

Foreign Direct Investment in Brazil: regulation, flows and contribution to development

Pedro da Motta Veiga

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1. Introduction

Over the last few decades, foreign direct investments (FDI) have played a very relevant role in Brazilian industrialization, attracted especially by the large domestic market – but also by government policies – and directed preferentially towards capital and technology-intensive industrial (and more recently services) sectors. The FDI regime in Brazil has been fairly liberal during this period and foreign capital is viewed with sympathy by the large majority of political currents and parties, who see it as a source of employment and modernization of the economy. Section 2 presents the background and emphasizes the recent evolution of the investments regime in Brazil and the policies applied to FDIs.

In the 90s, the FDI inflows to Brazil showed the tendency to diversify in terms of the countries of origin and the sectors targeted by such investments. In this same period, some nationally-owned companies broadened their investments overseas. Brazil, however, is still a substantial recipient of FDIs while a very modest foreign investor itself, as can be deduced from the elements that make up section 3.

Although one of the main recipients of FDI among developing countries, Brazil does not have any non-multilateral investment agreement in effect. Its sole commitments in this area are the GATS and the TRIMs Agreement. Bilateral investments agreements signed during the 90s were not ratified by Congress. The political consensus in favor of FDI have as counterpart a considerably widespread critical view of ambitious investment agreements. Section 4 analyzes

Brazil's participation in the network of investment agreements and seeks to explain the rationale of the Brazilian position vis-à-vis such agreements.

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The FDI share of the country's investments, production and foreign trade grew over the last decade, which ended with a debate on the FDI contribution to development and on the costs and benefits of the growing weight of transnational companies (TNCs) in the economy. While this debate does not actually damage the political consensus that is favorable to FDI, it nonetheless constitutes a novelty that deserves attention: it is understood that the FDI contribution to the development of Brazil could have been all the greater if public policies had been able to maximize the benefits this brought to the economy. One element missing from this debate, however, is the dimension of environmentally and socially sustainable development, which only lately has become the focus of some attention. These are the matters dealt with in section 5.

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What sort of policies and international agreements can help to increase the FDI contribution to Brazil's development? This is the question that guides the recommendations presented in section 6 of this paper.

2. The investment regime and regulation of FDI in Brazil

2.1. From import substitution to economic liberalization in the 90s

For the standards of the period in which industrialization was in most developing countries (including Brazil) assimilated to import substitution (IS), Brazil had a regime to regulate the flows of FDI that was not at all discriminatory. In contrast with the widespread tariff and non-tariff restrictions on imports, the investments regime presented a few "horizontal" reservations (that is, valid for all sectors) and conventional sectoral restrictions consistent with the model that was dominant at the time. This regulatory contrast nevertheless was highly functional from the point of view of the model of development: the large, dynamic domestic market protected by all sorts of trade barriers was the main factor that attracted the flows of FDI to Brazil. Since the very start, foreign investments in the country were regulated by a

logic of market-seeking, the profitability of the investment being guaranteed by the protectionist trade policy.

In addition to being relatively liberal, the Brazilian investment regime in effect during the IS period was notable for its stability, being regulated by constitutional rules and by a basic Law (Law number 4.131) from the early 60s. The stability of the liberal nature of the legislation was preserved despite the significant political changes that characterized Brazil between the 60s and the 80s.

The chief purpose of the regulatory mechanisms set down in Law 4.131 – exchange controls, tax regime, and so forth – was to discourage the outflow of the foreign capital already invested in the country and stimulate re-investment (Laplaine and Sarti, 1999). The constraints on inflow involved specific sectors of industry (such as mining), but they were especially relevant and long-lasting in the area of services. In the case of the manufacturing sectors, the inflow of foreign investments faced virtually no absolute limitations, and in certain sectors that the government held to be strategic, FDI inflows were submitted to certain conditionalities, such as requirements to associating with Brazilian companies or transferring technology.

The Constitution of 1988 reinforced the restrictions in effect up to then by introducing in Article 171 the legal distinction between a “Brazilian company of national capital” and a “Brazilian company of foreign capital”, which created the legal base for discriminating between the two types of company in terms of regulation and policy. The Constitution also maintained the state monopolies in the oil and gas sectors, and in telecommunications and postal services, as well as reserving for “Brazilian companies of national capital” the exploitation of mineral and water resources, coastal navigation, domestic air transportation, and media activities. Restrictions on the activity of foreign companies in sectors that provide financial and insurance services were likewise maintained. The Constitution did not alter the most restrictive sectoral regulation to foreign capital in Brazil, namely the Law on Information Technology adopted in 1984 and which reserved the domestic production of hardware equipment to companies of national capital.

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- Nonetheless, the liberalizing reforms that were the feature of the 90s reverted the movement outlined in the Constitution of 1988: in 1991, restrictions on the entry and operation of foreign companies in the information-technology sector were lifted, some mechanisms restricting the outflow of capital were removed, financial flows were partially liberalized, and a series of amendments to the Constitution (mostly adopted between 1995 and 1996) did away with the constitutional distinction between national and foreign companies, as well as the state monopoly in telecommunications and in oil and gas.
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- As a matter of fact, the main change that took place in the 90s involved the investment regime as such, and not specifically the regime applicable to FDI. The change to the investments regime in general implied “opening up” to private investments sectors that had until then been reserved to state investment, such as sectors providing public services. This change, together with the elimination of the constitutional discrimination provided for until then in Article 171, enabled foreign companies to participate in the privatization processes, bidding for public-services concessions, and so on.
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- As for policies and measures designed directly to attract and foster FDI, some institutional initiatives were taken. In the late 90s, Brazil’s Central Bank simplified the process of registration required for FDI inflows, reducing the administrative costs of entry of such flows. In the mid-90s a system to promote investments and the transfer of technology – SIPRI was set inside the Minister of Foreign Affairs. Moreover, an agency was set up in 2002 to promote investments – *Investe Brasil* – based on a partnership between the federal government and horizontal and sectoral business entities. Setting up the agency was based on a diagnosis and proposal formulated by FIAS, which, among other things, recommended that the agency should engage exclusively in promoting investments and let another agency take care of promoting exports. The agency’s sectoral priorities are infrastructure (transport and energy), tourism and agribusiness, while its services include mobilizing a network of governmental entities to support potential investors, as well as providing information on opportunities, regulations, incentives and other factors relevant to the foreign company’s decisions to invest in Brazil.
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- Another important change in the general investments regime throughout the 90s entailed the growing weight gained by horizontal-type policies¹ to stimulate investments and production and geared towards increasing competitiveness and exports, in opposition to the sectoral policies and measures that had practically monopolized the governmental efforts to promote investments up to the 80s.

This growing “horizontalization” of industrial and foreign-trade policies went beyond the official discourses and the setting up of explicit objectives, translating into a clear re-directing of budget incentives and subsidies, which migrated from the traditional incentives meant for specific industries to general incentives based on exemption from indirect taxation, and to “horizontal” public mechanisms for financing investment and exports (SPE/MF, 2000).

But the increasing weight of horizontal policies – which was seen too in a greater emphasis on policies to support PME and on policies to lower the “Brazil Cost” – did not mean abandoning the “sectoral axis” of policies. On the contrary, in the second half of the decade they regained strength through regimes that granted privileged treatment to investments and foreign trade of some specific sectors.

A wide variety of instruments was mobilized: the auto industry as the target of a sectoral regime of investments and foreign trade based on traditional mechanisms as tariff protection and tax exemption. The Law of Information Technology was reviewed as to its discriminatory aspects against FDI and tax exemption was granted for the manufacture of information-technology and telecommunications equipment, provided that companies allocated at least 5% of their revenue to R&D activities. The legislation applied to the Free Zone of Manaus, which benefits mainly the manufacturers of electronic consumer goods, was updated to also require the 5% minimum application to R&D activities. In the textile sector, the governmental policy combined defining favorable conditions of public financing for investments with the adoption of specific trade measures to protect domestic producers against imports.

- But the “sectoral axis” of the investments policies was also reinvigorated through the processes of reviewing the regulatory framework of the services sectors providing infrastructure and the

¹ Investment policies which impact all sectors and which are not tailored to specific sectors.

production of oil and gas. This process gave rise to a new form of sectoral policy – a “regulatory” one - quite different from the ones mentioned earlier, largely based on the traditional mechanisms of industrial policy (subsidies and trade protection).

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- - The auto industry regime
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The auto industry incentives regime has been presented as part of the governmental strategy to reduce the disequilibrium of the sector's trade balance from 1995 on. However, the idea of a regime for the auto industry -- imports of inputs and capital goods at reduced tariffs compensated by exports -- arose long before the avalanche of car imports and the Mexico crisis, in other words, long before the appearance of any threat to the trade balance stemming from a sectoral deficit of the industry.

In 1995, the Mexican crisis and growing trade deficits led the Government to, first, increase import tariffs on automobiles to 70%, and later, impose import quotas. The government ended up eliminating the import quotas after consultations held at the WTO. The idea of a special imports and exports regime reappeared, but now with greater stimulus to investments and with the possibility, for companies installed in Brazil or with investment projects, to import finished vehicles at a reduced tariff, given the high tariffs in force.

The regime adopted in 1996 sparked off a series of conflicts with the Mercosul neighbour and generated diverse contestations in the WTO by several countries and regional groups from the OECD (United States, European Union, Japan and Korea), all vehicle exporters to Brazil. In the case of these countries, Brazil introduced some alterations in the regime, accommodating to the diverse pressures. In the case of Argentina, a programme was defined for the elaboration of a sole Automobile Regime in the Mercosul. Tariffs on finished vehicles have gradually been reduced, standing today at 35%, the highest nominal level in the Brazilian tariff structure.

- The Auto Regime consists essentially of a reduction in import taxes on capital goods, raw materials and finished vehicles for companies investing in the production of autos, light vehicles, trucks, buses, tractors, bodies, breakdown trucks, parts, accessories, components, kits and subkits and tires in Brazil. Additional incentives were created for the companies located in

the North, Northeast and Mid-West, considered to be Brazil's lesser developed areas. The Regime was valid until 31/12/99 in the South and Southeast and applies until 2010 in the North, Northeast and Mid-West States.

Alongside the implementation of the Federal Auto Regime, several sub-national governments adopted a pro-active stance to attract the investments announced by the auto companies from 1995 on. This competition to attract FDI was referred to as the “fiscal war”, as it relied largely on the offer of a "package" combining fiscal and financial incentives as well as the offer, at subsidized conditions, of public investments in the infra-structure specifically required by the project to be attracted.

- As a result of this competition, "bidding wars" of incentives became a reality, between States as well as between municipalities. For instance, the contract negotiated between Volkswagen and the State of Rio de Janeiro in 1995, foresees the granting of fiscal benefits for a period of five years. In the agreements made between the State of Rio Grande do Sul and GM in 1997, the terms of validity of the incentives is apparently greater than thirty years. There is also some evidence that the “bidding war” of incentives tends to extend to the fields of regulatory derogations targeted at removing obstacles to the new investments, stemming from State laws or norms -- or which depend upon the State for their enforcement -- and considered too rigid by companies.

- **The sectoral investment regimes for infrastructure services**

The macro-economic difficulties experienced by Brazil as of the early 80s caused a drastic reduction in infrastructure investments, which until the mid-90s were almost exclusively the responsibility of the public sector. The subsequent deterioration of infrastructure came at a time when these sectors were going through a radical transformation of the technology, regulation and organizational models of management and operation all over the world.

