sine qua non*, stabilization is clearly not enough to ensure on its own the feasibility of projects of this kind. Well, despite recent advances, some important risk factors still continue high which impact the uncertainty surrounding long maturation projects, such as those of infrastructure. Consequently, until recently the number of operations was still timid and their terms relatively short.

[12] See www.bndes.gov.br/english/

Sustainable investments in infrastructure, involving relatively long terms – between 30 and 50 years – require stability of rules of the game, a requisite in which Brazil still presents a decidedly poor and short rating. Only this factor can now perhaps explain why countries with a visibly poorer macroeconomic situation than Brazil receive foreign financing and investments at higher levels and/or in more favorable conditions than those offered to Brazil.

An important example of uncertainty induced by the environment of change is the fact that the legislation, which legally supports the new institutional models arising from the structural reforms in each of the relevant sectors, is relatively recent. For this reason, the general perception is that the relevant legal framework is not yet consolidated – in some cases, not even complete – and much less tested in practice.

On this requisite, a peculiar feature of the current situation is the wide diversity of situations between the different economic infrastructure sectors. While some sectors are relatively advanced, with consolidation laws, well prepared agencies and legal decisions tested, others have gaps in their regulatory benchmark (the case of basic sanitation[13]), non-existent agencies, or inexperienced because they were implemented very recently.

The ignorance of the development of the Brazilian capital market is another formidable drawback to attracting private enterprise to financing long-term projects via Project Finance in Brazil. This scenario requires an effort of consolidation and communication by the Government, principally in those sectors where legislation and the institutional model itself are incomplete and/or undefined.

As a result of the long period of very restrictive monetary policy, supply of resources for Project Finance has been heavily dependent on foreign resources, with the honorable exception of BNDES.

However, although the flow of foreign resources, direct investments, has soared in recent years, the supply of specific foreign resources for financing infrastructure projects still

[13] Sector where there is a controversy about the constitutional competence.

encounters major constraints, between which perhaps the principal refers to the so-called *"custo Brasil"*, today clearly valued by the risk rating agencies.

Other equally important factors are:

1. The prevalence of perceiving exchange risk, considering that the change in exchange regulations is still very recent and the degree of vulnerability of our foreign accounts;

2. Instability in the world economy arising mainly from the uncertainties with respect to the future of the Japanese economy, the soft landing process of the American economy and upheavals in the Argentine economy.

These constraints do not mean closing the markets to infrastructure financing in Brazil, as happened in the past, but require creative schemes to mitigate risks, to be obtained by applying the techniques made popular in Project Finance. Moreover, there are already today conditions to provide for a reasonable funding supply in domestic currency.

Another particularly important question is that of assessing the risk Brazil itself. With rare exceptions, the country rate is a ceiling for assessing the risk of the projects – a clear distortion, which harms the good projects, since generally these projects have the corresponding risks mitigated, often deserving the investment grade, which eventually is not given by the constraint of country risk. The consequence of this may be very serious in terms of supplying funds to Brazil, since many institutional investors, including national, consider it impossible to participate in such projects due to statutory constraints, requiring the investment grade.

Anyhow, despite the recent efforts to increase the credibility of Brazil, the possibility of obtaining the investment grade for the country is remote. Furthermore, an examination of the behavior of the traditional rating agencies shows persistent distortions. Given the relative degree of lack of information noted in the past rating processes, a systematic effort to support and supply information to the rating companies could bring positive results; a diversification of official spokespersons of the agencies, which in general has been restricted to the monetary area of the Government, may go in the right direction[14].

Closing Remarks

The difficulties in attracting FDI to Brazil pointed out in this paper may be not a surprise but are the main impediments that may be keeping Brazil from achieve its full potential as a location for FDI.

The FDI comes to Brazil mainly by its large internal market. But a large internal market by itself is not a guarantee of global competitiveness. Indeed, small but agile countries have shown that they can compete with far larger economies for the location of prime investors. Being large still counts, but is no longer enough. Also, it is not enough to create a legal structure to adequate laws and regulations, but the application/enforcement of these laws and regulation as well.

Regarding the long term funding there is a group of difficulties associated with the macro scenario, involving parameters such as the healthy of the balance of payments, tax, tributary and financial status of the public sector and financial system and factors influencing the called “custo Brasil” (cost-Brazil). Another group of problems refers to structural reforms still underway, characterized by the unconsolidated regulatory model.

Another particularly important question is the risk Brazil as perceived by the market, since many institutional investors, including national, consider it impossible to take part in infrastructure projects, which requires large amounts of capital and long payback time, due to statutory constrains requiring the investment grade.

[14] Some agencies recently announced more flexible criteria of attributing ratings in foreign currency, opening up the possibility of granting, case by case, ratings above sovereign risk (Gazeta Mercantil, 06.26.01, page B-1).

Of course, the urgent investment requirements, specially those belonging to the multiyear government plan and considered strategic from the national point of view, can not wait for solutions to overcome the barriers, but, once identified, its necessary to have a coordinated multidisciplinary team working on it in order to improve and accelerate the process of solving specific problems as a way to keep Brazil on its path toward the achievement of its full potential as one of the world's leading powers.

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Appendix B: Sites of Interest

Associação Brasileira da Infra-estrutura e Indústrias de Base – ABDIB: www.abdib.com.br .

Agência Nacional de Água – ANA: www.ana.gov.br .

Associação Nacional de Bancos de Investimento e Desenvolvimento – ANBID: www.anbid.com.br .

Agência Nacional de Energia Elétrica – ANEEL: www.annel.gov.br .

Associação Nacional de Instituições de Mercado Aberto – ANDIMA: www.andima.com.br .

Agência Nacional do Petroleo – ANP: www.anp.gov.br .

Agência Nacional de Telecomunicações – ANATEL: www.anatel.gov.br .

Banco Central do Brasil – BCB: www.bcb.gov.br .

Banco Nacional de Desenvolvimento Economico e Social – BNDES: www.bndes.gov.br .

Brazilian Embassy: www.brasil.emb.nw.dc.us .

Comissão de Valores Mobiliários – CVM (Brazilian SEC): www.cvm.gov.br .

Economic Commission for Latin America and The Caribbean – ECLAC: www.eclac.org.

Empresa Brasileira de Energia Elétrica – ELETROBRAS: www.eletrobras.gov.br .

Foreign Investment Advisory Service – FIAS: www.fias.net .

Instituto Brasileiro de Geografia e Estatística – IBGE: www.ibge.gov.br .

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J. P. Morgan Securities – JPMorgan: www.morganmarkets.com .

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Multilateral Investment Guarantee Agency – MIGA: www.miga.org.

Organization for Econimic Cooperation and Development – OECD: www.oecd.org.

Overseas Private Investment Corporation – OPIC: www.opic.org.

Rede Brasileira de Promoção de Investimentos – INVESTE BRASIL: www.investebrasil.org.

United Nations Conference on Trade and Development – UNCTAD: www.unctad.org.

World Bank: www.worldbank.org.

World Economic Forum: www.wef.org.