The Heritage Foundation
LEADERSHIP FOR AMERICA

Promoting Economic Freedom

Brazil: Restoring Economic Growth Through Economic Freedom

James M. Roberts, Mark J. Schreiber, and Derek Scissors, PhD

SPECIAL REPORT
from THE CENTER *for* INTERNATIONAL TRADE AND ECONOMICS

No. 118 | SEPTEMBER 20, 2012

Brazil: Restoring Economic Growth Through Economic Freedom

James M. Roberts, Mark J. Schreiber, and Derek Scissors, PhD

SR-118

About the Authors

James M. Roberts *is Research Fellow for Economic Freedom and Growth in the Center for International Trade and Economics (CITE) at The Heritage Foundation.*

Mark J. Schreiber *is Associate Director for Strategy and Finance at The Heritage Foundation.*

Derek Scissors, PhD, *is Senior Research Fellow in Asia Economic Policy in the Asian Studies Center at The Heritage Foundation.*

CITE Research Assistant Ryan Olson and CITE intern Dylan DelliSanti made valuable contributions to this paper.

Photo on the Cover—
@ Ricardo De Mattos

This paper, in its entirety, can be found at:
http://report.heritage.org/sr118

Produced by the
Center for International Trade and Economics (CITE)

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Brazil: Restoring Economic Growth Through Economic Freedom

James M. Roberts, Mark J. Schreiber, and Derek Scissors, PhD

Abstract

Brazil is the world's fifth-largest country, Latin America's largest economy, and an important trading partner for the U.S. The Brazilian government dominates many areas of the country's economy, undercutting development of a more vibrant private sector, and Brazil's four-year growth average of 4 percent has recently weakened. Government expenditures consume more than 40 percent of GDP. The pace of Brazil's regulatory reform has slowed, and the tax burden is much heavier than in many other emerging economies. Corruption is high, private property rights are insecure, and the judicial system remains vulnerable to political influence. Brazil needs more economic freedom, and the government should eliminate barriers to entrepreneurial activity—burdensome taxes, inefficient regulation, flaws in long-term financing, and continuing government-created rigidities in the labor market.

The world's fifth-largest country and Latin America's largest economy, Brazil is an important American trading partner. The Brazilian economy averaged better than 4 percent annual growth from 2006 to 2010 largely thanks to surging prices for exported commodities. Yet that growth rate was substantially less than many other major emerging countries,[1] and growth has weakened considerably since 2011. Brazilians are justifiably concerned that their country has become stuck again in the decades-old cycle of high inflation and commodity dependence from which it emerged only in the 1990s. Strengthening the foundations of economic freedom is the critical step required to restore rapid growth.

The Brazilian government continues to dominate many areas of the country's economy, undercutting development of a more vibrant private sector. The efficiency and overall quality of government services are inadequate, and the government seems to be more skilled at collecting taxes than at implementing needed reforms.

Total government expenditures, including public-sector wages and transfer payments, consume more than 40 percent of gross domestic product (GDP). The overall pace of Brazil's regulatory reform has slowed, and the tax burden is much heavier than in the emerging economies of Colombia, Peru, and Mexico. Corruption is problematic, private property rights are insecure, and the judicial system remains vulnerable to political influence.

Brazil is also too dependent on commodity exports and risks being afflicted by the "Dutch disease,"[2] where revenues from natural resources make the currency stronger, imports cheaper, and manufactured products more expensive. Sustainable growth will require internal reforms to boost productivity and economic freedom.

The commodity-induced era of Brazilian prosperity has been driven primarily by China. If China continues to rise for another decade or more, Brazil may become locked in a dependent relationship, which it will have to break later. Alternately, Beijing also faces mounting challenges due to its own backsliding on economic freedom. If China stumbles before Brazil gets its house in order, the result will be more painful. In either case, Brazil's best response to China is to become more competitive and more innovative—to embrace greater economic freedom.

While U.S.-led advances in horizontal drilling and fracking technologies drive down oil prices and make production of Brazil's plentiful but difficult-to-extract "pre-salt" offshore oil ever more problematic, Brazil's government—living in the past—is demanding royalties that are too high for pre-salt production to be profitable. Meanwhile, a recent report indicates that "40 percent of the projects—in infrastructure, housing, transportation, and security—currently being carried out by the Brazilian government to prepare for the millions of tourists that will visit the country" for the 2014 World Cup and 2016 Rio Olympics are not complete.[3]

President Dilma Rousseff has won praise recently in Brazil for taking a hard line against corruption.[4] But her initial response to Brazil's current economic challenges has been to resort to the sort of Keynesian stimulus government spending programs[5] that not only have been tried—and have failed—in the United States and elsewhere, but will also create a plethora of new opportunities for cronyist corruption.

Instead, her government should make the painful structural reforms to create conditions for growth, especially in non-commodity sectors. These reforms should be led by further privatization, especially in infrastructure, and by reducing burdensome taxes, inefficient regulation, barriers to entrepreneurial activity, barriers to long-term financing, and rigidities in the labor market.

The Basis for Past Success

As Professor Walter Russell Meade has noted, the "past still haunts Brazil. In spite of its tremendous wealth of natural resources and human capital the country suffered countless booms and busts through the 19th and 20th centuries and was the poster child of hyperinflation in the 1980s and 1990s."[6] As a result, for many decades pundits have said that "Brazil is the country of the future, and always will be." This historic political and economic instability changed, first with the return to democracy through the 1988 constitution, and then with the groundbreaking "neo-liberal" policy reforms of the Washington Consensus—daringly begun in the early 1990s by Finance Minister (and later two-term president) Fernando Henrique Cardoso. This new relative stability was then surprisingly reinforced and strengthened by populist-leftist President Luiz Inácio "Lula" da Silva—and so the Washington Consensus reforms finally broke the back of Brazil's chronic hyperinflation and set the stage for record growth.