In an effort to overcome this situation, throughout the 90s the regulatory model applicable to the various sectors of infrastructure was drastically revised. From 1995 onwards, the initiatives of the federal government in this respect involved extending the privatization program to

infrastructure services, editing the Law of Concessions and the constitutional amendments suppressing several state monopolies in the oil industry, telecommunications and distribution of gas. In addition, the institutional model of regulation applying to the provision of public utilities underwent a profound change, with the setting up of sectoral regulatory agencies endowed with financial and operational autonomy and the edition of specific legislation for each one of the sectors earmarked for reform.

Almost a decade after the start of the process of re-regulating the provision of infrastructure services, the results of these initiatives are evaluated as uneven, according to the sector, even if they can be considered to be globally positive in terms of attracting investments, expanding domestic supply and intensifying competition.

The Brazilian telecommunications sector is usually held to be a successful example of the privatization program in view of the performance of the privatized companies as far as the quality and quantity of services are concerned. This sector attracted the largest amount of FDI between 1998 and 2001 and brought to Brazil various international players (newcomer investors). Moreover, some large Brazilian business groups included telecommunications in their growth strategies and became shareholders in the companies that emerged from the process of re-structuring and privatization.

The success of the process is attributed to the existence of an enormous unattended demand both for cellular and fixed telephony, as well as the fact that the strategy was rigorously designed to increase the profitability of investments and at the same time acted as a powerful incentive to competition among the privatized companies. It was especially in the case of fixed telephony that the regulation of the sectoral agency set up in the 90s had important effects on inducing expansion of investments. First of all, the investments were protected by a transitory market reserve - like a duopoly - which ensured that the companies that bought parts of the state holding company and the new entrants would enjoy reasonable conditions of profitability and time to plan their expansion. Secondly - and more importantly - the agency's goals to universalize the network combined penalties and premiums, and meeting these goals was a prerequisite for the future expansion of the companies set up, according to the calendar of progressive liberalization of competition among service providers. Those goals were an

important incentive for private companies providing fixed-telephony services to make new investments in a short space of time.

Although the regulatory reform scored a success as regards its direct objectives, nevertheless it did provoke mixed impacts on the base of local suppliers of telecommunications equipment and software. On the one hand, the complex that manufactured telecommunications equipment grew rapidly in Brazil², with the growth in demand in the wake of the regulatory reform, so that at the end of the decade practically all the relevant actors in the world market of telecommunications equipment were installed in the country. On the other hand, however, the insertion of large international operators in the domestic market (via privatization) seems to have lent great impulse to imports of goods and services provided by foreign suppliers, who often hold long-standing relations with newcomers to the Brazilian market. The growth of the trade deficit in this segment in the second half of the 90s attests the increasing relevance of imports of telecommunications equipment to satisfying the needs of public-service concessionaires.

If telecommunications is a good example of reform of a sectoral investment regime that met with success its objectives of attracting investments (including foreign investments), and expanding the domestic supply of infrastructure services, electrical power is a recurrent example of inconclusive and unsuccessful reform. The shortage of power registered in 2001 is presented as the most eloquent result of the failure of the transition between regulatory regimes in this sector.

At the root of this situation is the fact that “public investor logic had been abandoned and market logic did not have the means to function” (Bielschowsky, 2002), thus relegating companies’ investment decisions to the “limbo” that has prevailed until now.

In the pre-reform phase, State investments were greatly reduced without the conditions being available for private investments to quicken up. The latter did not grow due to the uncertainty of the operation of a long-term market for the power generated – which precluded structuring

² In fact, the revenue of this segment practically doubled between 1995 and 2001 and several new investments were made in the country by transnational corporations.

long-term financing operations based on project finance – and also due to the prospect of privatization, which recommended potential private investors to await the privatization auctions of the state generating companies instead of investing in new plants. Furthermore, the sectoral regulating agency was set up and began to operate without the guidelines of sectoral policy being defined, in contrast to what happened in the telecommunications sector.

The privatizations that took place in this situation attracted significant amounts of foreign investments but were unable to generate sufficient investments to expand capacity – investments that were urgently needed, given that the scarcity of electric power was already noticeable before the reforms.

The energy crisis of 2001 made these problems very clear to the public and produced an emergency program to reduce consumption of electric energy all over the country. More recently, some private investors (including foreigners) who bought state companies in the second half of the 90s have been beset by financial difficulties. Moreover, the process of privatization of the sector and the autonomy of the regulatory agency are being more and more challenged because of the real rise in prices of electricity charged to the consumers, which in large measure is the result of indexing tariffs to price indexes sensitive to exchange-rate variations (essentially indexes based on the real-dollar parity).

2.2. A synthesis of the present situation

The 90s were years of significant changes in the investment regime in Brazil, which opened up more space for private investment, whereas the policies to foster public investment grew more horizontal and less discriminatory among sectors. Specifically with regard to the treatment offered to FDI, there was a reversal of the anti-FDI movement begun by initiatives adopted in the 80s, thus allowing foreign investors full access to the sectors newly opened to private investment. The regulation in place ensures the FDI access to the market and practically unrestricted national treatment in the area of goods, while maintaining some significant constraints as regards both market access and national treatment in service sectors.

The main regulations concerning sectoral investments adopted in the 90s bore a particularly

strong impact on foreign investments insofar as they applied to the auto sector (which was totally controlled by transnational companies), the sectors of information technology and electronic and telecommunications equipment, and suppliers of infrastructure (plus oil), which became the principal recipients of the investments of the major foreign newcomers at the end of the decade. Both in the case of the auto industry regime and the rules applied as of 2003 to the concession of areas for investments in oil exploration and production, certain provisions classifiable as TRIMs (in the light of the WTO Agreement) - such as requirements concerning trade balance (in the case of the auto industry regime) and national content (in both cases) – condition the obtaining of benefits or market access.

None of the liberalizing measures introduced to the Brazilian regime on FDI in the 90s was suspended under the new government in charge since January 2003, although the institutional framework in which national and foreign investors operate in infrastructure sectors has become weakened, on account of the political pressure of the sectoral Ministries against the autonomy of the so-called regulatory agencies. Since a large portion of FDI in the second half of the 90s was addressed to these sectors, the impacts of a possible increase of the “regulatory risk” associated with these investments can be especially felt on foreign investments.

- On the other hand, the new government seems more willing to use performance requirements as counterpart for market access or as a condition to enable to the access to a public benefit. Requirements of national content applied to goods and services to be purchased by firms (national or foreign ones) investing in oil have been included in the Fifth Bidding Round for the Concession of Areas for exploitation and production of oil, promoted by the government agency in charge of the regulation of the sector of gas and oil (ANP – Agência Nacional do Petróleo)³. Brazil’s position in the WTO – favorable to making TRIMs Agreement more flexible when applied to developing countries – sanctions this domestic orientation.

- In the last few years, it seems that environmental policies and regulations, in general set up during the Eighties, growingly affected investment-related decisions from firms, especially in

³ It is very difficult to map out the performance requirements applied by Brazil to investors (domestic and/or foreign ones). It is well known that TRIMs prohibited under the WTO agreement have been largely used by the Auto Regime. In some cases, performance requirements are not set by Law, but through administrative

sectors intensive in the use of natural resources. Problems related to the enforcement of such regulations are now widely perceived in Brazil as a factor negatively affecting investment-related decisions. However, as FDI flows to Brazil only secondarily target these sectors and environmental polices and regulations do not discriminate against foreign firms, their impact on FDI should not be overstated.

Brazilian policy towards the environment was implemented in the early Eighties and was essentially based on command and control instruments, among which the concession of environmental licences conditioned to the approval by the government of the study on environmental impacts required from firms interested in investing in activities considered as actually or potentially polluting or identified as able to cause environmental degradation⁴.

Since the mid-Nineties, federal banks financing investments also internalized in their operational routines the environmental dimension: firms applying for such financing – the only one available for investment in the domestic credit market – must comply with environmental regulations and issue a study on the environmental impacts arising from their investment.

Many institutions pertaining at different governmental levels interfere in the setting and the implementation of environmental policies and regulations. At the federal level, the main guidelines and policies are set and one agency is responsible for the enforcement of the national law. Sub-national governments have their own regulations and institutions for applying them: the degree of enforcement of national and sub-national regulations depends heavily on the institutional capabilities of these local agencies, which implies that environmental policies are applied unevenly and following different criteria, depending on the

instruments issued by regulatory agencies and federal banks. BNDES finances the buying of capital goods in Brazil through FINAME lines of credit if the goods have at least a 60% national content.

⁴ Until the early Nineties, the problems of deforestation caused by the implantation of cattle- breeding, forest exploitation projects and mineral production hubs, as well as huge hydroelectric projects in the Amazon region, attracted the attention and concern of local and international environmental agencies. However, economic and regulatory changes in Brazil and worldwide have been diversifying the focus of concern over the trade-off between economic growth versus environmental preservation. In this scenario, a new field of preoccupation, studies and negotiations is created around the pattern of economic use of environmental resources by Brazilian industry and the consequences of this pattern on its present and future competitiveness. Some studies made in the early Nineties spotlight the high participation of industrial sources in the emission of organic matter and heavy metals in Brazil (60% and almost 100% respectively) and the agenda of the industry became increasingly connected with the environmental policy one.

State or region of Brazil.

Institutional and regulatory problems in the area of environment have become more explicit in the last years: long delays for the concession, by Government agencies, of environmental licenses have been often blamed as responsible for blocking many productive investments. An official document of Brazilian Industry Confederation (CNI, 2002) stresses that the “main challenge to the environmental policy in Brazil is to guarantee, at the same time, improving standards of environmental quality and conservation and an efficient regulatory system, one that does not imply uncertainties, increased risk and the blocking of decisions on investment”⁵. In the last months, criticisms against the misenforcement of domestic environmental laws have been voiced by large firms’ CEOs, who stressed the negative impacts of the licencing mechanism – as it is used in Brazil – on their decisions related to new investments.

In short, although domestic environmental regulations has been an important factor pushing firms towards more sustainable productions patterns, the (bad) quality of the enforcement of these policies seems to have recently begun to impact in a negative way investment-related decisions from large firms, specially those concentrated on natural resources-based activities.

The impacts on investment-related decisions arising from the problems in the enforcement of environmental regulations point to two broader issues which currently affect the “investment climate” – not specifically the climate for FDI - in Brazil. The first one has to do with the administrative process involving the authorization to make the investment: the process can be lengthy and costly to the firms, some of which have recently decided to postpone announced investments due to the administrative obstacles faced in the process of approving them. The main criticism made by investors was directed to the long delays for the concession, by Government agencies, of environmental licenses required to initiate the investment.

The second issue involves the functioning of the legal and judicial system in Brazil as it applies to investments and especially to the dispute settlement involving the State and the

⁵ CNI blames the diversity of legislations, regulations and technical standards and the misuse of command and control instruments by the governmental agencies, specially the licencing one – in contrast with the scarce use of economic and cooperation-based tools – as the main factors that shape a climate business-unfriendly in this field of policy.

private investors. Broadly speaking, the judicial system in Brazil is widely recognized as inefficient and costly. Slowness is seen among businessmen as the main problem of the judicial system, which is also characterized by a strong heterogeneity (according to the states and the regions of the country⁶) and by a high degree of “politization”.

