

# Opportunity Cost In Brazil, Thicket Of Red Tape Spoils Recipe for Growth

**Former Emerging-Market Star  
Loses Ground to Asia, EU;  
Lufthansa's 24-Year Fight  
Waiting All Night at Tax Office**


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RIO DE JANEIRO -- When Vinicius van der Put tried to start a telecommunications company here last October, it took him six months and trips to eight government agencies just to obtain a temporary business license.

"Some clients gave up on us because they started questioning our credibility," says Mr. van der Put, a former development manager for Royal Dutch/Shell Group, who estimates the delay cost him \$20,000 in expenses and lost sales. The reason for one snag: A state tax official thought the margins on Mr. van der Put's invoices were a few millimeters off.

That wasn't unusual. Entrepreneurs seeking a foothold in South America's largest economy must hack their way through an Amazonian thicket of red tape. Mr. van der Put's tribulations offer an important clue to a big mystery: Why has Brazil, an emerging-market star during the 1990s, lost ground to China, India and Eastern Europe in the race for growth, markets and investment?

Since 1994, Brazil has dropped to 14th place from eighth among the world's largest economies. On the latest ranking of attractive destinations for investment, as compiled by consulting firm A.T. Kearney, Brazil sank to 17th place from third place in 2001. Even last year's exceptionally strong economic performance, caused by high prices for Brazil's agricultural and mineral commodities, hasn't been sufficient to reverse this decline: Per capita income in real terms remains slightly less than it was a decade ago, and unemployment is stuck in double digits.




**Chapter 10**  
***Staying the Course***

How a long-term  
strategy helped  
an investor

**stay the  
course**

when the  
temptation  
was to head  
the other way.

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Brazil's struggles, which are mirrored in several other Latin American countries, have puzzled development economists. After all, these resource-rich nations broadly followed Washington's free-market recipes during the 1990s. They put a lid on spending and inflation, privatized state-owned companies and tore down trade barriers. Then, with economic payoff slow in coming, frustrated Latin American countries began lamenting to Washington that "we have followed every sort of advice...and we're still not growing," says Simeon Djankov, an economist at the World Bank.

So, after touting a few big ideas during the 1990s, the World Bank has started pushing a lot of little ones, advocating a raft of changes to create a more business-friendly environment. The new thinking is that the devil of underdevelopment may lie in the details that make countries like Brazil such unwelcoming places to invest.

The country's snail-paced justice system represents one of these hurdles. German airline Lufthansa has been in court for 24 years fighting a wrongful-termination lawsuit filed by a former sales manager named Günter Kattelmann. In the early 1990s, because of a court clerk's mathematical error, Mr. Kattelmann was awarded a \$56 trillion judgment. It took Lufthansa seven years to get the award overturned; courts are still trying to determine how much the airline owes its former employee.

In the past couple of years, much of the World Bank's focus in 10 Latin American countries has been on "competitiveness loans" that help combat this kind of bureaucratic morass. Among these loans is the \$505 million credit Brazil received last year to simplify the registration of new businesses, to ease the paperwork for processing containers at ports and to streamline the opening of bank accounts.

Such measures can mean a lot, Mr. Djankov says. Brazil could add half a percentage point to its output -- translating into some 160,000 jobs -- simply by reducing the licensing time for new businesses from the current 152 days to Chile's level of 27 days. In the U.S., according to the World Bank, the waiting time is just five days. ([See more information on the World Bank's Doing Business report.](#))

For Washington, it's vitally important that Brazil prosper. Neighboring Venezuela and Argentina got frustrated with the free-market model and have veered toward a populism mixed with growing anti-Americanism. Brazilian President Luiz Inácio Lula da Silva, a pragmatic former union leader, has resisted pressure to take the same route: He's trying to combine market rigor with social justice. "The impression I have is that the Brazilian state was set up in order not to function, to delay a lot," President da Silva remarked last year to O Globo newspaper.



A study by Brazil's small-business association found that 70% of entrepreneurs who try to open a business legally

never conclude a process that requires about 100 different documents. Most simply operate off the books in an underground economy that's nearly half the size of the country's official output. Endemic tax evasion, in turn, increases the burden on the narrow base of law-abiding taxpayers, who get hit with 61 different taxes and an aggregate tax burden of more than 35% -- about twice that of Mexico, China or India. A new tax regulation is issued, on average, every 40 minutes.

The human cost of such a dysfunctional system is visible every midnight during the workweek, as paralegals and interns start lining up on a sidewalk outside a big federal tax-office here in Rio de Janeiro. Their mission: to pick up in the morning a prized number that's required for an interview with a tax official. Fábio Pereira Kapp, a 20-year-old office assistant, says the savvy tax office supplicants know to bring beach chairs. Yet it's no picnic waiting in the dark in a crime-ridden part of town. "It is kind of dangerous, really," he says.

Such ordeals explain why, among Brazilians themselves, the World Bank's anti-red-tape push is so popular -- unlike many other programs championed by international financial institutions.

Using the World Bank study as their rallying point, small businesses have launched a nationwide campaign that will culminate with a march on the capital in June. Brazil's two dominant media companies, Organizações Globo and Editora Abril SA, also joined the crusade for bureaucratic downsizing.