The groundwork for reform was laid in 1985. When President Jose Sarney unexpectedly assumed office upon the death of Tancredo Neves, he established a strong executive presidential system with "emergency powers" to enact temporary laws (*medidas provisorias* or MPs) that became crucial to governmental operation. Thus, although neither Sarney's heterodox *Plano Cruzado* (involving the creation of a new currency, the "cruzado," aimed at cutting inflation) nor his successor Fernando Collor's more orthodox *Plano Cruzeiro* (plans for a second new currency, that also failed to bring inflation under control) were successful in defeating hyperinflation, which peaked at nearly 3,000 percent in 1990,[7] crippling Brazil economically, the MP tool was in place. This tool assisted Cardoso in launching the successful *Plano Real* (the third, and finally successful, introduction of the "real" currency) in 1994 that fundamentally restructured Brazil's economy. Cardoso issued more than 300 MPs (and re-issued 4,500 more)[8] to spur privatization and open Brazil to global trade and investment.

1. Such as the other so-called BRIC countries (Brazil, Russia, India, and China) and other large developing countries, such as Indonesia and South Africa.
2. In the 1960s, the Netherlands discovered large natural gas deposits. This ostensibly positive development had serious repercussions for important segments of the economy, as the Dutch guilder became stronger, making Dutch non-oil exports less competitive. This phenomenon has come to be known as the "Dutch disease." Christine Ebrahim-zadeh, "Back to Basics," International Monetary Fund *Finance and Development*, Vol. 40, No. 1 (March 2003), http://www.imf.org/external/pubs/ft/fandd/2003/03/ebra.htm (accessed August 7, 2012).
3. "AQ and Efecto Naím Joint Report: Is Brazil Ready for the Olympics?" Americas Society/Council of the Americas, August 5, 2012, http://www.as-coa.org/articles/aq-and-efecto-na%C3%ADm-joint-report-brazil-ready-olympics (accessed August 16, 2012).
4. Andrew Downie, "Brazil Targets Corruption in 'Trial of the Century,'" *The Christian Science Monitor*, August 15, 2012, http://www.csmonitor.com/World/Americas/2012/0815/Brazil-targets-corruption-in-trial-of-the-century (accessed August 17, 2012).
5. Mamta Badkar, "Brazil's $66 Billion Stimulus Could Signal a Shift in Its Growth Strategy," *Business Insider*, August 15, 2012, http://www.businessinsider.com/brazil-66-billion-dollar-stimulus-2012-8 (accessed August 16, 2012).
6. Walter Russell Meade, "Brazil: The Country of the Future, Again?" *The American Interest* Via Meadia blog, March 8, 2012, http://blogs.the-american-interest.com/wrm/2012/03/08/brazil-the-country-of-the-future-again/ (August 7, 2012).
7. Index Mundi, "Brazil: Inflation, Consumer Prices (Annual %)," March 2, 2011, http://www.indexmundi.com/facts/indicators/FP.CPI.TOTL.ZG/compare?country=br (accessed August 7, 2012).
8. Albert Fishlow, *Starting Over: Brazil Since 1985* (Washington, DC: Brookings Institution, 2011), p. 9.

A vigilant, restrictive, and independent monetary policy overseen by neo-liberal former international bankers and "anchored" to the U.S. dollar by high real interest rates permitted the economic rules in Brazil to become more permanent and predictable. Foreign direct investments flowed in. According to Professor Albert Fishlow of Columbia University, the agriculture, mining, and petroleum sectors increased exports while many state-owned industries and much state-owned infrastructure were sold to private entrepreneurs who could manage them more efficiently. The result was a revived industrial sector, increased access to private credit, more efficient bankruptcy processing, and a more effective regulatory regime. Meanwhile Brazil's economy and its politics became "more stable."[9]

Brazil's success would not have been sustained without Lula's commitment upon assuming office in 2003 to continue Cardoso's policies, which he deemed at the time "a political as well as an economic necessity," and to abide "by the terms of a [Cardoso-era] $30 billion bailout"[10] from the International Monetary Fund (IMF). Lula reaped direct political benefits by sticking with these pro-growth policies. Brazil's subsequent prosperity enabled Lula to increase social spending on education, health care, and other programs for more than 11 million households living in poverty. For example, funding for Lula's Conditional Cash Transfer (CCT)[11] *Bolsa Familia* (Family Stipend) program was made possible only through tax proceeds generated by private-sector-led economic growth.[12]

Helped by booming global commodity prices, Lula's early adherence to Cardoso's neo-liberal reforms boosted the emerging Brazilian middle class while also lifting up the poorer classes. But in the latter years of his presidency, Lula also instituted increasingly assertive and statist "neo-developmentalist"[13] industrial policies through the National Bank for Economic and Social Development (BNDES).[14]

Blaming global economic conditions, Lula gradually abandoned earlier efforts at decentralization and federalism inherent in the 1988 constitution in favor of recentralization. The tendency to backslide toward statism in Lula's second term set the stage for potentially repeating past mistakes by recreating an inefficient and bloated central government that intervenes too much in the marketplace.

The question now is whether President Rousseff will make federalism and private-sector-led growth a priority again. Fishlow has observed that "the new leadership needed in Brazil should not come from the federal government, but from the state and municipal levels as power is concentrated in the hands of mayors of important cities and state governors."[15]

Brazil v. China: Don't Follow the "Red" BRIC Road!

Over the past five years, the People's Republic of China (PRC) has become Brazil's largest trading partner, as well as a significant investment partner. Brazil's fortunes have become intertwined with China's, and the two are understandably compared. The PRC is undeniably the leader in the pace of economic growth, and some see China as a viable economic model for Brazil. Such a view is severely misguided, however, and Chinese-style development would have ugly consequences for Brazil.