Beside that, when the investments require the setting of some kind of contract between the investor, on the one side, and the State, on the other (as in the contracts for the concession of public utilities), the legislation on the dispute-settlement mechanisms available is ambiguous and varies widely according to specific laws. In addition, there is a strong legal debate on the use of the arbitration in contracts involving public entities, although Brazil has adopted an Arbitration Law in 1997, considered to follow international standards, and has, since then, ratified the New York Convention.

While the problems in the judicial system affect equally domestic and foreign investment, the dispute-settlement issue impacts strongly FDI as recent flows have concentrated in public utilities sectors regulated by the Law of Concessions and specific sectoral regulations. In the case of this latter issue, the problem for investors is especially acute as the production in this area requires “specific investments and assets” (Castelar, 2000) and is regulated through long term contracts, both features raising the regulatory and political risks of the investment and indicating the need (i) of laws that restrain the ability of the State to change the rules set in the contracts and (ii) of an independent and efficient judicial system⁷.

As the Brazilian judicial system is not efficient and is unevenly independent, foreign investors – and their lawyers – are pushing for the legal adoption of the arbitration as a valid dispute-settling mechanism in the contracts involving the State or a public entity.

So far, “there is no criteria uniformity in terms of dispute-settlement in the various laws which regulate issues referring to the public sector” (Pucci, 2004). The obligation to include the

⁶ In many states, tribunals are less independent from the government and / or from the powerful local groups than in others (Castelar, 2000).

⁷ As far as the relationship between the State and the firms are concerned, an empirical study with private firms in Brazil showed that problems were identified in the level of protection guaranteed to the firms against the State, the non-application of judicial decisions against the State and the existence of a judiciary bias towards protecting the “weakest part” (which is never the investor) in a litigation (Castelar, 2000).

conciliation and international arbitration in the contract for the exploitation and the production of oil is set explicitly in the so-called Oil Law (1996). In the case of the Telecommunications Law, the fora and the modality for the extra-judicial solution of divergences referred to the contract of concession must be indicated by the contract itself. The original project to regulate the Public-Private Partnerships⁸ – the institutional model preferred by the new government to attract private capital to finance and operate public utilities - provides for the adoption of the arbitration for the settlement of disputes arising from the execution of the contracts signed under the PPP legislation. However, at the same time, a project of constitutional amendment (also being discussed in the Congress) forbids the use of the arbitration for contracts signed by the public entities.

3. Brazil and FDI flows

- 3.1. FDI inflows to Brazil

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- FDI began to gain importance in Brazil in the late 19th century, especially through British investments in services directly related to exports activities such as railroad and sea transportation, financial services and commercialization. Foreign investments in urban infrastructure services (transportation, energy, and so on) gained strength in the first decades of the 20th century, driven by growing urbanization and industrialization. Later on, provision of a great deal of public services was taken over by the State, through a unilateral decision of governments or negotiations with the foreign investors.

In the case of the manufacturing sectors, only after the Second World War do FDI began to gain prominence. This is when their functionality for the industrialization strategy in a country with low rates of savings becomes obvious and “the combination of a liberal policy with regard to foreign capital and protection for the domestic market through high tariff and non-tariff barriers on imports stimulated the flow of FDI to industry” (IEDI, 2003).

- The FDI in the manufacturing sectors sought access to the internal market especially in sectors that produced durable consumer goods, mechanical and electric equipment. From the late 60s

⁸ Project currently being analyzed by the Congress.

on, the transnational companies increased their investments in these “non-traditional” sectors, maintaining a share of close to 50% in the total capital of the manufacturing industry (Chudnovsky, 1999). The share of foreign capital was particularly high in the industrial sectors that were more capital and technology-intensive (transportation equipment, electrical and mechanical equipment, plastics, rubber and pharmaceuticals). In 1975 the transnationals accounted for 42% of the sales of the 500 leading Brazilian companies and operated with higher levels of productivity and more modern technologies than the average nationally-owned companies. As of the second half of the 70s, under the State policy of fostering the creation of joint ventures with private and state-owned Brazilian companies, FDI participated in large investment projects in intermediate-goods sectors (notably chemical and petrochemical) as well as capital goods.

- Benefited by a high degree of trade protection, the transnational companies made a contribution to consolidating, in Brazil of the IS days, “inefficient market structures where the number of firms was too large to allow competitive scales, yet too small to guarantee a competitive environment. This phenomenon was relevant to all the categories of use, but in particular to durable consumer goods (autos and electronics) and capital goods” (Moreira, 1999). Besides favoring operations under non-competitive scales of production and consolidating highly concentrated market structures, protection also induced a high degree of vertical integration among transnational companies – partially as a consequence of governmental requirements as to the level of nationalization – preventing them from benefiting from specialization gains. As a result of this set of distortions, up to the 70s the transnational companies based in Brazil acted as stand-alone affiliates and had scant connections with international trade and with the other associates operating in other countries.
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- The reduction of the economy’s anti-export bias in the late 60s through an exchange policy that was more favorable to exports and the implementation of an aggressive scheme of tax and credit incentives for exporters, led the transnational companies to deeper involvement with foreign trade via exports. These companies contributed heavily to the process of diversification of Brazil’s exports and above all to the dynamism registered in the 70s in exports of manufactured goods. They also became relevant users of the incentives and

subsidies to exports: in 1978 they accounted for 37% of exported manufactured products and absorbed 42% of the tax incentives.

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The crisis of the 80s practically wiped Brazil off the FDI map. On average, the annual net inflow of FDI to the country dropped from US\$ 2.3 billion in the 1971-81 period to a mere US\$ 357 million between 1982 and 1991. In the 80s, the transnationals adopted a “waiting position, without expanding their activities but also without implementing a more aggressive strategy of disinvestment, given the stock of past investment, the size of the internal market and the possibility of continuing to guarantee their profitability by raising the profit margin and by means of financial investments” (IEDI, 2003). This strategy was made feasible by two “inheritances” from IS, namely the dominant position occupied by the transnationals in their sectoral markets in Brazil and the high levels of trade protection (which were even reinforced after the exchange crisis in the early 80s). Exports too gained prominence in the strategy of these companies during the 80s as a result not only of the stagnation of the domestic market but also of the commitments made by the companies in the framework of the Befiex Program⁹.

The 90s, especially from the middle of the decade on, marks Brazil’s return to a relevant destination of FDI among developing countries. Between 1990 and 1995, Brazil received about US\$ 2 billion a year in FDI, which corresponded to 0.9% of the world flows of FDI and to 2.7% of the flows directed towards developing countries. In 1996 the FDI meant for Brazil multiplied by five in relation to the annual average for the first half of the decade. In 1998 the FDI flows totaled US\$ 28.9 billion, that is, 4.2% of the world flows of FDI and 15.4% of the flows sent to developing countries. These shares fell from that point on, but the flow in the direction of Brazil went on growing until 2000, when the total reached US\$ 32.8 billion. From then onwards, the inflow of FDI bound for Brazil fell. Even so, in 2001 the flows heading for Brazil (US\$ 21 billion) amounted to 3% of the world total and 11% of the FDI received by the developing countries.

⁹ This program, set up in 1972, was designed to stimulate the expansion of export capacity of manufactured goods, but it required that the beneficiary companies maintain a positive net balance of foreign currency. The principal benefit ensured by the Program was exemption from import tariffs, and the main beneficiaries of BEFIEEX were companies in the sector of

Various factors contributed to the FDI boom in the 90s. In the first place, in the middle of the decade, macro-economic stabilization caused a strong growth in domestic demand, which attracted new transnational companies as well as new investments from already established TNCs.

Secondly, the unilateral trade liberalization brought about in the beginning of the period led companies to increase investments in order to face an environment that was less protected and more competitive. It should be remembered that Brazilian trade liberalization was limited, especially in the industrial sectors preferred by FDI, which maintained high import levels.

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A third factor was that for some industrial sectors the consolidation of Mercosur as an amplified domestic market lent incentive to new investments. Although Mercosur as a source of dynamization of FDI flows can only be considered as a protagonist in the case of the auto sector, the consolidation of the regional bloc played an important secondary role in this process in several other sectors and even generated some impact on the FDI outflows from Brazil to its neighbour countries.

In the fourth place, the regulatory updating carried out by the government - privatizations, concessions, suppression of public monopolies, among others – affected principally the sectors of public services by opening them to private investments, including foreign investments. In the late 90s, privatizations accounted for about 31% of the FDI flows directed towards Brazil.

The fifth factor is that some sectoral regimes for promoting industrial investments – such as the auto regime and the new version of the Information-Technology Law – worked to attract important flows of direct investments in the manufacturing industry.

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According to data for 1995 on the stock of FDI, this was concentrated (64.7% of the total) in industry, where five large sectors absorbed an impressive portion of the investments: electrical and mechanical machines and equipment (16.3% of the total FDI), autos and auto parts (13.1%), the base chemical industry (9.5%), the metals industry (6.1%) and foods (4.5%)

transportation goods (chiefly the auto sector), in addition to paper, metallurgy, electric appliances and electronic equipment, etc.

accounted for 50% of foreign investments in the country and for 68.7% of the foreign investments in the manufacturing sectors. The United States consolidated itself over the years as Brazil's leading investor, accounting in 1995 for 28% of the total stock of FDI, followed by Germany (10.8%), Japan (9.6%) and Switzerland (6.6%). The whole of the European Union, however, accounts for about one third of the total stock. As in the case of foreign trade, with FDI Brazil holds a portfolio of diversified interests in geographical terms.

In respect to this past pattern, the flows of FDI earmarked for Brazil in the second half of the 90s introduced some important changes, the biggest one being the new sectoral composition of FDI: in fact, services became the main destination of the flows. In addition, countries that had a marginal participation as origin of the flows directed towards Brazil gain prominence in the period. Actually, at least five trends should be taken into account in analyzing the FDI flows triggered by Brazil's return to the "map" of international investors, in the second half of the 90s:

- Between 1996 and 2000, 90.3% of the investments received by Brazil went to the services sector, the bulk going to telecommunications, energy and financial services, on account of the privatization programs that involved the first two sectors and the process of restructuring of the financial sector. In contrast with the data for stock accumulated up to 1995, when it accounted for 66.9% of the total, between 1996 and 2000, the manufacturing sectors received only 18% of the total flows that entered Brazil. As of 2001, the smaller number of privatizations causes a decrease in the participation of the services sector in FDI flows, but these remain majority up to the end of 2002 (56% that year). In counterpart, there is an increase in the weight of the manufacturing sector, with 33.3% in 2001 and 40.6% in 2002, while there is also significant growth in FDI in mining sectors as a result of investments in oil and gas. FDI in the agricultural sectors was never relevant in Brazil: in december 1995, FDI in agriculture, cattle and mining activities other than oil represented 2% of the total FDI stock in Brazil. In december 2000, such participation had been reduced even further to 1,3%.
- Within industry, the auto sector has enjoyed more participation in recent flows. Between 1996 and 2000, this sector received 25.6% of the flows directed to the manufacturing

sector (against 17.3% of the stock in 1995). There was an increase too in the participation of the chemical and electro-electronic sectors, and food and beverages, whereas there was a drop in participation of basic metallurgy, mechanics, rubber and plastics and electrical appliances;

- The new investments show a relatively low propensity to exports, due to the fact that investments in public services constituted an important and growing (at least until 2001) portion of total FDI, and the average propensity to export associated with these investments is low. Besides this, FDI in industry have gone towards the same sectors traditionally dominated by the transnationals in the Brazilian economy, and such sectors are not net exporters. On the other hand, both in the case of services and industry, the FDI have generated new flows of imports of industrial goods, thereby increasing significantly the trade deficits of some sectors.
- The United States has maintained its rank as leading investor country in Brazil, corresponding to 26% of the total flows received by Brazil between 1996 and 2000. Some European countries increased their participation significantly, such as Spain (16.2%), Holland (10.1%) and Portugal (6.8%) – while Germany, the United Kingdom, Canada and Japan lost considerable weight as countries of origin of international investments received by Brazil¹⁰. The participation of Spain and Portugal in the recent cycle of FDI was especially important in the segments of telecommunications and financial services.
- The recent flows of FDI involve both newcomers who entered the domestic market via privatizations and through other modalities, and transnational companies already installed in Brazil. Although there are no systematic data on this, there are sure indications that mergers and takeovers, without immediate addition of capacity, represented a significant portion of the new investments, if only because of the weight of the privatization processes of state-owned companies as a factor to attract foreign investments in the 90s.