Brazil's massive paperwork problem has been accumulating since 1549, when the first Portuguese governor-general, Tomé de Sousa, disembarked carrying a complete set of laws drafted in Lisbon. In the early 19th century, Brazil reaffirmed the centralist tradition as Portugal's King Joao VI established his court in Rio de Janeiro after being menaced by Napoleon's army. It was the only case of a European monarch ruling his realm from the New World.

In 1943, inspired by Benito Mussolini's Italy, President Getúlio Vargas introduced to Brazil a 922-article labor law modeled on fascist legislation. Subsequent laws enshrined paternalistic labor relations, in some cases subjecting companies to fines if employees' children don't get timely vaccinations.

In 1979, a military government launched a typically Brazilian plan to streamline the bureaucracy: It named economist Hélio Beltrão to the new cabinet post of Minister of De-bureaucratization. Mr. Beltrão introduced fast-moving small-claims courts and reduced the licensing time for a new business to three days from several weeks.

But de-bureaucratization lost momentum after Mr. Beltrão and his team faded from the scene in the 1980s. The program was swallowed by an obscure secretariat of the Planning Ministry. Since then, new regulatory areas, such as environmental law, have emerged to frustrate investors. Officials say environmental protection is crucial at a time when Brazil's record is increasingly criticized by ecologists. But delays can undermine sectors such as electricity, so starved of investment that Brazil had to endure power rationing just four years ago. Industrial conglomerate Grupo Votorantim has had equipment for a hydroelectric project standing idle for more than 15 years while awaiting environmental permits.

More problems came when Brazil returned to democracy and drafted its 1988 constitution, with 245 articles, one of the world's longest. The constitution broadened the powers of state and city administrations, stoking turf battles with the federal government and causing gridlock.

Permit requirements from a crazy quilt of federal and local agencies prolong the construction time of an apartment building to 42 months from eight and quintuple the cost, according to a study by the construction industry's association. "You often spend more time filling out forms than building buildings," says Paulo Safady Simão, president of construction company Wady Simão-Construções e Incorporações.

Though Brazil's wages are relatively low, benefits mandated by the labor legislation double the nation's overall labor cost. Because of this, Brazilian workers end up costing nearly as much as their better-trained counterparts in European Union members Poland and the Czech Republic, and much more than those in Thailand. It's almost impossible for companies to stay in compliance with all the regulation. Brazil's special labor courts handle 2.2 million cases per year, compared with only about 3,000 such cases in Japan.

Companhia Estadual de Energia Elétrica, an electric utility, has 3,329 employees and nearly three times that many pending labor lawsuits. The value of worker claims -- \$274 million -- is 2.4 times the company's net worth.

Companies try their best to adapt to the myriad obstacles. Lawrence Pih, president of Moinho Pacífico Indústria e Comércio, which owns Brazil's biggest flour mill, located his plant at a port to compensate for customs delays. To avoid more labor suits than the 300 he already faces, Mr. Pih automated his operations, boosting production by 50% over the past five years with the same number of workers. Still, he says, "it's very hard to make money in Brazil."

The abundance of such economic speed bumps is one reason why Brazil has had difficulty attaining steady growth and withstanding the shocks that periodically roil emerging markets. Brazil's erratic performance, including repeated currency crises, has disappointed many of the foreign investors who flocked here during the 1990s. Brazil has attracted about \$200 billion in foreign investment since the mid-1990s, but in a survey of 400 multinationals published by the Brazilian magazine *Veja* last year, 46% said they lost money. Last year's foreign-investment total of \$18 billion, while up from the 2003 level, was still far below the \$32 billion Brazil received in 2000, according to Brazil's central bank.

Trying to reverse this trend, President da Silva has moved to advance the computerization of customs, which should speed up port traffic. A separate drive to apply the Internet to environmental licensing is projected to reduce turnaround time for permits, the government says. In another initiative last week, the government said it would send a bill to Congress to reduce the time it takes to open a new business to 15 days.

President da Silva also won a landmark legislative change last December when he pushed through a long-stalled bankruptcy law that may make bank loans more accessible. The new law, effective from June, should at least halve the 10-year average length of bankruptcy restructurings and boost the amount of a failed company's assets that lenders can recover. Economists say a greater loan-recovery rate should prompt banks to lower corporate interest rates, currently among the world's highest at about 30%.

But President da Silva has found that cutting bureaucracy is grinding work. The new bankruptcy law had been stuck in Congress for 11 years. Another recent change, to reduce the caseload of the Supreme Court, had been in the works since the 1960s. The government is preparing amendments to the labor law, but the matter is so controversial it will be difficult to advance before next year's presidential elections.

Complaining about the slow pace of change, President da Silva said last year that a foreign investor "visits 10 or 12 ministries. After a week here he goes back and hasn't resolved anything." So last July, he appointed a special adviser, Walter Cover, a 1960s pro-democracy activist who became a corporate executive, to offer a helping hand to stymied investors.

But even the president's man can't surmount some obstacles. Japan has

expressed interest in loaning Brazil \$1 billion for a badly needed overhaul of its sanitation system, Mr. Cover says. But the project is held up: Brazil's Congress and courts must first clear up constitutional ambiguity on whether sanitation is the purview of state or local government.

"In some countries, like China, it could be easier to make changes," Mr. Cover says. "But that's the cost of democracy."

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