Nineteen hundred ninety-one was the last full year of the political and economic repression in the PRC that followed the crackdown after the demonstrations in Tiananmen Square in 1989. At that time, Brazil was eight times wealthier than China and larger in aggregate terms. In 1992, the General Secretary of the Communist Party, Deng Xiaoping, restarted Chinese economic reform. Twenty years later, China is three and a half times larger than Brazil in aggregate terms, and Brazil is less than twice as wealthy. The story of

9. Ibid., p. 86.
10. Lourdes Sola, "Politics, Markets, and Society in Lula's Brazil," *Journal of Democracy*, Vol. 19, No. 2 (2008), pp. 32–34.
11. The World Bank, "Conditional Cash Transfers: Key Facts," 2011, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSOCIALPROTECTION/EXTSAFETYNETSANDTRANSFERS/0,,contentMDK:20615138~menuPK:282766~pagePK:148956~piPK:216618~theSitePK:282761,00.html (accessed June 20, 2012).
12. Sola, "Politics, Markets, and Society in Lula's Brazil."
13. Neo-developmentalism was first used in 2003 by Brazilian economist and former policymaker Luiz Carlos Bresser-Pereira in an attempt by statists to oppose the neo-liberal policies of the Washington Consensus. See "A New Developmental State?" *Heterodox Political Economy Blog*, April 14, 2012, http://europeaneconomics.wordpress.com/2012/04/24/a-new-developmental-state/ (accessed August 8, 2012).
14. María de Lourdes R. Mollo and Alfredo Saad-Filho, "Neoliberal Economic Policies in Brazil (1994–2005): Cardoso, Lula and the Need for a Democratic Alternative," *New Political Economy*, Vol. 11, No. 1 (2006), p. 117.
15. Fishlow, *Starting Over: Brazil Since 1985.*

TABLE 1

Comparing Economic Performance in Brazil and China

Figures are in constant 2005 dollars.

	Brazil	China
1991 GDP	$607 billion	$574 billion
2011 GDP	$1,134 billion	$4,183 billion
1991 GDP per capita	$3,955	$493
2011 GDP per capita	$5,575	$3,130

Source: U.S. Department of Agriculture, Economic Research Service, International Macroeconomic Data Set, http://www.ers.usda.gov/data/macroeconomics (accessed July 24, 2012).

SR 118 heritage.org

the PRC's recent positive growth performance is well known, but has been misinterpreted.

China's success stems not from the past eight to nine years of government intervention, which has led only to macroeconomic imbalances and unsustainably high liquidity[16]—similar to problems seen in the American economy over the last decade. The PRC's success stems from the market reform years of 1978 to 1989 and 1992 to 2002, culminating with entry into the World Trade Organization (WTO).

As of 2002, the PRC had no macroeconomic imbalance and no excess liquidity, and its economy has structurally weakened since 2006. As it continues to do so, the misunderstanding of the role of an expanding state in market activity is finally giving way to skepticism about China's long-term prospects absent reform. Brazilian policymakers should not be fooled by claims of statist superiority.[17]

China's rapid growth does, however, have important implications for the bilateral relationship. The PRC's expansion and ensuing demand for commodities that it lacks, such as iron ore, soybeans, crude oil, and natural gas, has pulled Brazil along.[18] But while the Brazilian agricultural competitiveness, metal deposits, and expanding energy role have been a boon to China, they certainly do not drive Chinese growth. Rather, China's expansion has driven Brazilian growth.

If China stumbles, the challenge for Brazil will be to find sources of growth that do not rely on transient external demand. Brazil's resource endowment is a boon, but one that waxes and wanes with global cycles. Improving the productivity of domestic labor and capital through reform is a permanent boost, not a transient one. As China fades in this scenario, more economic freedom could make Brazil the new China, only richer.

On the other hand, if China revives its economy, it will be due to renewed reform aimed at achieving greater economic freedom, as Deng accepted in 1978 and re-initiated in 1992. Renewed Chinese reform and efficiency would cut demand for some Brazilian goods, such as iron ore, but gas and farm goods would remain strong on the basis of Chinese consumer demand for higher-quality food and environmental improvements.[19]

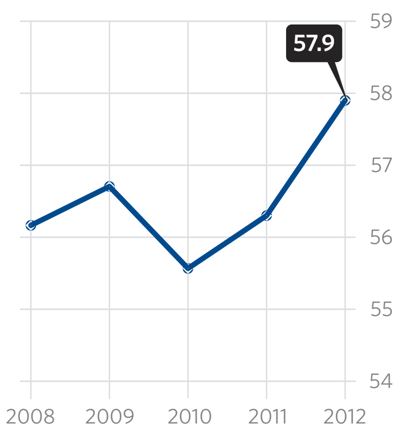
The question is whether that is enough. Should Brazil be content following in China's wake even if the PRC can rise for another decade or more? No, Brazil can do better. There is no necessary choice to make between a huge trade and investment relationship with a vibrant China and greater economic freedom. Market-based reform will make Brazil more competitive and more innovative, better able to take advantage of China's strengths, *and* better able to compete with China. The belief that Brazil must curb

16. Derek Scissors, "China Drowning in Money: What It Means for the U.S.," Heritage Foundation *Issue Brief* No. 3616, May 29, 2012, http://thf_media.s3.amazonaws.com/2012/pdf/ib3616.pdf.
17. See, for example, Derek Scissors, "China Grows 10 Percent Again: Is This Believable?" Heritage Foundation *WebMemo* No. 3098, January 20, 2011, http://www.heritage.org/research/reports/2011/01/china-grows-10-percent-again-is-this-believable.
18. "Brazil Sets Trade Records, Due to Chinese Demand," NPR, January 2, 2012, http://www.npr.org/2012/01/02/144587105/brazil-sets-trade-records-due-to-chinese-demand (accessed August 8, 2012), and John Whalley and Dana Madianu, "The Deepening China Brazil Economic Relationship," CESIFO *Working Paper* No. 3289, December 2010, http://www.cesifo-group.de/portal/pls/portal/docs/1/1183998.PDF (accessed August 8, 2012).
19. Leslie Hooks, "China: Beijing Will Drive Global Natural Gas Demand," *The Financial Times*, December 20, 2011, and Jikun Huang, "Feeding Growing Food Demand in China," presentation at SAIS conference, Washington, DC, April 17, 2012, http://www.sais-jhu.edu/agriculture/Presentation%201_Jikun%20Huang_China.pdf (accessed August 8, 2012).