¹⁰ Germany, which held 14% of the stock of FDI in Brazil in 1995, accounted for only 1.8% of the flows between 1996 and 2000.

- In 2003 the flows of FDI to Brazil suffered a sharp reduction, falling to just US\$ 10.1 billion, a figure 45% lower than that posted in 2002. As the preliminary data from UNCTAD point to the world flows of FDI having remained stable in 2003 when compared with 2002, Brazil's participation in these flows fell to 1.6%, the lowest since 1995. In terms of the sectoral make-up of the investments, the expansion of the oil sector explains the growth in the share of the mining industry in the total for the year: from 3.4% in 2002 to 11.5% in 2003. The United States recovered its position as leading foreign investor, outdoing The Netherlands, which led the field in 2002.
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- So, at the beginning of the early 21st century the stock of FDI in Brazil presents some marked differences in relation to the amount accumulated up to the mid-90s. The most significant change concerns diversification both with regard to sectors of destination and countries of origin of FDI inflows.
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- Concentrated until the mid-90s in capital and technology-intensive industries, at the end of the decade the stock of FDI was far more diversified: services gained prominence and there was somewhat more participation of industrial sectors intensive in natural resources, including mining sectors (oil and gas). The countries of origin of the investments also diversified, although the United States maintains top position among them.
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3.2. Brazilian FDI abroad

- In contrast with some Asiatic and even some Latin-American countries, Brazil's participation as a foreign investor is negligible. More than anything else, this fact reflects the low degree of "extroversion" of Brazilian companies are, for decades almost exclusively dedicated to supplying the domestic market.
- The trade opening and the change to the investments regime seen in the 90s brought no significant change to this dimension of Brazilian companies' behaviour and strategies. According to Lopez, this might in part be explained by the fact that in a situation of deep regulatory change that substantially altered the degree of competition in the domestic market itself and tended to attract new players to dispute these markets, Brazilian companies

“essentially concentrated their activities in the local market (...) to guarantee their survival before the new competitors – be they importers or transnational companies coming into or strongly expanding their position in Brazil.”

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- Nevertheless, some factors have induced nationally-owned firms to make some moves in their international strategies, pushing them to adopt a more offensive stance. Mersour’s integration has been one of such factors. The 90s witnessed a significant participation of Argentina as destination of FDI from Brazilian companies: in 1996, Argentina already accounted for 6.7% of Brazilian investments overseas (against 2.1% four years before). In some cases the investments of Brazilian companies entailed buying local firms, in others forming strategic alliances and joint ventures with transnational or local companies for the purpose of obtaining a position in the local market. Less often, these investments were geared at implementing sub-regional production strategies, contemplating the rationalization of production at the sub-regional level, productive complementation, and so on.
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- A second factor to dynamize Brazilian investments abroad in the 90s was the growing involvement in export activities on the part of a few large companies. Some of these companies began to invest overseas, although this seldom involved productive investments, rather concentrating on activities that supported commercialization and foreign distribution of export goods. A recent survey with a sample of Brazilian export firms revealed that 85% of the foreign investments made by these companies involved commercial activities and distribution of goods, with productive investments representing only 12% of the total (Iglesias and Motta Veiga, 2002)¹¹.
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- Although the process of internationalization of Brazilian companies is essentially “trade-related”, even on this level it is quite small. According to Iglesias and Motta Veiga (2002), the

- ¹¹ Some of the big Brazilian industrial companies that invested in productive activities abroad as early as the 80s – in sectors such as auto parts and domestic appliances – were bought by transnational companies in the 90s (Lopez, 1999). In other words, transnational corporations took over the most internationalized Brazilian-owned firms and incorporated the acquired assets into their international production and distribution strategies.

insufficiency of Brazilian investments abroad to support exports seems to be closely related to three reasons: the macro-economic process that affected the rate of overall investment of the economy, the low exports-sales coefficient of most Brazilian exporters of manufactured goods (and especially nationally-owned companies), and some characteristics of exports, such as the sectoral structure of exports and the origin of the capital of exporters in the sectors where foreign investments are required by the competition pattern.

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- In respect to the type of good exported, Brazil concentrates on homogeneous products, which do not require installations abroad to control the quality and avoid misrepresentation of the trade agent/importer or to carry out after-sale services. In the case of the sectors that demand investment abroad to form networks of after-sale services, supply spare parts or to be close to the client for the purpose of adapting the product to market needs, the participation of TNCs is high in the production and exporting of these sectors. This does not stimulate foreign investments, since these firms use the distribution and customer-service network of the branches in the destination market or the home base.
-
- The last few years have seen an increase in Brazilian foreign investments in oil – with the internationalization of Petrobrás – and in the metallurgical chain, with the expansion of mining companies as well as steel companies in the United States to avoid anti-dumping rights being imposed. The same logic of tariff (or NTB)-jumping ruled the investments made in Florida in the 90s by the leading Brazilian orange-juice companies¹². Also recently many important investments from Brazilian companies are being made in Argentina, in different sectors such as oil, textiles and steel. In these cases, Brazilian companies are buying large and well-established Argentinian firms and trade marks.
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- ¹² Only a few companies see exporting as a need to maintain a leading position in the domestic market, which to a large extent can be explained by the fact that the latter has not yet reached its “saturation point” as well as by the persistence of a tariff structure that in practice preserves a good deal of the internal market from foreign competition.

- In an effort to support the internationalization of Brazilian companies and especially to carry out investments related to these companies' objectives to expand exports, the federal government, through the BNDES, implemented, at the end of 2002, a program to support foreign investments of nationally-owned firms.

4. Brazil in the network of investment agreements

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Investment negotiations have developed on the multilateral and regional levels, becoming especially intense in bilateral relations. In the Americas, essentially during the 90s, a dense network of investment agreements was consolidated that involved principally bilateral but also some sub-regional initiatives. These agreements are based on the paradigm that combines core concerns with protecting investments and with liberalizing the national regimes applicable to FDI flows.

Brazil took part in this process in the WTO – the TRIMs and GATS Agreements - negotiating within Mercosur and signing bilateral agreements to promote and protect investments with other countries of the continent and with European countries. The issue, which is a particularly controversial one, is also part of the FTAA agenda and the Mercosur–European Union negotiations.

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Although Brazil has been involved in various instances of investment negotiations, the binding commitments actually assumed are limited to those derived from the Uruguay Round agreements. The Mercosur protocols and bilateral agreements were not ratified and are not in effect, while negotiations proceed in the other instances.

4.1. Brazil's commitments in the WTO

On the multilateral sphere, the binding commitments made by Brazil are those that appear in the GATS and the country's List of Specific Commitments in respect to mode 3 of provision of services, besides the commitments assumed in the TRIMs Agreement.

In the GATS negotiations, construction and engineering, financial services and tourism were among the sectors targeted for most specific commitments, with or without restrictions to national treatment and/or access to market. These sectors were submitted to regulatory reform during the early Nineties, which liberalized the conditions applying to FDI (national treatment and market access). The commitments undertaken under the GATS followed the main trends of the domestic reform, but were less liberal than the degree of liberalization achieved by it.

Generally speaking, the commitments signed by Brazil were less restrictive in national treatment than in market access, indicating the preference to consolidate a situation of non-discrimination of foreign suppliers active in the domestic market, as against the commitment of non-discrimination of entry of foreign suppliers.

Furthermore, the commitment indicators relating to modality 3 of provision of services are higher than for the other modalities of provision, which attests to a preference on the part of Brazil to condition the consolidation of a broad degree of liberalization to the commercial presence of foreign services providers (direct investment).

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4.2. Mercosur protocols of investments and services

In January 1994, the four members of Mercosur signed the Protocol for the Promotion and Protection of Investments from Non-Member Countries (called the Buenos Aires Protocol). In August of the same year, the Protocol for the Promotion and Protection of Investments of Member-Countries (the Colonia Protocol) was signed. Neither of the agreements came into effect because they were not ratified by the Member-States and the theme does not seem to feature among the priorities of the Mercosur agenda in this period in which efforts are being made to re-launch the process of building the sub-regional bloc.

In both agreements the concept of investment is wide-reaching - an asset-based definition of investment) rather than a company's based one - which means that both direct investments and financial and capital-market operations are contemplated, besides intellectual property rights and public-service concessions.

Both Protocols provide for national and most-favored-nation treatments of the investments of the various Member-States and third-party countries, but these obligations do not extend to tax matters – covered by specific double-taxation agreements – nor do they apply to sectoral exceptions admitted for a non-specified transitory period.

One important difference between the two protocols affects both the treatment of admission and establishment of foreign investments and the concession of national treatment of such investments. While the Colonia Protocol – applicable to the investments of member-countries – applies to the phase of pre-establishment, and consequently involves the right to admission and establishment, the Buenos Aires Protocol – applicable to the investments of extra-zone countries – admits foreign investors and their investments in Mercosur in accordance with national laws and regulations, thus being characterized as an Agreement whose scope is limited to the post-establishment phase.

Performance requirements are banned under from the Colonia Protocol, with explicit reference to export and national content requirements, as well as to “any other similar requirements” – going, at least potentially, beyond TRIMs list of prohibited performance requirements - but Brazil and Argentina have reserved the right to maintain temporarily the performance requirements applied to investments in the auto industry. The Buenos Aires Protocol makes no reference to performance requirements, which means that in this area the member-states did not assume any commitment to third-party States other than those already assumed in the WTO Agreement on TRIMs.

- The Buenos Aires Protocol underscores, in respect to the incentives granted to investments, the need to harmonize legal principles applicable to extra-zone investments, aiming at not creating differentiated conditions that distort the flow of investments. Nevertheless, there is nothing defined concerning the implementation of this guideline. The Colonia Protocol “was even more explicit in authorizing divergent national treatments for intra-regional investors” in its Article 7, which establishes the possibility of a member-State granting an intra-regional investor more favorable treatment than what the Protocol provides (Bouzas, 2003).

