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Tracking Foreign Direct Investment

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INTRODUCTION

Brazil has a long tradition as a host country for international direct investment. Foreign companies have been in the country for decades and most big multinational corporations have invested in Brazil. More than 10 thousand Brazilian firms have nonresidents as shareholders. The current value of the total direct investment registered by the Central Bank of Brazil up to June 1995 reached US\$ 98 billion. The foreign direct investment flowing in the new borderless world may be viewed as a potential, even an essential, source of financing for Brazilian economic growth and development.

In this context, high quality data on the external sector are very important for planning and executing policies designed to boost the attractiveness for productive foreign investments, as well as to route it into areas of greatest interest to Brazil's social and economic development.

Up to 1995, the certificates of registration of investments and the foreign exchange contracts were the principal sources of the data collected by the Foreign Capital Department of the Central Bank of Brazil. The information thus gathered does not provide the means for a broader knowledge of the foreign sector of the economy. In order to obtain more useful data the Central Bank carried out , in 1996, the Census of Foreign Direct Investment in Brazil.

This paper describes the objectives, the methodology and the treatment of the data in the Census of Foreign Direct Investment in Brazil. It also analyzes the role of the data in attracting new productive investments and its affects on the development of the country.

1. OVERVIEW

1.1. The Regulation of the Census of Foreign Direct Investment in Brazil

Brazilian law states that both domestic and foreign capital enjoy equal treatment. The 1988 Brazilian Constitution, which established a series of state monopolies in some sectors of the economy and assured protection and preferential treatment to domestic capital, has been altered. At present, the legislation that regulates foreign capital has eliminated many state monopolies and restrictions to the foreign capital and no longer discourages new foreign investments.

In the 1990's, the process of liberalization of the Brazilian economy to include the external market has favored the economic relationship of the country with the rest of the world by:

- (1) removing or reducing tariffs and non tariff barriers on international trade;
- (2) simplifying the bureaucratic rules and procedures and;
- (3) eliminating or reducing the tax on capital income. The program known as Plano Real also contributed to the improvement of foreign trade relations by reducing the rate of inflation and by stabilizing the economy decreasing the risks involved in investing in Brazil.

Foreign capital is regulated by Law no. 4.131/62, as amended by Law no. 4.390/64. The amended Law assured no limit on capital repatriation and remittance of profits and the registration of reinvested dividends as foreign capital. The Law provides for registration with the Foreign Capital Department of Central Bank for any foreign capital entering the country. Although not mandatory, the registration is a prerequisite for repatriation of capital and transfer of earnings.

Article 55, 56 and 57 of Law no. 4.131/62 authorizes the Central Bank "to carry out, periodically, a census of the foreign capital invested in the country, to draw up the plan and forms of the census in order to make possible a complete analysis of the situation, flows and results of the foreign capital" and "draw up a wide-ranging and detailed report for presentation to the Council of Ministers and the National Congress on the basis of these censuses."

The Law provided the Central Bank with the legal and administrative authority to require survey respondents to report information on FDI (Foreign Direct Investment). Nevertheless, in preparing for the national survey, the authorities still needed to address the issue of data confidentiality, to set the penalties for failure in reporting and to determine the report requirements.

In this context, Central Bank Vote no. 227/96 established as subject to reporting enterprises included in the following classification:

(1) any Brazilian business enterprises in which a nonresident person owned or controlled, directly or indirectly, 10 percent or more of the voting shares or 20 percent or more of the total shares, and;

(2) all Brazilian business enterprises with an external debt equal or superior to R\$ 10.000,00 (ten thousand Reais) in December 31, 1995.

In Paragraph 12 of the Vote it is assured that the data gathered will be treated with confidentiality and for analytical and statistical purposes. Central Bank Resolution no. 2.275/96 established the penalties for failure in reporting.

1.2. Foreign Capital Data Gathering in Brazil

The origins of organized international business goes back to the traders of the ancient eastern civilizations. Connections between the extreme orient and western countries are very ancient, dating from before Marco Polo's travels. In the 17th and 18th centuries, the British and Dutch trading companies established outposts in places as remote as the East Indies with a complex financial and commercial organization.

Even though international trade may be as old as civilization itself, international capital flow statistics, although abundant and valuable nowadays, were almost non-existent up to the 1930's. After World War II, United Nations specialists, using information from the balance of payments of each country, started building up international capital flow tables.