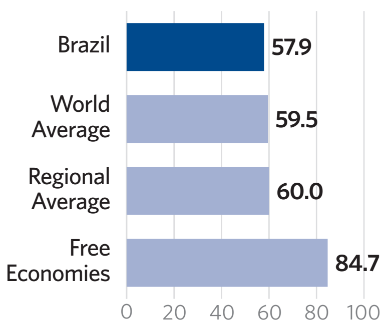
CHART 1

Economic Freedom in Brazil

FREEDOM SCORES IN THE *INDEX OF ECONOMIC FREEDOM* SINCE 2008



COMPARISON OF SCORES IN THE *2012 INDEX OF ECONOMIC FREEDOM*



Sources: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2012 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2012), at *www.heritage.org/index*.

SR 118 heritage.org

economic freedom to compete with the PRC is mistaken.

State support for industries in an attempt to ensure their competitiveness against Chinese or other firms comes at a cost to the rest of society. The PRC has paid that price in ecological degradation, rising income inequality, and economic imbalances that must ultimately be corrected.[20] Brazil can mimic Chinese top-down planning for a time, but it will pay a high price. Meanwhile, market-based reform to improve the productivity of Brazilian workers and expand the range of action for Brazilian companies enhances competitiveness and costs nothing.

Greater efficiency minimizes the threat to the environment by minimizing resource depletion. An open Brazil integrated with the world economy is in better position to take full advantage of global demand for its resources rather than facing retaliation for its own protectionism and exclusion from preferential trade agreements. A more open Brazil will reward Brazil's farmers, miners, and energy workers, alleviating income inequality. Brazil should respond to a successful China the same way it would to an unsuccessful China: with more economic freedom.

The 2012 *Index of Economic Freedom*,[21] published by The Heritage Foundation and *The Wall Street Journal*, provides some important perspectives on Brazil's most-needed reforms. Brazil's overall economic freedom score is 57.9 out of 100, making its economy the 99th freest of 179 countries in the 2012 *Index*. Its score is only 1.6 points better than in 2011, with improvements in just four of the 10 economic freedoms. Brazil is ranked 20th of 29 countries in the South and Central America and the Caribbean region, and its overall score is below the regional and world averages of 60 and 59.5, respectively. In each area of economic freedom there is room for significant improvement.

Protection of Property Rights. All contracts in Brazil are generally considered secure, but Brazil's judiciary is inefficient and subject to political and economic influence. It is also under-resourced compared to other government ministries and its staff lacks adequate training. Court decisions can take years to be handed down, and judgments by the top-level Supreme Federal Tribunal are not automatically binding on lower courts.

In 2011, the U.S. Department of State reported that the courts were overrun with property rights cases and that the backlog was growing larger.[22] In a 2009 "Assessment of Brazil" conducted by the anti-corruption group Global Integrity, small companies reported that they often cannot afford the costs of a lawsuit.[23]

20. Ben Blanchard, "China Gives Bleak Assessment of its Battered Environment," Reuters, June 3, 2011, http://www.reuters.com/article/2011/06/03/china-environment-idUSL3E7H30FL20110603 (accessed August 8, 2012); Didi Kirsten Tatlow, "China's Hidden Wealth Feeds an Income Gap," *The New York Times*, January 25, 2012, http://www.nytimes.com/2012/01/26/world/asia/26iht-letter26.html?pagewanted=all (accessed August 8, 2012); and "China's Falling Surplus Masks Domestic Imbalance, IMF Says," Bloomberg, http://www.bloomberg.com/news/2012-04-17/china-s-falling-trade-surplus-masks-domestic-imbalance-imf-says.html (accessed August 8, 2012).

21. Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2012 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2012), pp. 121–122.

22. U.S. Department of State, "Background Note: Brazil," November 30, 2011, http://www.state.gov/r/pa/ei/bgn/35640.htm (accessed August 8, 2012).

23. Globalintegrity.org, "Global Integrity Report: Brazil 2009," p. 128, http://report.globalintegrity.org/reportPDFS/2009/Brazil.pdf (accessed August 21, 2012).

The World Bank's International Finance Corporation revealed in its 2009 "Enterprise Survey" that almost half of small and medium-sized companies in Brazil consider the functioning of the courts a major constraint for doing business in the country.[24] Courts at the lower levels are particularly prone to corruption, political influence, and intimidation.[25]

It is vital to Brazil's healthy economic growth that people, both native and foreign, be able to buy and sell real property easily, with low transaction costs. Brazil's mortgage market is still underdeveloped and foreigners in particular may encounter difficulty in obtaining mortgage financing. Protection of intellectual property rights has improved, but piracy of copyrighted materials persists.

Freedom from Corruption. Corruption is often an obstacle to investment in Brazil. Businesses bidding on government procurement contracts can encounter corruption, which is also a problem in the lower courts. In 2010, corruption investigations of politicians from opposition and government-coalition parties resulted in prison sentences for two governors. Since then, even higher-profile scandals have come to light. Between June and September 2011 "President Dilma Rousseff lost five cabinet-level officials, none who face criminal charges, but four of whom left after allegations of corruption were levied against them."[26]

Corruption also hinders the daily operations of companies, both Brazilian and foreign-owned. A 2008 business survey commissioned by Norway's Ministry of Foreign Affairs, "Collaboration on Anti-Corruption: Norway and Brazil," found a general lack of trust in the judicial system that makes companies reluctant to file complaints to the courts in situations where they have been victims of corruption. According to the survey, filing complaints to courts is considered a waste of time and money by most respondents. Hence, many companies remain silent about corrupt acts committed against them, even if such crimes have cost them important contracts.[27]

Fiscal Freedom. Although Brazil's economy shows great promise to move from the 10th-largest economy in the world to the fourth-largest by 2050, it must still overcome enormous challenges and reduce burdensome regulations and rates of taxation in order to fully realize its potential. The Rousseff government should seek to become more competitive by improving Brazil's score on fiscal freedom.