The two Protocols also provide mechanisms for settling disputes opposing investors and contracting parties. In the case of intra-Mercosur investments, the provision is to seek a solution by means of “friendly consultations”. Should the dispute remain un-resolved in this way, then it will be submitted to one of the three following procedures, at the criterion of the investor: the courts of the host country, international arbitration or whatever permanent system of dispute-settlement with private parties comes to be established in Mercosur. The Buenos Aires Protocol provides for two options for treatment, should the “friendly consultations” fail: sending the matter to the court of the host country or international arbitration.

- The trade of services has been on the official agenda of the bloc ever since June 1992, when, in the framework of the 10th SGT, the ad-hoc Committee on services was set up to analyze the establishment of a regional regulatory framework suitable for liberalizing the trade of services.
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- In October 1993, the Committee concluded its draft of the Framework-Agreement on the Trade of Services, strictly based on the GATS. Two years later, Mercosur Plan 2000 defined the liberalization of the trade of services as an objective of the process of deepening sub-regional integration.
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- Explicitly based on the GATS – in other words, including investments in services as modality 3 of trade and adopting the methodology of commitments by positive lists – the Mercosur Protocol on Trade in Services, finalized in December 1997, is not in effect because it has been ratified by only one of the bloc’s member-States (Argentina)¹³. The Protocol establishes a ten-year liberalization program supported by annual rounds of negotiations with a view to incorporating new sectors and negotiating lowering or doing away with trade restrictions¹⁴.
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¹³ In Brazil, the Protocol is in process of ratification by the Congress, pending on the approval of the first list of specific commitments, annexed to the agreement.

¹⁴ It has already been pointed out (Bouzas, Motta Veiga and Torrent, 2002) that the Montevideo and the Colonia Protocols overlap/contradict each other. Indeed, the Montevideo Protocol on services follows the WTO/GATS system of definitions. Therefore, it covers the "commercial presence" of foreign services suppliers. But since "commercial presence" is in practice "foreign direct investment" of other member states' firms in the country of origin, those transactions are also covered by the Colonia Protocol on investment, which is not limited to goods, covering also services. This overlapping creates a potential for conflict.

- So far, despite the lack of ratification of the Protocol, four rounds of negotiations and exchange of specific commitments have been held. The 4th Round of specific commitments, concluded in December 2003, completed for all the sectors the exercise of consolidating the domestic regulatory *status quo* of the member-countries: from now on, the regulatory framework in effect in member-countries defines the minimum threshold of intra-Mercosur liberalization commitments.
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- Similar to what was seen with the commitments made in the WTO, in the intra-Mercosur negotiations Brazil favors liberalization via mode 3 as against the other modalities of provision. In mode 3, Brazil is more liberal in its commitments to national treatment than in those concerning market access and the percentages of commitments negotiated in Mercosur are far superior to those negotiated in the same modality at the GATS

4.3. Bilateral agreements to promote and protect investments signed (but not ratified) by Brazil

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Brazil is a signatory of a large number of bilateral agreements (24 in all) designed to prevent double taxation, and has signed almost two dozen bilateral investment agreements with OECD countries and developing countries, two of them with other Latin-American countries: Chile (March 1994) and Venezuela (July 1995).

None of the bilateral agreements signed has been ratified by the Brazilian Congress, where they have been the subject of various questionings, precisely because of their wide scope and because they sanction the presence of components typical of the new paradigm of international treatment of investments: a broad concept of investments, free transfer of resources associated with investments and clauses provide for investor – State dispute settlement.

The Brazil-Chile bilateral Agreement is an example compatible with this paradigm: a wide scope in terms of “investments” and “investors” covered by the Agreement, national and most-favored-nation treatments, the usual sectoral exceptions, reservations as to the tax-related

questions and preferences granted on account of participation in free trade and integration agreements, etc. It should be noted that the Agreement provides for the exceptions presented by Brazil based on restrictions of a constitutional nature “ceasing to have effect” if such restrictions are revoked “by amendment or constitutional reform.”

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Expropriations are limited to cases of “public utility” or “national interest” and should be granted “immediate, adequate and effective compensation” corresponding to the market value that the investment had “prior to the measure (expropriation) becoming public domain”, plus the interest applicable to the period between the expropriation and payment of the compensation.

The mechanism for settling disputes between contracting parties provides, for cases where a friendly solution has not been reached within six months. For disputes between investors and contracting parties that are not solved amicably, the possibility remains open to refer disputes to a court of the country hosting the investment or international arbitration through the UNCITRAL or the ICSID.

However, since none of the BITs signed by Brazil was ratified by Congress – and the probabilities seem remote for this to happen – these agreements imply no generate commitment for the country in the area of investments.

4.4. The investments negotiations in the FTAA and the Mercosur-European Union Agreement

The negotiations on investments in the FTAA refer explicitly to the paradigm of the BITs and the sub-regional (NAFTA) agreements that spread through the Western Hemisphere during the 90s, to the extent that the scope and range of these agreements had a clear influence on the definition of the “skeleton” of the FTAA chapter¹⁵.

¹⁵ This sub-section draws on Motta Veiga (2002).

It seems also true to argue that these negotiations also reflect - through the posture of some of the Parties, and especially Brazil – the process of critical re-assessment of the commitments made by developing countries in the trade negotiations held in the 90s.

The ambition of the United States in the FTAA is quite clearly to reproduce the NAFTA and US BITs model, especially provisions granting to foreign investors high standards of protection, while allowing for sectoral reservations.

From the Brazilian point of view, the biggest worries with regard to establishing a hemispheric agreement on investments based on NAFTA and US BITs model relate to the very ambition of a hemispheric agreement within following that paradigm, including investment-protecting provisions that today tend to be seen more and more – not only in Brazil – as a source of asymmetries and undesirable constraints for developing countries.

In this sense, themes that make this ambition concrete, such as the treatment to be granted to pre-establishment, the definition of ambiguous concepts such as “similar circumstances”, “fair and equal treatment”, “measures whose effect is similar to expropriation” and the setting of a mechanism for settling disputes between investors and State, all acquire priority status for Brazil.

Specifically in respect to goods, one concern involves the eventual expansion, in the FTAA agreement, of the prohibition of requisites as to performance currently defined by the WTO TRIMs Agreement. Both for goods and services, the way that the agreement would deal with the issue of public-services concession is seen as extremely relevant to Brazil

In general the main polarization of positions within the group sets the United States against the Mercosur countries, especially Brazil, since the other members of the bloc have less restrictions than Brazil to negotiate a broad agreement on investments. These countries have ambitious agreements with European countries and the United States and Brazil is the only relevant player in FTAA negotiations player without any commitment to the WTO-plus in the area of investment.

The recent evolution of FTAA negotiations suggests that the hemispheric “baseline agreement” on investment will be, at the outset, far less ambitious than the model proposed by the United States and supported by many other countries. At the very best, such ambitious investment agreement should be reached at the plurilateral level among the United States and like-minded countries.

In the case of the Mercosur–European Union negotiations, the treatment of the investment issue produces less conflicts and tension than the FTAA negotiations. This basically comes from the fact that the principles that guide the European proposal resemble quite closely those advocated by Mercosur, and in particular by Brazil.

As a matter of fact the European proposal includes a chapter on establishment applicable only to goods – since the commercial presence in services would be dealt with in the chapter on services – and a chapter referring to the movement of capital and transfers¹⁶. Both texts are quite succinct and far less ambitious than the chapter that has been negotiated in the FTAA during the last few years.

- In the European proposal, the chapter on investments, in addition to referring only to goods, only contemplates FDI flows. So, the concept of investments is quite restricted. Besides this, the chapter defines rules on market access and goes beyond the post-establishment phase, inasmuch as it provides for national treatment in both the establishment and the operation phase. The proposal of the EC, consistent with Brazil’s preferences, is that the establishment commitments should be made within the modality of positive lists.

Moreover, the chapter does not provide for the mechanism to settle disputes between investor and State and admits exceptions and reservations to national treatment, in accordance with the methodology already adopted in the GATS. It also excludes any mention to performance requirements and TRIMs.

- 4.5. Brazil and the theme of international investments in the OECD

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- Consistent with its policy of drawing close to the OECD throughout the 90s, in 1996 Brazil was accepted as observer at the the organization's Committee on International Investments and Multinational Enterprises. Within the sphere of this Committee, Brazil accompanied, always as an observer, the process of negotiations of the Multilateral Agreement on Investment - MAI. In 1998, Brazil formally presented its preliminary list of reservations to the MAI, in order to ensure its status as full negotiator of the Agreement.

- Besides this, Brazil joined the 2000 review of the OECD Guidelines for Multinational Corporations and Foreign Investments. As a result, Brazil set in motion the National Point of Contact within the Ministry of Finance in May 2003. This point of contact is responsible for promoting those guidelines at the national level, responding to information requests about them and discussing issues concerning the working of the instrument in particular situations. Therefore, its establishment was a central element in the OECD review of the Guidelines implementation procedures in Brazil. (Vilmar, 2002)

4.6. Brazil and the investment agreements: the current situation and the Brazilian position

As pointed out in the preceding sub-sections, the level of international commitments assumed by Brazil in the field of investments is rather limited, being restricted to those signed within the sphere of the WTO (for goods and services), since bilateral and sub-regional agreements already signed by the country have not yet been ratified or come into effect.

Besides this, Brazil's official position has been increasingly characterized by rejecting ambitious investment agreements. In the early 90s, Brazil negotiated investment agreements in Mercosur that in many aspect followed the model of the then proliferating bilateral agreements to protect and promote investments: mechanisms to settle investor-State disputes and, in the case of intra-Mercosur investments, extending national treatment to the pre-establishment phase. On the other hand, the Executive signed various bilateral agreements, most of them with developed countries, which were likewise linked in scope and degree of ambition to the model of BITs typical of the 90s. Partly due to resistance manifested in Congress (in the case of

¹⁶ These comments are based on the EU proposal, which has not been made public so far.

bilateral agreements) and partly because of lack of interest on the part of the Executive itself (in the case of the Mercosur agreements), none of these agreements was ratified.

In the FTAA, Brazil resists the establishment of specific WTO-plus disciplines and intends to direct the investment negotiations to the multilateral sphere. Although this position became more explicit after the new Brazilian government decided not to present its original offer of investments in hemispheric negotiations, the polarization between Brazil and several countries, including the United States, in this area of negotiations goes back to at least 1998-99, when the texts of the chapters of a future agreement began to be negotiated in greater detail.

What are the reasons for Brazil's resistance to the negotiations of the themes of investments, and especially to the broad agreements based on the NAFTA and BITs-like models

First of all it should be remembered that the essential guideline of Brazil's economic foreign policy throughout the last forty years has been to preserve "national autonomy" and to maintain ample spaces for the national State to exercise its authority, especially in the field of development strategy. As known, policies to encourage investments – including FDI – were one of the main lines of action of the "national-developmental" State that drove IS industrialization. In Brazil there is a fairly wide-spread understanding that such initiatives, which contemplated adopting various performance requirements, were successful, whatever their costs.

Conversely, it is also widely assessed that mechanisms existing in the investment agreements of the 90s (such as the mechanism for settling disputes between investor and State) cause a substantial reduction of the regulatory capacity of national States and that they would bear a negative impact on the possibility of Brazil continuing to practice industrial policies.

Furthermore, over the last few decades Brazil has been an important destination of FDI flows without any agreement having been signed. So there is a more or less generalized disbelief among policy-makers concerning the potential benefits of – or the need for – these agreements in order to attract FDI.