In Brazil, during the Empire, most of the external capital came from England, from this period up to the 1930's, no effort was made to measure the flows of international capitals. Brazil's foreign exchange difficulties in 1931 led to a consolidation of the foreign debt. A systematic calculation of the Brazilian's international balance of payments started only after the end of the Second World War. The institution in charge of this task was SUMOC -Superintendence of Currency and Credit- which later became the Central Bank of Brazil.

Nowadays, foreign capital is registered by the Central Bank in the currency in which it enters the country. Reinvested earnings are registered in the currency of the country to which the profits could have been remitted. Registration is completed with the issuance of the Certificate of Registration by the Foreign Capital Department - FIRCE. Foreign direct investment includes only equity capital i.e., resources directly applied in the capital of enterprises established in the country. Statistics on foreign direct investment flows and stocks are based on three valuations:

- (1) on historic cost basis i.e., at the parity of exchange the transaction actually occurred;
- (2) on current cost basis i.e., converted to the parity of exchange among currencies on the date the table refers to and;
- (3) on corrected cost basis, i.e., corrected according to US Consumer Price Index.

Before the Census, the primary source of information on foreign capital in the Central Bank were the Certificates of Registration and the foreign exchange contracts. They provided information for the Department of Foreign Capital to build statistics on the total stock of investments and reinvestments by country and by economic activity based on the three valuations mentioned above.

The data that the Department of Foreign Capital of the Central Bank collected prior to 1995 lacks much relevant information and it has been the subject of much criticism such as the following:

- (1) the amount of stock of capital is obtained from the registration of inflows and outflows, but the statistics do not reveal the amount of assets - plants and equipment - of the foreign

firms;

(2) only the foreign direct investment is taken into account, the indirect participation of nonresidents through subsidiaries established in the country should also be considered;

(3) only the investment of nonresidents on equities is taken into account. Most of the countries includes inter company loans as direct investment. For example, the United States, presently Brazil's major investor, transfers large amounts of investment to its worldwide companies through loans;

(4) given that only the direct investment is taken into account and that some groups have holding companies, the many economic activities of a whole group of companies may be registered as just one, hence many economic activity may go unnoticed;

(5) some groups have holding companies or central offices in major cities of Brazil and assets and plants in different sites. Since the companies are only required to inform the address of their central offices, many times the information about the investment is not placed in the state in which it actually occurs;

(6) there is no information on the size of the company receiver of the investment;

(7) important economic indicators such as employment, operational and financial cash flows, domestic and international sales, prices policies and liquidity are not available;

(8) because it does not follow international standards, the methodology used for gathering and sorting does not provide for international comparability; and

(9) missing information on the type of the enterprise's economic activity and CGC.

Taking into account these problems and facing the international changes towards globalization and domestic changes attitude towards trade liberalization and also in order the supply the demand for better data, an updated version of FIRCE structure of data gathering has became peremptory. The former structure was built up to perform Central Bank's functions of supervision and inspection. The increased liberalization of investment and financing flows has been gradually shifting this controlling trend to one of planning, highlighting the importance of data gathering and diffusion.

2. THE FIRST CENSUS OF FOREIGN CAPITAL IN BRAZIL

2.1. The Census of Foreign Capital

The process of liberalization and the stabilization program mentioned in section 1.1. above, together with the regularization of external payments fostered the exceptional recovery of direct investment inflows. According to Central Bank, the net entries increased from US\$ 287 millions in 1990 to approximately US\$ 9.5 billion in 1996.

These figures and facts demonstrate the foreign investor's recognition of Brazil's potential market. In despite of this recognition, The Central Bank could not satisfy an important requirement of international business marketing: provide updated, systematic, high-quality information on the capital invested in the country.

In this context, the first census was conducted with the following objectives:

(1) produce a comprehensive data set in order to make possible a complete analysis of the stocks, flows and results of the foreign direct investment in Brazil, as determined by Law no. 4.131/62;

(2) provide the necessary information to State regulators, replacing the Certificate of Registration - CR, in this function. The CR became an electronic declaration, integrated into the new methodology, which aims to reduce State interference in the private sector. With the new electronic declaration, which is being implemented, the foreign company does not have to have a certificate issued each time it makes an investment in the country. Information on the operation will be given to Central Bank electronically, by the company itself or by the financial institution through which the transaction was done. Further balance of payments and operational data will only be asked periodically, on Census or sample surveys;

(3) obtain information for formulating strategic, global and sector economic policies for the government and obtain information to support studies carried out by academic and government researchers to assess the impact of Brazilian policy on foreign direct investment;