Achieving that goal will not be easy. As Sao Paolo attorney Raphael de Neto told *The Economist*, the Brazilian "government's ability to collect taxes has run far ahead of any effort to streamline them, increasing the burden on businesses."[28]

The top personal income tax rate is 27.5 percent. The standard corporate tax rate is 15 percent, which when combined with a 10 percent surtax and 9 percent social contribution on net profit paid by most industries brings the effective rate to 34 percent. Other taxes include a financial transactions tax, with the overall tax burden equal to 34.3 percent of total domestic income. Public spending is over one-third of GDP, resulting in chronic budget deficits. Government debt is 66.18 percent of GDP.[29]

Tax environments that are welcoming to business can help lead to an increase in foreign direct investment (FDI). This is of particular interest to Brazil since "FDI inflows to Brazil fell by 42 percent year-on-year, to USD$25.9bn in 2009, down from record-high inflows of US$45.05bn in 2008."[30]

Among other reasons, Brazil will require massive amounts of FDI and access to advanced technology in order to extract the 80 billion to 100 billion barrels of light sweet crude oil that are thought to lie offshore under five miles of ocean water and an additional mile or two of "pre-salt" rock below the South Atlantic.

As it stands today in Brazil, tax filings are not only financially costly,

24. The World Bank, "Enterprise Surveys: Brazil," 2009, http://www.enterprisesurveys.org/ (accessed June 21, 2012).

25. Business Anti-Corruption Portal, "Brazil Country Profile: Judicial System," 2011, http://www.business-anti-corruption.com/country-profiles/latin-america-the-caribbean/brazil/corruption-levels/judicial-system/ (accessed August 8, 2012).

26. "5th Brazilian Cabinet Member Resigns Amid Corruption Allegations," CNN, September 15, 2011, http://articles.cnn.com/2011-09-15/world/brazil.resignations_1_president-dilma-rousseff-corruption-probe-corruption-allegations?_s=PM:WORLD (accessed August 8, 2012).

27. Tina Søreide and Claudio Weber Abramo, "Collaboration on Anti-Corruption: Norway and Brazil," Chr. Michelsen Institute *CMI Report* No. 2008:1, 2008, http://www.cmi.no/publications/file/2935-collaboration-on-anti-corruption-norway-and-brazil.pdf (accessed August 8, 2012).

28. "A Bull Diminished," *The Economist*, May 19, 2012, http://www.economist.com/node/21555588 (accessed August 8, 2012).

29. International Monetary Fund, World Economic Outlook Database, April 17, 2012, http://www.imf.org/external/ns/cs.aspx?id=28 (accessed August 8, 2012).

30. "Brazil Investment Regulations," Economist Intelligence Unit, October 4, 2011.

but the time required to complete tax filings also has an additional negative impact. For business managers, time is money. The complex tax structure consumes roughly 2,600 hours a year for local medium-size companies, according to the International Finance Corporation's and World Bank's annual Doing Business survey. This is primarily due to taxes, such as Brazil's corporate income tax (IRPJ), social security contributions (INSS), and taxes on goods and services (ICMS) that are similar to value-added taxes.[31]

In comparison, Doing Business reports that China has taken steps to improve the tax environment with its new corporate income tax law that unified the tax regimes for domestic and foreign enterprises and clarified the calculation of taxable income for corporate income tax purposes.[32]

Brazil's disadvantage in the worldwide competition for FDI has been noted by corporate executives. These corporate leaders understand that the current tax structure in Brazil is too complicated. Commenting on Brazil's taxation regulatory regime Mark Buthman, chief financial officer for Kimberly–Clark, has said that "if it's not the most complicated tax system in the world, it's certainly right up there."[33] Tarek Farahat, CEO of Procter & Gamble Brazil, has expressed similar concerns, stating that Brazil needs "tax simplification. This will bring transparency and competitiveness [and lay the groundwork for] sustainable growth."[34]

Government Spending. In the most recent year, total government expenditures, including consumption and transfer payments, amount to 41 percent of GDP; public debt is just below 40 percent of GDP. Besides debt service, government spending is focused mainly on pensions, transfers to local governments, and funding the bureaucracy. Public-sector wages and transfer payments account for more than 70 percent of the country's primary spending.

Both private-sector and public-sector pensions in Brazil "are among the most generous in the world, replacing on average 75 percent of pre-retirement income." Some of these pensions are paid to the very poor and are intended to reduce poverty. In general, however, "rural workers aged over 60, and anyone poor and over 65, can get a pension of 622 reals—the minimum wage—without ever having paid into the system."[35] Although this provision is relatively low in budgetary cost to the government—2 percent of GDP annually —the bigger problems it creates, ones which Brazil shares with de facto bankrupt welfare states, such as Greece, stem from rules that allow contributing workers to retire earlier, with larger pensions, than almost anywhere else in the world.[36]

Given that set of anti-competitive and ultimately fiscally unsustainable incentives, perhaps it is not surprising that most Brazilians retire startlingly early: The average male in the private sector is 54; the average woman, 52. Survivors' benefits have no age limits. To make Brazil's unfunded entitlement liabilities even more daunting, there is also a provision that permits families to inherit 100 percent of the pension of a deceased breadwinner, meaning that even young, childless widows never need work. Today in Brazil fully one-tenth of all 45-year-olds are already receiving pensions.[37]

Business Freedom. To become more globally competitive, Brazil should eliminate barriers to entrepreneurial activity by, for example, reducing the number of procedures, the number of days, and the cost associated with obtaining a business license. Although the Brazilian government took some steps in 2011 to ease business start-up costs by enhancing the degree of electronic synchronization between federal and

31. Doing Business, "Ease of Doing Business in Brazil," International Finance Corporation and The World Bank, 2012, http://www.doingbusiness.org/data/exploreeconomies/brazil (accessed August 8, 2012).

32. Doing Business, "Ease of Doing Business in China," International Finance Corporation and The World Bank, 2012, http://www.doingbusiness.org/data/exploreeconomies/china (accessed August 8, 2012).

33. Kate O'Sullivan, "Brazil is Booming (and Maddening)," *CFO Magazine*, July 15, 2010, http://www.cfo.com/printable/article.cfm/14508833 (accessed August 8, 2012).

34. Jonathan Wheatley and John Paul Rathbone, "Brasileiros não parecem desejar mudanças políticas, mas empresários estão preocupados" (Brazilians Do Not Seem to Want Political Change, But Employers are Concerned), in Portuguese, UOL, January 10, 2010, http://wap.noticias.uol.com.br/midiaglobal/fintimes/2010/10/01/brasileiros-nao-parecem-desejar-mudancas-politicas-mas-empresarios-estao-preocupados.htm (accessed July 5, 2012).