- It is relevant too that since the volume of investments of Brazilian companies abroad is very limited, there is little domestic pressure in favor of signing agreements that protect those investments.

Finally, the provision of infrastructure services has gone through intense regulatory changes in the last few years, and establishing rules and disciplines typical of a broad investment agreement, such as a loose concept of indirect expropriation and the setting of an investor-State mechanism for settling disputes, tends to be viewed essentially as an important constraint on eventual improvements to the recently implemented regulatory framework.

- Without any doubt, it is possible to claim that, except for this last argument, the factors that support the Brazilian position have been eroding in the last years. There is greater competition to attract FDI, and in some cases an internal market with the dimensions of the Brazilian market is no longer sufficient to attract investment, especially since FDI's face competition from the imports of this market. The growing flows of FDI to infrastructure sectors – which demand large investments and long return periods – heightens the perception among investors of the “regulatory risk”. Furthermore, resorting to policies that are active and costly (in fiscal terms) in order to attract external investments becomes increasingly difficult in a context of severe fiscal adjustment. Finally, the growth of Brazilian investments abroad tends to strengthen, at least potentially, the coalition of business interests favorable to this type of agreement.

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- As the scenario moves and the offer of incentives to attract FDI becomes more restricted – for fiscal reasons, essentially – the functionality of investment agreements could increase, for investors – whose profitability will not be guaranteed by the volume of incentives they can get “at the entry”- as well as for the host country, which would have a regulatory mechanism rather than an incentive-based one to attract FDI.

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- Besides, as pointed out in sub-section 2.2., the inefficiency of the judicial system in Brazil growingly affects the investment-related decisions of the firms, especially in sectors where the presence of FDI is or could be very important: public utilities, oil and gas and technology-intensive industrial sectors. As strong political resistance remains against accepting the idea of

the arbitration (domestic or international) as a dispute-settlement mechanism between investors and State, the problem of the inefficiency and lack of independence of the judiciary becomes particularly acute for private investors in the above mentioned sectors.

5. FDI's and transnational companies in the Brazilian economy: relevance and debate

5.1. The weight of FDI's and transnational companies in the Brazilian economy

FDI's played an important part in Brazil's industrialization and in the first cycle of investments after the revision of the paradigm of public policies that marked the 90s. The role of the FDI's in the rate of investment in the Brazilian economy and GNP has been significant over the last few decades, when the country was a prominent destination of FDI flows. An exception to this was the 80s, when the model of industrialization by import substitution was exhausted and the country experienced a serious balance of payments crisis and an accelerated deterioration of the macro-economic situation.

Between 1986 and 1994 (the year in which the macro-economic deterioration began to be remedied), the rates of aggregate investment in the economy fell to historically very low levels. As a matter of fact, the investment coefficient, which was of the order of 23.5% in the 70s, dropped to 17.2% between 1984 and 1989 and then to 14.9% between 1990 and 1992 (Bielchowsky, 2002). The participation of FDI flows in the GNP fell to 0.2% between 1986 and 1994, and in this period the FDI accounted for only 1.1% of the total investment in the country (against 3.3% between 1978 and 1994).

As of 1995, all the aggregate indicators related to FDI flows to Brazil enjoyed significant growth: the participation of Brazil in world flows rose to 4.1% in 1998, and then dropped. Even so, in 2001 this participation was equivalent to 3.1%, far above the 1.1% recorded on average between 1986 and 1994.

Among the developing countries, Brazil's participation as point of destination for FDI inflows also increased a great deal in the 90s. Between 1990 and 1995, this participation stood at 2.7%

and then grew until 1998, when it reached 15.4%. In the following years this indicator diminished, but it has always been above 10% (11% in 2001).

The census on foreign capital carried out by the Central Bank in 2000 recorded assets of the corporations with foreign participation (majority or not¹⁷) equivalent to US\$ 467 billion, that is, 80% of the Brazilian GNP, and revenue from sales of these corporations equivalent to US\$ 231 billion, that is 40% of the GNP.

The principal beneficiaries of the sectoral regimes to promote investment, in the second half of the 90s, FDI flows increased their contribution to the Brazilian GNP and the aggregate rate of investment. This period saw an accentuated “detachment” between the dynamic of the FDI – driven by the processes of privatization, re-structuring of the financial sector and the investments made under the umbrella of the industrial sectoral regimes – and the dynamic of total investment in the economy (and of non-transnational corporations in particular).

Thus, between 1995 and 2000, the FDI/GNP ratio went from 0.8% to 5.7%, after reaching its highest point (5.9%) in 1999. The participation of the FDI in the gross formation of fixed capital (the rate of investment of the economy) underwent a spectacular expansion in the period, passing from 3.8% in 1995 to 31.3% in 1999 and to 30.6% in 2000. In other words, at the end of the decade, at the height of the period of privatizations in the telecommunications sector and of foreign investments in the financial sector, FDI flows accounted for nearly a third of the total investments of Brazil’s economy, a tendency that will be difficult to maintain in the future, even if the aggregate rates of investment remain low.

FDI flows are traditionally attracted by the large Brazilian market, that is, they are clearly market-seeking investments. In the import-substitution period, this was practically the only logic underlying the influx of FDI. As observed by Chudnovsky (1999), “in a context of protected internal markets, the TNCs (...) concentrated on a set of oligopolistic sectors that were capital and technology-intensive and where they explored their property advantages by means of processes and products brought over from the head offices.” For the Brazilian governments, the functionality of FDI was linked precisely to the fact that these corporations

added to the development effort factors that were domestically scarce, such as capital and technology¹⁸.

From the second half of the 70s, some resource-seeking FDIs can be found in the sectors of mining and pulp and paper. In the 90s the logic of market seeking continued to prevail - even stronger as a result of the privatization of infrastructure services – but the context of industry opening further to the competition of imports obliges the TNCs to complement their market-seeking strategies with actions of rationalization and productivity-enhancing traditionally associated to efficiency-seeking models of investment (Chudnovsky, 1999).

- Although exports had to wait the early 70s to gain some priority in the Brazilian strategy of industrialization, the TNCs made a relevant contribution to the strong growth of exports of manufactured goods registered in that decade. Several studies have estimated the participation of transnational companies in Brazil's industrial exports during the 70s to be about 50%. The presence of these corporations was particularly relevant in more dynamic and technology-intensive sectors and, as mentioned above, TNCs made use of a substantial portion of the incentives and subsidies to export implemented by Brazil from the 70s on.

In the 80s the presence of TNCs in Brazil's exports continued to grow: the exports of manufactured products expanded at an annual average rate of 3.2% between 1980 and 1989, whereas the exports of the transnational grew 5% per year and these firms maintained export coefficients higher than the average for Brazilian industry (IEDI, 2003).

These characteristics prevailed and were even accentuated in the 90s, after trade was opened up. According to Moreira (1999), in 1997 the propensity to export on the part of TNCs producing manufactured goods was almost three times that of their national counterparts. This was especially true of the sectors capital and technology-intensive. In addition, in these same sectors, in 1997 the transnational companies accounted for 56% of the exports of the manufacturing industry. For the entire manufacturing industry, this figure was 43.4% in the same year.

As regards the FDI contribution to the growth of productivity and efficiency in the economy, it was noticed that “the branches of transnational companies in Brazil operated with higher levels of productivity and more modern technology than the average firms of national capital” (Chudnovsky et alii, 1999). The same authors report that in some sectors, such as the auto industry, “significant externalities in terms, for example, of the development of suppliers of parts and equipment” were generated as a result of TNCs investments.

In the 90s, faced with sharper competition from imported products, the TNCs tried to achieve higher degrees of productive specialization and lower levels of vertical integration. In many cases this led to increasing the imported content of the final products manufactured in Brazil by reducing the local value added and/or the inter-sectoral links associated with producing final goods. Less frequently (and in the opposite direction), TNCs redefined their relations with local suppliers, enabling them to develop specific skills to meet the new requirements in terms of price and quality, a shift felt above all in the branches of TNCs that moved away from the stand-alone model of operation in Brazil and evolved towards a model of integration, albeit limited, with the intra-corporative networks of production and trade.

5.2. The current debate on the contribution of FDI to development

Therefore, at the end of the economic re-structuring of the 90s, FDI and TNCs had increased their participation in the rates of investment, production and foreign trade, and the sectors in which these companies were most prominent had experienced a high level of dynamism and intense processes of supply concentration¹⁹. The increased weight of the TNCs in the economy and the growing gap between TNCs and nationally-owned companies as far as capabilities and resources are concerned were among the main factors at the root of the debate on the contribution of FDI and these companies to the country’s development.

¹⁹ TNCs refer to firms owned by foreigners and incorporated under Brazilian laws. They constitute the micro-economic “output” of FDI flows and the analysis of FDI impacts on production, trade and domestic investment usually benefits from research conducted at the firm-level, referring to transnational and non-transnational corporations. Hence, this notion is not used in this paper in opposition to FDI. However, criteria used to assert the “transnationality” of a firm may vary. For instance, the Central Bank’s census on foreign capital includes the firms incorporated under Brazilian laws having at least 25% of their total capital controlled by foreigners,

In this debate, the critics of the trade opening and the liberal reforms carried out in the 90s laid emphasis on some characteristics of post-liberalization FDI that would lessen the contribution made by these flows to development.

These investments are charged with having a pro-import bias that raised the participation of the transnationals in Brazil's total imports from 38.8% to 60.4%. This growth was far stronger than that observed on the exports side, where growth was also recorded (from 46.8% to 60.4%). The counterpart of the growth of imports of these companies would be a limited generation of technological externalities and processes of development of local suppliers through this cycle of foreign investments.

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- Besides this, emphasis is made too on the negative contribution made by remittances of profit and payment of royalties to the disequilibrium of the country's foreign accounts (IEDI, 2003). Between 1995 and 2000, the foreign (including trade) deficit of the companies with majority participation of foreign capital rose from US\$ 6.2 billion (33.8% of the deficit in the country's current transactions) to US\$ 14.9 billion (61.4% of the total deficit).

In addition, a critical assessment is made of the fact that the recent cycle of FDI was in large measure based on takeovers of firms and assets that until then were in the hands of Brazilian companies. Besides reducing the additional installed capacity to be expected of foreign investments, it was argued that this process had contributed to the "denationalization" of some of the more efficient nationally-owned companies.

- As the critics saw it, the privatization of State-owned companies in the public utilities sectors – which absorbed a great portion of the FDI in the second half of the 90s – displayed these negative features: being meant for the production of non-tradeables, they do not generate exports and the commitments of investments to expand and modernize services led to new flows of imports of equipment and services, thereby limiting the generation of positive

although eventually presenting some data that refer specifically to the sub-set of firms under majoritary control by foreigners.

externalities through the development of domestic suppliers. Furthermore, when these companies began to remit profit, this pushed up the country's deficit in current transactions.

- Hence, criticism towards the post-liberalization cycle of FDI challenged the quality of such flows in terms of their contribution to development and in particular to the growth of exports and the introduction and diffusion of technological innovations. Together with this debate emerged a discussion on the most appropriate policies to improve the quality of FDI or to maximize its benefits for the economy. The dominant paradigm in Brazil as far as policies to attract investments are concerned include a mix of trade protection, performance requirements and sector-tailored incentives, a paradigm that shaped the auto regime in the 90s.