(4) identify the financing and investing opportunities, the borrower characteristics and the target sectors, and therefore promote investment;

(5) improve the quality and availability of data by the use of international standards that allow the exchange of bilateral data (so far as confidentiality constraints permit) which can also be useful in conducting negotiations to reduce barriers to investment and trade;

(6) provide a set of data for empirical analysis of the effects (negative and positive) of multinational companies in the economic growth of Brazil including geographical and historical detail;

(7) provide information indicative of profit by sector and profit by region through verification of liquidity indicators, indebtedness and relations with other national and international enterprises and;

(8) institute a reliable policy for periodical update and renewal of the data.

2.2. Methodology

The project started with a benchmark. The designated team made a three-months research on various censuses realized worldwide. The American and German questionnaires were selected for further research. We contacted the institutions responsible for carrying out surveys in those countries: the Bureau of Economic Analysis -BEA- in the United States and the Bundesbank in Germany. They both sent us updated material and periodicals. Later the Central Bank invited a specialist from each country to share their experiences.

The BEA conducts benchmark surveys, which are conducted every 5 years, and annual sample surveys on both U.S. direct investment abroad and foreign direct investment in the United States. The American surveys collect a wide variety of data items related to balance-of-payments, direct investment position and financial and operating data, the complete form has around 300 questions. The Bundesbank collects only balance-of-payments data, the form has around 65 questions. The general data concepts and survey methods employed for the Brazilian survey are in accordance to those used for both countries, although we tried to fulfill our particular needs and reduce the reporting burden.

The cooperation of these two countries and IMF's recommendations were of great importance to make international comparability possible and to ensure data quality.

Reporting in the survey was determined by Law 4.131/62 and the penalties for failing to report were established by Central Bank Resolution no. 2.275/96. Confidentiality was granted by assuring that

information that is individualized through use of the name of the person or company in question would be treated as confidential. The information may be used only for analytical and statistical purposes.

The survey covered Brazilian businesses in which, on December/95, at least ten percent of voting shares/quotas or at least twenty percent of total shares/quotas belonged, directly or indirectly, to nonresidents of the country.

Entities carrying debts on December/95 with a principal debt balance that is greater than or equal to R\$10,000.00 (ten thousand Reais) when such debts are consequent upon credits granted by nonresidents, independently of the currency of which such credits are denominated and of whether they have or have not been registered at the Central Bank Department of Foreign Capital.

The declaration can be delivered in magnetic media (floppy disks) using a software developed by Central Bank, or through forms. The forms and the software are sent to the companies registered at Central Bank and they can also be obtained, free of cost, at the regional offices of the Bank. Declarations from companies with annual gross operational revenues equal to or greater than R\$ 200,000.00 (two hundred thousand Reais) have to be made using the software and delivered in floppy disks.

Most of the concepts and principles underlying the survey were applied in conformity with those contained in fifth edition of the IMF's *Balance of Payments Manual (BPM5)*.

A nonresident is a person or enterprise which is situated outside Brazil. The country of residence, rather than the nationality of a person is used to determine whether a business enterprise owned by a direct investor is Brazilian or foreign.

The definition of direct investment is in Chapter XVIII of *BPM5* and the *OECD Detailed Benchmark Definition of Foreign Direct Investment*. Direct investment is the category of international investment in which a resident entity in one economy obtains a lasting interest in an enterprise resident in another. A direct investment relationship is established when a resident in one economy owns 10 percent or more of the ordinary shares or voting power or the equivalent.

All indirect lines of ownership interest held by a nonresident must be summed to determine whether the enterprise is a Brazilian affiliate of the foreign person for purposes of reporting. A foreign percentage of indirect ownership in a given enterprise is the product of the direct ownership percentage of the foreign parent in the first Brazilian enterprise in the ownership chain times that first enterprise's direct ownership percentage in the second Brazilian enterprise times each succeeding direct ownership percentage.

The ultimate beneficial owner or holding of a Brazilian affiliate is the person, proceeding up the affiliate's ownership chain, that holds the ultimate control of the affiliate.

Data for Brazilian affiliates are required to be filed on a fiscal year basis. An affiliate's 1995 fiscal year was defined to be the affiliate's financial reporting year that ended in calendar year 1995. The survey data must be adjusted to a calendar year basis before they are entered into the foreign direct investment position.

Consolidation rule establishes that all branches and agencies of a given affiliate under the same CGC number should be aggregated on a single form.