35. "Tick, Tock: The Senate Debates a Small Measure to Help Disarm an Economic Time Bomb, *The Economist*, March 24, 2012, http://www.economist.com/node/21551093 (accessed August 20, 2012). At the March 2012 exchange rate, 622 reals were worth about USD$300.

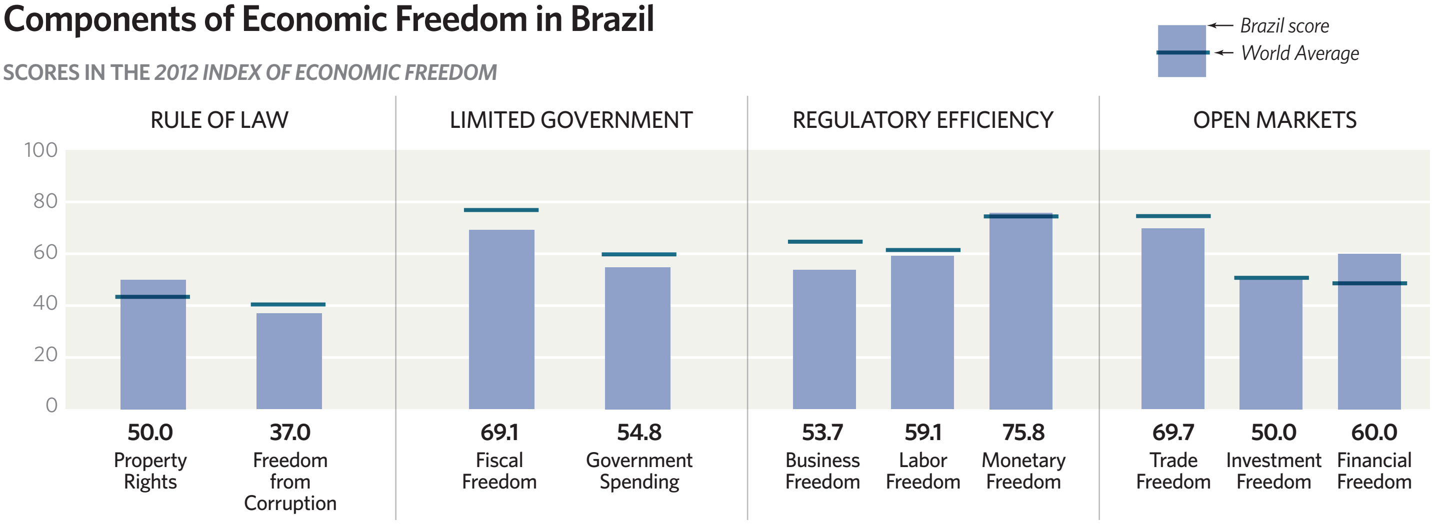
36. Ibid.

37. Ibid.

CHART 2

Components of Economic Freedom in Brazil

SCORES IN THE *2012 INDEX OF ECONOMIC FREEDOM*



Sources: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2012 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2012), at www.heritage.org/index.

SR 118 heritage.org

state tax authorities, according to Doing Business,[38] it is nowhere near the top 10 reformers in business freedom globally.

In 2011, the government of neighboring Peru made it significantly easier to start a business, obtain construction permits, register property, and trade across borders. Peru eased the process of starting a business by simplifying the requirements for operating licenses and creating an online one-stop shop for business registration.[39]

In Brazil it takes 13 procedures, 119 days, and roughly the cost of 5.4 percent of income per capita[40] to start a business. In New Zealand, it takes only one procedure and one day to start a company.[41] Even China scores slightly better—starting a business there takes 14 procedures, 38 days, and costs 3.5 percent of income.[42]

Labor Freedom. Brazil's rigid labor market is an added layer of regulatory burdens on the country's private sector that negatively impacts its ability to compete for a stellar ranking in economic freedom. Stifling labor regulations continue to undermine employment and productivity growth. Brazil's labor freedom score falls in the bottom half of the world rankings. The non-salary cost of employing a worker is high, and dismissing a redundant employee can be costly because of government-imposed regulations governing severance and dismissal. Mandated benefits amplify overall labor costs. As a result, the informal sector remains sizeable.

As *The Wall Street Journal*'s Sao Paolo correspondent Paulo Prada has reported, Brazil's "restrictive business environment" and rigid labor code date "back to the 1940s and were originally modeled on the statist policies of Mussolini."[43] The result, tragically for people in Brazil who would aspire to middle-class living standards, is that the high costs generated by these retrograde policies hinder companies from hiring new workers, thus trapping many would-be small business owners, laborers,

38. Doing Business, "Economy Rankings: Ease of Doing Business in Brazil," 2012, http://www.doingbusiness.org/rankings (accessed August 8, 2012).
39. Ibid., Doing Business, "Business Reforms in Peru," 2012, http://www.doingbusiness.org/reforms/overview/economy/peru (accessed August 16, 2012).
40. Doing Business, "Ease of Doing Business in Brazil."
41. Doing Business, "Ease of Doing Business in New Zealand," International Finance Corporation and The World Bank, 2012, http://www.doingbusiness.org/data/exploreeconomies/new-zealand/ (accessed August 8, 2012).
42. Doing Business, "Ease of Doing Business in China."
43. Paulo Prada, "For Brazil, It's Finally Tomorrow," *The Wall Street Journal*, March 29, 2010, http://online.wsj.com/article/SB10001424052748704743404575127913634823670.html (accessed August 8, 2012).

and self-employed artisans in the shadows of the informal economy. As *The Economist* reported:

> That many of the new jobs are formal (i.e., legally registered) is despite, rather than because of, the labor laws. The trend to formalization is largely a result of the greater availability of bank credit and equity capital on the one hand, and recent changes that make it easier to register micro-businesses on the other. And it coexists with two long-standing Brazilian weaknesses: high job turnover and low productivity growth.[44]

Monetary Freedom. The average rate of inflation was 5.2 percent in August 2012.[45] Prudent fiscal and monetary policies helped Brazil avoid the worst of the global financial crisis of 2008 and 2009, although its booming economy (led by strong commodity exports) ultimately may force authorities to resort to monetary tightening to reduce future inflationary pressures. Although such public services as railways, telecommunications, and electricity have been privatized, regulatory agencies oversee prices. The National Petroleum Agency fixes the wholesale price of fuel and the government controls airfares.