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Concern was raised too about the denationalization of Brazilian companies, leading to proposals (i) of discriminatory use of incentives and public-financing instruments to benefit nationally-owned companies, and (ii) of encouraging the creation of large private national conglomerates endowed with a suitable business scale to face competition from foreign firms in the globalized commodities markets.

For the advocates of the trade liberalization and the shift in the public policies paradigm that marked Brazil in the 90s, some of the criticisms addressed to the characteristics of recent FDI flows are not valid, and the output of trade and investment liberalization is seen as largely positive. According to this view, criticism should rather be addressed to the model of import substitution, its excesses and its inheritances. By granting TNCs high levels of trade protection, this model promoted for these companies “a way of acting that reduced the contribution of FDI by undermining the incentives either to increase productivity (via gains of scale or innovations) or to expand exports” (Moreira, 1999).

- At the same time, Brazilian protectionist strategy of industrialization would have contributed decisively to consolidating strongly concentrated sectoral supply structures, and the dominance of TNCs in capital and technology-intensive sectors reinforced this tendency with special intensity in these sectors. Some of the sectors dominated by TNCs are among those most benefited by the industrial and export promotion schemes and trade protection regimes in the period of import substitution. Even after the trade liberalization of the early 90s, these sectors

(auto industry, mechanical and electrical equipments) were the object of programs of specific incentives and maintained higher levels of nominal and effective protection against imports than the weighed average of industry (Motta Veiga, 1999). Parallel to this, it was in the sectors where the participation of transnational corporations in operating revenue exceeded 50% that the process of concentration of production witnessed over two decades (between 1978 and 1997) was felt with greatest intensity. According to Moreira (1999), in these sectors the market share of the four leading firms grew at an average of 24% in the period.

On discussing the hypothesis – so dear to the critics of liberalization – that post-liberalization FDI flows generated productions with a “pro-import bias,” the liberal point of view stresses that, beyond this trend (seen as a temporary one), new FDI flows will positively contribute to Brazilian exports by granting them access to distribution channels and trademarks with world penetration.

Besides this, with the trade opening, FDI tends to be far more integrated with international trade than it was during the import-substitution period, when trade protection contributed greatly to isolating the Brazilian branches of the transnationals from trade flows. Integrating the TNCs that operate in Brazil to international trade flows necessarily involves both exports and imports. “It would be (...) a mistake to disconnect the propensities to import and to export, as exported goods, on account of the greater competitive pressure on the international market and tax facilities (for example, drawback), tend to present a greater import content than those geared to the internal market” (Moreira, 1999). Today, simultaneously very high propensities towards exporting and importing are a major feature of some of Brazil’s leading export companies active in technology-intensive sectors, be they nationally-owned companies or TNCs.

While the anti-liberal views converge to criticize the absence of active policies to “mold” FDI flows qualitatively and adjust them to the country’s needs, the point of view that defends the liberal reforms of the 90s blame the quality of some policies implemented by Brazil to attract and foster FDI inflows, in the last decades.

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With regard to the policies adopted in the 90s, the auto industry regime is a policy paradigm that is emphatically rejected by this position. In fact, for those who question the quality of investment policies in Brazil, the experience of the auto industry regime and the sub-national mechanisms to attract foreign investments to this sector implies some heavy criticism.

- At the level of investment decisions involving volume, scale of production and location, these being closely related to the supply of incentives, the regime is seen as providing for a high potential for allocation distortions and rent-seeking behaviour by the industry.

The federal regime provides incentives for the assemblers to create plants of not necessarily optimum scale. Furthermore, sub-national incentives, by reducing investment costs even more, could accentuate the existing over-investment tendency deriving from the federal regime. These concerns seem to justify by the fact that although these investments are quite recent, there has already been some disinvestment in the sector since 2000. Other companies, faced with high levels of idle capacity, try to offset this by increasing exports.

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- Moreover, the volume of incentives granted and their long period of validity should produce important fiscal impacts, at the state and municipal levels, at the same time as they establish a relationship of dependence - economic and political - of the state governments in relation to the sector, with potential impacts on the Federal Government's trade policy, as state governments become captive of the industry's protectionist demands.

Whatever the position adopted in the debate underway in Brazil, the starting point is the perception that the FDI contribution to development was limited by the policy options made over the last few decades. For both positions, the main policy challenge "entails not only maintaining the capacity to attract FDIs but also improving their contribution to the processes of the economic development" of Brazil (Chudnovsky et alii, 1999). The different positions essentially attribute to domestic policies the key role of creating favorable conditions for maximizing the benefits of FDI for development, the divergences between them referring essentially to the nature of the policies to be put in place. None of the positions attributes to the investment agreements any kind of function related to this objective.

5.3. Sustainable development and FDI: expanding the debate on the quality of flows and policies

The contribution made by FDI to Brazil's development is usually assessed in terms of performance of foreign trade, generation of qualified jobs and technological externalities, but rarely is there any reference to criteria and indicators of sustainable development. There are practically no studies or reflection on the contribution (whether positive or negative) of FDI to sustainable development in Brazil.

There is a rationale behind this. FDI in Brazil have concentrated on sectors that are capital and technology-intensive rather than sectors that are intensive in labor or natural resources, which have been dominated by large national groups. Although over the last few years FDI has also targeted some segments intensive in natural resources, such as oil, mining and pulp, this tendency is still not enough to alter the picture that has consolidated over several decades. So, if the FDI contribution to development in Brazil is evaluated in terms of impacts on productivity, exports and technological innovation, this is fundamentally due to the fact that the FDI flows were directed towards industrial (and later services) sectors intensive in capital and technology, a "preference" that can at least partly be explained by government policies to promote investment and attract FDI.

Consequently, very few effort has been made as to assess the role of FDI and the TNCs in diffusing in Brazil a paradigm of business and economic actions based on principles of sustainable development. The same situation prevails with regard to studies on the hypothetical role of FDI and the TNCs in the degradation of the environment (or local environmental standards) and labor conditions (or local labor standards) in Brazil²⁰.

²⁰ Similarly, no debate has taken place in Brazil as for the relationship between FDI and poverty. This is partly due to the fact that FDI flows have been directed to the modern sectors of the economy, characterized by higher wages and concentrated in the more developed regions of the country. But it also relates to the fact that, when made in poorer regions, the most immediate result of FDI is an upgrading of the average level of labor standards prevailing in these regions. However, for the critics of the protectionist model of industrialization policies geared at attracting FDI through subsidies were typical of an economic development model (the IS model) that increased income inequality in Brazil.

Up to the late 70s, the environmental and labor practices of the TNCs were not noticeably any different from those of other companies operating in Brazil, being essentially molded by the “domestic tradition” in these areas. This pattern is compatible with the hegemony of the stand-alone model of operation among TNCs and was only clearly changed from the 90s on with the opening up of trade and the transition, in some industrial sectors, to a model of “simple integration” of the Brazilian branches to production and marketing networks of the companies.

However, since the early 80s the environmental and labor practices of the TNCs have gained some autonomy in relation to local management practices. In the case of labor relations, these changes resulted in part from the needs of the companies – interested in stabilizing part of the labor contingent – and in part from trade-union pressure to include in the list of workers’ demands matters related to labor conditions and the freedom to organize in workplaces, themes alien to the tradition of Brazilian legislation in this area.

The change in the business environment in the 90s speeded up these transformations, which included re-organizing the corporative structure of many TNCs in Brazil. In this process, the corporative functions of the company in Brazil are concentrated in a holding which is responsible for unifying the policies practiced by different business units in the country around principles and values generated in the head office. This new form of concerted action between the head office, the Brazilian branch office and its units all over the country reduces the weight of the “domestic tradition” and the requirements for adapting to local conditions when defining the company’s management strategy on environmental and labor questions. In counterpart, principles of management clearly inspired by the paradigm of sustainable development and adopted by the head offices are growing more and more relevant.

This integration of branch offices to the paradigm of management adopted by the head office was carried out unevenly by companies and industrial sectors. It was unquestionably affected by the fact that it happened in a period of strong re-structuring of the profile of TNC activities in Brazil and worldwide, with a succession of decisions as to buying and selling units and companies, mergers, transferring lines of production, and so on. Effectively integrating principles of sustainable development into the management of the companies – with its environmental and

labor components – must have been a difficult task for those responsible for the Brazilian branches, and in some cases the discourse of the social responsibility of the companies only served to try to cover the breach between the companies' intentions and practices.

One interesting experience in monitoring labor and environmental standards and other norms related to work health and safety in the modern sectors of the economy and, particularly, in transnational companies is the one developed by the Instituto Observatório Social (OS), as institution connected to Central Única dos Trabalhadores (CUT), the largest central labor union in Brazil (Motta Veiga and Lengyel, 2003).

The ILO “core labour standards” conventions (on child and forced labor, collective bargaining, discrimination, etc), those applying to occupational health and safety as well as various environmental issues, are pivotal parameters for the OS work. The 2000 OECD Guidelines on Transnational Corporations has also been gaining more relevance in the evaluation of the performance of corporations made by the OS. In the case of TNCs associated to the Global Compact and operating in Brazil, some research efforts were directed to identify their degree of compliance with the principles contained in the document.

The OS strategic prospect is to be part of ongoing efforts for the “globalization of rights”. And the birth of this initiative is closely related to developments on labor standards at the international level²¹. The initial discussions to set up the OS involved the CUT, some Brazilian research institutes related to the labor movement and the Dutch labor confederation (FNV). The ILO and labor unions from developed countries such as the United States, Holland and Germany financially support the OS. This support from external sources has led its inquiry and

²¹ Trade and international integration issues got into the agenda of the CUT leadership by the mid-1990s, emerging in discussions on the organization's stance in MERCOSUR and the inclusion of a “social clause” in international trade agreements – a debate promoted by some labor unions from developed countries in trade-union fora. The issue of the social clause was raised by the International Relations Secretariat of CUT within the Brazilian labor union, following the Marrakech Agreement and pressures from the United States and France to include the issue in the WTO. The Executive Office of the CUT passed a decision favoring the clause with certain reservations because of its fear about developed countries' protectionist use of the mechanism. In 1997, the CUT created the OS even when its adherence to the social clause proposal was partial. At that time, the labor (or social) agenda was also gaining momentum in MERCOSUR.

monitoring work to focus on multinational corporations mainly from the countries where the funds were coming.

The OS has made so far almost 30 inquiries, 24 of which were made public through its website. Twenty-one out of 24 firms analysed are transnational corporations. The set of studies made public have a broad coverage in terms of origin and sectors of destination of FDI, location of the companies and how long the companies have been installed in Brazil.

All TNCs but one in the group studied are US or European (especially Northern ones): there are 4 US firms, 5 Scandinavian firms and 6 firms from the Netherlands (two of them are controlled by capitals from the Netherlands and the UK) among the companies inquired. The studies have tried to cover a wide array of industrial and service sectors: 6 of them refer to services (telecommunications, retail, banks, etc), 4 to food and agribusiness sectors and 5 to mining. These studies apply to TNCs located in different regions of Brazil (including the Amazon region) and to investments made by newcomers in the 90s as well as by earlier foreign investors in Brazil.