The codes for classification of economic activity is the same used by the *Instituto Brasileiro de Geografia e Estatística-IBGE*. These classification are adapted from those in the *International Standard Industrial Classification*.

Financial and operating data focus on the overall operations of Brazilian affiliates. Among the items covered by these data are the following: identification; direct and indirect participation; balance sheets and income statements; gross product; sales of goods and services; interests; taxes; dividends; royalties; import; export; economic activity; plants and equipment by state; and number of employees (see *attached forms*).

The computer software to be used in the processing of the data include microcomputer routines developed for data gathering, programs for processing the information on Central Bank main frame (using ADABAS Data Base Management System), and installation of a time intelligent database warehouse management system to produce and store time series data (SAS).

2.3. Expected Results

The resulting reports will bring significant improvement and changes in the quality and scope of the foreign direct investment data in Brazil. Statistics on direct foreign investment produced by the census will provide a comprehensive and integrated data set for empirical analysis of multinational companies and of its effects on the economy of the nation. The scope of these statistics has expanded in accordance with the complexities brought by the integration of the global economy. We expect to have information ranging from traditional balance-of-payments items to new financial and operating items. The new profile includes the following improvements and innovations:

- (1) the foreign capital measurement shows the amount of stock of capital, which is obtained from the registration of inflows and outflows. The new statistics will also reveal the amount of assets of the foreign firms, which is expected to be much higher than the original amount invested;
- (2) the scope of statistics has broadened. The foreign direct investment has been being accounted for. The new scope includes indirect participation of nonresidents through subsidiaries established in the country;
- (3) the criteria for evaluation of the stocks has changed. Only the investment of nonresidents on equities was taken into account as direct investment. The methodology applied now comprehends equity capital, reinvested earnings, and intercompany debt as direct investment. This new criteria will not only gauge a larger and more real figure but also reveal the financing profile of firms and the role of intercompany bonds in competitiveness, domestic sales, and exportation;
- (4) the distribution of the investments by economic activities is more detailed. The many economic activities of a group of companies and the activities of the companies in which it participates indirectly will be registered separately. Therefore we will be able to produce tables of profitability, taxes paid and others, by economic activities.
- (5) the geographic distribution of investments is more precise. While previously we were informed only of the holding companies address or central offices in major cities of Brazil, now we are informed the state where assets and plants are located or the site the investment actually occurs;
- (6) the distribution of the investment by size of the company receiver of the investment will be available. The foreign participation on small, medium and big companies will be known;
- (7) financial and operating data will be used to evaluate the economic impact of multinationals on Brazilian economy that could not be addressed by balance of payments data alone. They provide a wide variety of indicators of the overall operations of foreign affiliates such as employment, operational and financial cash flows, domestic and international sales, merchandise trade, import, export, and prices policies;

(8) international comparability was made possible by the adopting economic activity codes compatible with the *Standard Industrial Classification Manual* and by applying the same definition of direct investment is in Chapter XVIII of *BPM5* and the *OECD Detailed Benchmark Definition of Foreign Direct Investment*;

(9) valuable data to economic policy makers, the academic community and the public in general will be available. The Foreign Capital Department of Central Bank shall publish a periodical with the aggregated results of the survey including direct investment position and financial and operational data. This publication will broaden considerably the information now available;

(10) the use of codes such as the national CGC number and the standard industrial classification code also used by IBGE, will allow to cross-check the survey data against other data reported to a different Department of Central Bank or other government institutions as far as confidentiality constraint permits and;

(11) the choice of a temporal database warehouse management system (SAS) that incorporates routines to store time series efficiently.

The reports and outputs shall produce a comprehensive profile of the foreign capital in the country including: origin of investment, economic activity, geographic distribution, size of affiliates, equity structure, total assets, liquidity and indebtedness of affiliates, profit-margin, domestic sales, import, export, amount of taxes produced, and employment. (*see attached sample tables*).

3. FINAL CONSIDERATIONS

Poverty, social inequality, disparity in income distribution, low levels of literacy and life expectancy are the bitter consequences of underdevelopment. According to the IMF, the estimated annual rate of GDP growth necessary to combat poverty in Brazil is around 6%.

Economic growth can be achieved through an increase in the factors of production: land, labor, and capital or investment. Brazil has experienced, in the last years, a substantial decline in public investment. The country has not enough domestic savings to provide the necessary resources of financing such investment. The government can no longer support public investment policies in Brazil for the simple reason that it lacks funds. Opening up the economy to foreign direct investment is to import the necessary savings to finance the long-term economic growth.