The fiscal system for petroleum production includes, in addition to royalties, a special participation tax (PE). This tax protects the government from underpayment by companies who discover large volumes of hydrocarbon. It has a progressive rate, ranging from 10 percent to 40 percent, depending on the volume produced, the water depth, the location of the field, the net production revenue, and the time of production.[46]

Trade Freedom. Paulo Prada neatly summarizes Brazil's trade freedom challenges thus:

> To casual observers, things will look better as Brazil gears up for hosting soccer's World Cup in 2014 and the Summer Olympics in Rio de Janeiro in 2016. New roads and airport terminals will be christened along with modernized stadiums and scenic, well-policed promenades. But manufacturers, exporters and shippers—who regularly wait days or weeks for backlogs in ports and customs facilities to clear—know Brazil needs more than just cosmetic changes.[47]

According to the World Bank, Brazil's average trade-weighted tariff rate in 2009 and 2010 was 8.7 percent.[48] Increasing reliance on non-tariff barriers and the use of anti-dumping measures is a cause for concern. In September 2011, Brazil slapped an anti-dumping tax on steel products from China, one of its closest trade partners.[49] Foreign investors are granted national treatment (the same treatment that domestic investors receive), but their activity is restricted in some sectors, including communications and mining. The banking sector emerged relatively unscathed from the global downturn, with credits to the private sector increasing. Import bans and restrictions, market access barriers in services, border taxes and fees, restrictive regulatory and licensing rules, subsidies, complex customs procedures, and problematic protection of intellectual property rights add to the cost of trade.

Investment Freedom. Despite some progress, new investment and production remains cumbersome and bureaucratic. Foreign investors are granted national treatment, but foreign investment is restricted in the communications, transportation, and mining industries. In general, Brazilian nationals must constitute at least two-thirds of all employees and receive at least two-thirds of total payroll in firms employing three or more persons. The tax and regulatory environment is burdensome, and legal disputes can be time-consuming. There are few restrictions on foreign exchange transactions. Foreign investors, upon registering their investments with the central bank, may remit dividends, capital (including capital gains), and royalties. The central bank regulates outward direct investment in some cases, including

44. "Employer, Beware," *The Economist*, March 10, 2011, http://www.economist.com/node/18332906 (accessed August 8, 2012).
45. Trading Economics, "Brazil Inflation Rate," August 2012, http://www.tradingeconomics.com/brazil/inflation-cpi (accessed August 20, 2012).
46. Monica Rebelo Rodriguez and Saul B. Suslick, "An Overview of Brazilian Petroleum Exploration Lease Auctions," *Terrae*, Vol. 6, No. 1 (2009), pp. 6–20, http://www.ige.unicamp.br/terrae/V6/PDF-N6/T-a1i.pdf (accessed August 8, 2012).
47. Prada, "For Brazil, It's Finally Tomorrow."
48. The World Bank, "Brazil: Trade-at-a-Glance Table," World Trade Indicators 2009/10, http://info.worldbank.org/etools/wti/docs/Brazil_taag.pdf (accessed August 8, 2012).
49. "Brazil Slaps Anti-Dumping Tax on Chinese Steel," Reuters, September 6, 2011, http://www.reuters.com/article/2011/09/06/brazil-china-trade-idUSN1E7851TN20110906 (accessed August 8, 2012).

transfers and remittances. Foreign investors must obtain specific authorization to purchase land along borders.

Brazil should privatize state-owned enterprises, such as Petrobras, and open Brazil to more foreign equity participation to develop its rich resources and improve its score in the *Index of Economic Freedom*. Petrobras will need significant funding in order to develop the billions of barrels of pre-salt oil and natural gas that lie beneath as many as 10 kilometers of water, rock, and salt under Brazil's South Atlantic continental shelf. "Despite its profitability and high market value," states *The Economist*, "the company lost some US$50bn in market value in January–August 2010 due to rising debt levels," although by May 2012 oil output was back up.[50] Recently, Petrobras increased its "five-year investment plan—already the world's largest corporate spending program—to $237 billion."[51]

Yet Dr. Susan Kaufman Purcell, director of the Center for Hemispheric Policy at the University of Miami, recently noted that the Brazilian government is living in 2008, not 2013, when it comes to its policies to develop these pre-salt reserves. The biggest game-changer has been the tremendous U.S.-led advances in horizontal drilling and fracking technologies to extract oil from shale, which have reduced the

> estimated cost of producing a barrel of oil from shale [to] $70… [which] is less than the cost of producing a barrel of oil from Brazil's pre-salt reserves, which some analysts have placed at over $100 per barrel.
>
> Furthermore, shale exists in abundance. The largest deposits are in the United States, whose production of crude oil has increased 15 percent since 2008, making it the world's fastest-growing oil and natural gas producer. The U.S. Energy Department projects that the daily U.S. output of oil could reach almost seven million barrels per day by 2020.
>
> Others think that it could ultimately hit 10 million barrels per day, which would place the United States in the same league as Saudi Arabia. Brazil currently produces about 2.5 million barrels per day of oil.
>
> The accessibility of oil from shale means that there will be abundant oil for years to come. This also means that world oil prices will continue to decline. Given this situation, Brazil needs to quickly begin reducing the cost of producing its pre-salt oil. Unfortunately, Brazil is going in the wrong direction, as the government continues to insist on demanding a high percentage of local content in the production of ships, drills and other assets needed to exploit its pre-salt reserves.[52]

In another sign of trouble for Brazil, new foreign investment in Brazilian equities plunged 70 percent in the first half of 2011, dragging down what had been one of the world's most attractive markets for global investors.[53] Although by December 2011 foreign investment had rebounded somewhat, a large portion of that new investment came from China Petroleum & Chemical Corp.'s purchase of a 40 percent share in Repsol, a domestic oil producer.[54]