The OS research seems to confirm that the changes brought to the organization of transnational companies in Brazil over the 90s contributed to the branch offices adopting and diffusing principles and guidelines for sustainable development elaborated at the head offices. The business policies and practices in the labor and environmental sphere were unified around these principles, although the depth of this change varies a great deal, as does the integration of the new paradigm to the day-to-day management of the TNCs in Brazil.

According to interviews held with OS technical staff, the major world companies with globalized trademarks and a strong market position in various countries and regions display great concern and capacity to implement principles and guidelines for social and environmental sustainability. Another factor that impacts the degree of adhesion of transnational corporations to sustainable practices would be the corporate culture of the companies in their countries of origin and the “domestic tradition” of their countries of origin in these areas. This being so, it is possible to differentiate the degrees of adhesion of the companies to sustainability principles according to their

origin: Scandinavian, Dutch and German corporations would be among the most advanced in terms of adhering to principles and practices associated with sustainable development.

The management of the environmental issue is in general more closely linked to the strategy and management of the transnationals than the one of the labor themes. As a matter of fact, the TNCs view the environmental issue as a more sensitive theme than the labor one. On the one hand, the interest of international investors -including institutional ones - in firms' social performance, particularly in those aspects that may strongly affect returns to investments (i.e., the performance), is an increasingly strong incentive for the adoption of sound environmental practices and assessment methods. On the other hand, the environmental risk often exceeds the company's limits and consequently affects other actors, so it cannot be treated as just another in-house matter (as might happen with labor questions).

With regard to the environmental issue, some transnationals worry about the performance of their suppliers. In the case of the labor question, this type of concern is far less common, except in the case of child labor: several transnational companies explicitly reject buying input material from suppliers who use child labor in their production. As a rule, in the labor area the positive spill-overs – to suppliers and other producers – of the practices of transnational corporations tend to be more limited than in the environmental area.

The differences between regions in Brazil are a relevant factor in the TNC's decision as to location, and in this decision take into account elements like labor cost, resistance to change on the part of trade unions, possible rigidity on the part of sub-national government as for the management of environmental regulations, etc. But once the company has been implanted in less industrialized regions, the most immediate result is an upgrading of the average level of environmental and labor standards prevailing in these regions.

In short, although this process actually began in the 90s, it seems correct to state that TNCs have played a relevant role in integrating the principles of sustainable development to their business practices, and that such corporations contribute towards raising environmental and labor standards in Brazil, even though the spill-over effects of this trend are still somewhat limited.

6. Conclusions and policy recommendations

Detailed evaluations made in the late 90s pointed out the limited integration of Brazilian branch offices to the production, trade and technology networks of transnational corporations and the limited positive externalities (both technological and productive) on domestic firms as two important indicators of the insufficient contribution of these companies to development.

According to Chudnovsky *et alii* (1999), “these assertions are not surprising if we take into account the very history of FDI (in Brazil), the style of industrialization adopted (...), the relative weakness of the “assets created” in human resources, technological capacities, physical and communications infrastructure and the absence, abandonment or weakness of the policies that could revert the tendencies predominant in the current phase of FDI.”

To these negative factors that conditioned the FDI contribution to development in Brazil should be added the country’s weak macro-economic performance since 1980: low and volatile rates of economic growth, downward-pointing investment rates and a situation of disequilibrium that translated up to 1994 into accelerated rates of inflation and after that date into persistently high domestic interest rates.

It is against this backcloth that in the second half of the 90s the first criticisms appear involving the FDI inflows to the country. Throughout the lengthy period of crisis and restructuring, the gap grew between the performance of the transnational and national companies, mainly due to the capacity of the former to finance themselves at competitive rates in the international markets. In the late 90s the implications of this wide gap are notable: the FDI contribution to the economy’s rate of investment reached levels unheard of, the TNCs gained increasing weight in the country’s production and foreign trade, and some more efficient and internationalized national companies were bought by foreign groups.

As stressed earlier, in the debate on the FDI contribution to development, both positions attribute to domestic policies the key role in creating conditions favorable to maximizing the benefits of this type of investment; the divergences between the two positions refer essentially to the nature of the policies to be implemented.

The “liberal” position focuses its attention on the horizontal policies aimed at creating conditions favorable to investment in general (rather than just FDI) and fostering the creation and multiplication of productive, technological and commercial linkages among transnational corporations and the domestic “business environment”, and between both and the international environment.

According to this view, the horizontal factors that condition the propensity to invest in the country play a key role: a rational tax structure, a proper legal framework, stable rules and fulfillment of contracts (especially in sectors where the regulatory risk is high). Furthermore, domestic conditions of competition and trade opening define in large measure the extent of benefits arising from FDI inflows, leading the advocates of this view to support exports promotion policies, trade liberalization and the adoption of a domestic competition policy as key elements of a strategy geared at increasing the contestability of domestic markets and fostering the productive internationalization of nationally-owned firms.

This approach also defends technological and educational policies as fundamental elements (i) to encourage transnational companies to interact with other domestic actors in the host country, and (ii) to increase the capacity of the domestic actors to benefit from the spill-overs of the activities of transnational corporations. Finally, the need is asserted of adopting measures to regulate and limit sub-national competition to attract FDI based on incentives so as to prevent the overshooting of subsidies and bidding wars, that foster the inflow of foot-loose investments. If this position was to integrate the sustainable development dimension to its set of recommendations, it would probably support the enforcement of environmental and labor standards resulting from domestic legislation, but its proposals would prevent measures that could burden the competitiveness of Brazilian exports or discourage investments, including FDI²².

²² According to this view, the trade liberalization strengthened the integration of branch offices to the transnationals’ production and marketing networks, which favored the increasing absorption, on the part of the management of these branches, of “universal” sustainable development principles and guidelines diffused by the head offices.

The explicitly or implicitly “activist” or “interventionist” stance considers this whole set of policies to be insufficient, although it may agree with the adoption of some of them. Its diagnosis leads to defending active policies directed specifically towards attracting “quality” FDI, in other words, FDI with the potential to generate exports and transfer technology.

One preliminary line of action associated to this attitude – certainly its “lighter” version – suggests that “within the limits of WTO-compatible policies, it is possible to advance in devising initiatives that favor greenfield investments and increased capacity, as well as those with a powerful export content and/or that generate important spill-overs for the local economy” (Chudnovsky et alii, 1999). How can this be done? There may be different ways, but the proposal most commonly formulated in Brazil advocates adopting measures geared to attract a certain type of investment by conceding trade protection and incentives, conditioned to performance requirements, that is, the use of TRIMs associated with subsidies and trade protection.²³

A “nationalist” or “discriminatory” variant of this stance involves “unleveling” the field where transnational and national corporations compete through mechanisms (i) for the discriminatory use of incentives and instruments of public funding for investment and exports in benefit of nationally-owned companies²⁴, and (ii) for inducing the formation of large private national conglomerates.

The Brazilian experience clearly shows that the policies geared at improving the general regime of investment and creating an appropriate “investment climate” are essential for raising the rate of investment in the economy, for attracting FDI and for generating through these flows positive externalities for the recipient economy. This means, first of all, that “government-imposed imperfections” – related to a large and irrational tax burden that inhibits investment and productions, inadequate regulations and imperfect enforcement of property rights and contracts should be minimized. In the case of Brazil, this means also, that the cost of

²³ On the foreign policy level, this attitude unfolds as advocating more flexible disciplines of the TRIMs Agreement for developing countries and as resisting the hypothesis of enlarging the list of prohibited TRIMs of the Agreement.

²⁴ Recently, BNDES begun to apply different interest rates in its loans, according to the nationality of the firms. In the case of national firms, interest rates are lower than in the case of foreign companies acting in Brazil.

investment needs to be reduced, as many documents from industrial associations repeatedly stress.

Recently, this claim seems to have gain strong academic support from a paper elaborated by two well-known Brazilian economists, which identifies a “sustained increase in the relative price of investment” during Brazilian industrialization (1950-2000) – “a Brazilian anomaly in a worldwide perspective”. For the authors, possible explanations for this phenomenon include “increased oligopoly power in industries producing both final and intermediate investment goods (such as cement) and inefficiencies in the capital goods productions process”, factors strongly related to the pattern of trade and investment-promotion policies that characterized the IS industrialization (Bacha and Bonelli, 2004).

- Furthermore, the creation of an environment favorable to qualifying labor and increasing productivity and competition would enhance the quality of FDI by fostering interaction among TNCs, national companies and the recipient economy as a whole. The existence of such an environment – rather than the industrial sector that is the destination of the FDI (for example, technology-intensive) or the export potential of the investment – is what “qualifies” the FDI. From the Brazilian experience, it appears to be fundamental not to create for the FDI “non-competitive environments” to operate in the host country, because this reduces the contribution of this type of investment to the economy and contributes to making the decisions to invest, re-invest and disinvest very sensitive to the structure of policy incentives, thereby potentially increasing the volatility of the FDI flows.

Nevertheless, the creation of such an “investment-friendly” regime (and climate) may require “creative interventions” from policy-makers to overcome market imperfections “that block investment and entrepreneurship in non-traditional activities” and relate to learning spill-overs and to coordination failures (Rodrik, 2003). Hence the hypothesis should not be disregarded of exploring WTO-compatible creative policies to foster domestic as well as foreign investment, through measures whose benefits cannot be completely captured (or internalized) by the TNCs, investments that are promising from the point of view of generating externalities for the host economy.

On the other side, legal measures geared at accepting the (domestic and international) arbitration as an alternative mechanism²⁵ to settle disputes between investors and the State and public entities can prove to be very relevant to reassert the commitment of the Brazilian State with the rule of law, especially – but not exclusively - as far as the contracts of concession of public utilities are concerned.

Missing from the current debate is the discussion of the role of investment agreements as instruments to increase FDI flows and the contribution of these investments towards development. Section 4 contains an explanation of the reasons for the devaluation of the role of such agreements as instruments to promote investments. The idea that such agreements can help to increase the FDI contribution to development or improve the quality of the flows is totally absent from the debate.

As a matter of fact, investment agreements do not take into account development-related concerns as they are not elaborated or signed to cater for these concerns. On the contrary, they protect foreign investors from the potential discrimination deriving from domestic policies and regulations, most of which, at least theoretically, seek to promote development.

In order for this type of agreement to be able to offer some contribution to development, it would have to (i) contemplate aspects that help to increase the sustainability of FDI and (ii) content itself with a degree of protection of FDI that would not be perceived as capable of reducing the possibility of host countries to adopt pro-development policies that respect the WTO rules in effect.

With regard to the first type of provision, attention should be given to:

- provisions to guarantee the pledge of signatories (States) and companies concerning social and environmental objectives of sustainable development; and
- provisions to discipline the use of incentives and subsidies to attract FDI.

As regards the second type of provision, the following guidelines should be retained:

²⁵ To be used as the exclusive way to settle disputes once actioned.

- the GATS model should be seen as a proxy for market access and NT commitments;
- the scope of the agreement should be limited to the concept of FDI, excluding portfolio or financial investment flows;
- these agreements should ambition to guarantee a balanced output between the protection of FDI and the right of States to regulate through mainly (i) the clarification and restriction of the scope of the protections assured to FDI by concepts like indirect expropriation, fair and equitable treatment and (ii) the dropping of the Investor– State mechanism of dispute settlement resolution.
- no extension of forbidden TRIMs should be incorporated to the agreement.

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