Other sources of economic growth are improvements in technology, in methods, and in quality factors. Human capital is not bound by diminishing rates of returns. Together with increase in capital, human capital can cause increasing rates of returns. The experiences of other countries tell us that there is no economic or political stability in the long-run without investments in human capital. A few of the known effects of some foreign direct investment for host countries include transfer of technology and improvements in productivity and efficiency.

Inflows of foreign investment alone can not be viewed as the sole solution to all problems facing the Brazilian economy, but it is an important part of it. Other measures aiming the stability and the recovery of the development process are also necessary, but they are beyond the scope of this paper.

The attitude of developing countries towards foreign investment has shifted from the restrictive policies and skepticism that characterized the early 1970's to policies that seek to attract increasingly larger amounts of foreign investment. In the 1970's, the idea was of the developing country as the passive victim of exploitation; now, the idea is in terms of the developing country encouraging inflows of investments.

The impact of direct foreign investment on developing countries is being re-examined because of changes in the external economic situation, in technology, in the nature of the world-wide companies, and in the private sector-government relations. Foreign direct investments may be viewed as potential sources of benefits as well as potential sources of problems for the host country economy. On one side, it is important now to encourage the inflows of capital and to construct policies to ensure the transparency of the foreign firms. On the other hand, it is important not to concede indiscriminate privileges to investors under threat of losing the investment, especially if it involves sheltering the investors from competition to the detriment of host economy.

Policies should try to focus on the positive economic consequences of foreign direct investment for host countries such as: inflow of savings, transfer of technology, increases in labor productivity, efficiency of resource utilization, creation of employment, earnings in foreign currency and access to export markets. The appropriate combination of these elements can contribute to accelerate the growth process of Brazil's economy for they bring not only the capital for financing the growth but can also cause an improvement of human capital. The information obtained by the census can be utilized to quantify the positive consequences. Further, this information can be used to define and attract the desirable investment for Brazil.

The negative economic consequences of foreign direct investment for host countries can arise from the ability of multinational companies to use their market power to generate supernormal profits and transfer these to nonresidents or to undermine domestic enterprises. Multinational companies might also be capable of influencing local political processes to the detriment of the host nation's economy. Finally, foreign direct investment can cause a rise in industry concentration that could imply in an increase of monopoly power in some sectors.

Given that the final objective of investors is to maximize profits, we have to consider that, in the long run, the inflows of capital in the form of investments may be inferior to the outflows of capital in the form of return of investment, or income, to home countries. Therefore, in the long run, foreign investment can reduce, in net, the amount of international savings available to host countries, this may reduce capital formation and long term growth prospects.

According to Edward Graham, *"the evidence seems to support those who maintain that foreign direct investment tends to have net positive effects on host nation economies."* Our point is to highlight the importance of providing a mass of empirical data on FDI to support policies that will maximize the benefits and minimize the costs of accepting multinational enterprises.

A comprehensive data set on FDI can give support in establishing adequate policies, designed according to the particular needs of the country, to foster the benefits that foreign capital can bring to host countries, such as:

- (1) the value of earnings must be compatible with the value of taxes paid. A comparison between the amount of repatriated earnings with taxes collected can give means to detect supernormal profits. The reallocation of taxes collected on profits can bring redistribution of income;
- (2) data on the amount of money spent by MNC (Multinational Companies) on local research and development may reveal a positive effect on education;
- (3) an increase in the amount of tax paid by local firms may be a sign of higher productivity enhanced by increased interfirm rivalry engendered by the entry of a foreign company in the market;
- (4) there is a large inequality of investment distribution among the regions of Brazil. MNC establishing new plants in remote sites and in regions lacking investments may be given subsidies;

(5) foreign firms engaged in economic activities using non-renewable resources may be requested to invest some of their profits on environmental projects;

(6) large, unexpected capital outflows can bring economic instability and affect the level of international reserves. Historical series gives empirical data and allows projections that can forecast net outflows in time to set stabilizing policies.

As Brazil places increasing emphasis on attracting foreign investment, providing data to future and existing foreign investors is also a service the Foreign Capital Department of the Central Bank can offer. Providing effective information and assistance on relevant data about, for instance, costs or markets can bring more investment in. The results of adopted policies can be evaluated through periodical reviews of critical data obtained by running sample updates of the census.

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