In general, rising inflation, political interference in key sectors, and measures that slowed down credit growth have all dampened foreign investor sentiment toward Brazil's equity market, forcing some companies to put off the initial public offering (IPO) of stock despite the overall strength of the country's economy.[55]

Financial Freedom. Overall, Brazil's well-regulated and supervised banking sector withstood the global financial turmoil of 2008 relatively well, and has expanded. It has become more competitive and diversified, although the state's role remains significant. Loans to the private sector have steadily increased,

50. "Brazil: State Role in the Economy," Economist Intelligence Unit, September 1, 2010, http://country.eiu.com/article.aspx?articleid=1307475115 (accessed August 8, 2012).
51. "Petrobras Oil Output Up in May with Platforms Back," Reuters, June 27, 2012, http://www.reuters.com/article/2012/06/27/petrobras-brazil-production-idUSL2E8HR47H20120627 (accessed August 8, 2012).
52. Susan Kaufman Purcell, "Brazil Creates Its Own Economic Woes," *The Miami Herald*, August 2, 2012. http://www.miamiherald.com/2012/08/02/2928298/brazil-creates-its-own-economic.html (accessed August 17, 2012).
53. Samantha Pearson, "Foreign Investment in Brazil Market Dives 70%," *The Financial Times*, July 26, 2011.
54. Kenneth Rapoza, "Brazil at Risk of Becoming One Big Petrobras," *Forbes*, February 2, 2012.
55. James Lord, "Brazil's Equity Market Runs Risk of Overheating," *The Financial Times*, January 19, 2010.

with solid economic expansion and the formation of a new lower middle class. Public-sector commercial and development bank assets account for around 40 percent of the financial system's total assets. The two largest state-owned banks control about 25 percent of total assets, and the government directs banks to channel loans to preferred sectors. Three of the top 10 banks are now foreign-owned.

Brazil's insurance sector is now South America's largest, and the reinsurance market was opened to private-sector competition in 2008. The domestic insurance and pension-fund sectors are important institutional investors in local capital markets. The sector is expected to continue to deepen as the domestic economy expands and real incomes of the middle class rise. The operating networks of non-bank financial institutions, however, continue to be underdeveloped.

According to the World Economic Forum's 2011 "Global Competitiveness Report"[56] Brazil improved five places to rank 53rd overall due in part to having one of the world's most efficient financial markets (40th place) and one of the highest rates of technological adoption (47th place) and innovation (44th place) in Latin America and the Caribbean.

In order for the middle class in Brazil to grow, and entrepreneurs to succeed in starting and growing small and medium-sized businesses, the Brazilian government must reverse the country's inadequate mechanisms for long-term financing. "Public-sector bank assets accounted for 41.5 percent of total banking assets at end-June 2010," according to the central bank (*Banco Central do Brasil*).[57] Despite the surge in lending by state-owned banks, the private sector still lacks access to long-term financing opportunities. The average annual market rate on bank loans was 35.4 percent in July 2010, significantly higher than the subsidized long-term interest rate (TJLP) of 6 percent.[58]

Despite well-intentioned efforts, the Brazilian Development Bank (BNDES) may very well be encouraging mal-investment and distorting market signals. BNDES enjoys preferential access to lower interest rates, cheaper credit, and government backing that private banks do not. Thus BNDES—backed by the deep pockets of the government—threatens to monopolize the credit market and obstruct competition among private free-market banks. This obstruction inhibits the only effective way to ensure optimal credit allocation.[59] The rise of BNDES under Lula and Rousseff is fraught with moral hazard, not unlike the one in the United States involving U.S. government-sponsored enterprises (GSE) and mortgage industry heavyweights Fannie Mae and Freddie Mac.

Conclusion

Brazil's progress the past two decades led Goldman Sachs's Jim O'Neill—10 years after including Brazil in his "BRICs" formulation in 2001—to conclude that his "big, bold bet" to include Brazil in the BRICs had been vindicated.[60] Brazilians were finally going to shake off their old habits and turn their country into a world-class power.

Notwithstanding O'Neill's cheery assessment in 2011, however, there have been numerous negative developments since Dilma Rousseff took the reins from Lula that same year. Stalling economic growth, higher inflation, growing regulation, and possible moves toward renationalization of some key sectors of the economy (such as mining and energy production), as well as numerous government corruption scandals, are raising old questions. Is Brazil back sliding? Can Brazil ever permanently escape from its perennial trap of high inflation, due in part to the Dutch disease of overdependence on commodity exports? Is Brazil fated to be the perennial "country of the future?" As O'Neill himself notes, "If we look back 100 years, the majority of the successful world economies were not tied to commodities."[61]

Brazil needs to shake itself loose from its dependence on exporting commodities to China, no matter what happens with the PRC's own economic development. China's current statist model should not

56. World Economic Forum, "The Global Competitiveness Report 2011–2012: Country Profile Highlights," http://www3.weforum.org/docs/WEF_GCR_CountryProfilHighlights_2011-12.pdf (accessed August 8, 2012).
57. "Brazil: Trade Patterns and Regulations," Economist Intelligence Unit, September 1, 2011.
58. Ibid.
59. Alexandre Marinis, "Banks Gone Wild in Brazil Distorts Market," Bloomberg, August 18, 2010, http://www.bloomberg.com/news/2010-08-19/bank-gone-wild-in-brazil-distorts-market-alexandre-marinis.html (accessed July 3, 2012).
60. Jim O'Neill, *The Growth Map: Economic Opportunity in the BRIC and Beyond* (New York: Portfolio, 2011).
61. Vinicius Medeiros, "Interview: Jim O'Neill," *Petrobras Magazine*, 2011, http://www.petrobras.com/en/magazine/post/interview-jim-o-neill.htm (accessed August 8, 2012).

be emulated—it is China's earlier market-reform era that should be emulated. President Rousseff's government should implement the necessary structural reforms to spur growth in non-commodity sectors by further privatization (especially in infrastructure) and by eliminating barriers to entrepreneurial activity, burdensome taxes, inefficient regulation, flaws in long-term financing, and rigidities in the labor market.

The Heritage Foundation
LEADERSHIP FOR AMERICA

214 Massachusetts Avenue, NE
Washington, DC 20002

(202) 546-4400
heritage.org