POLICY MONITOR

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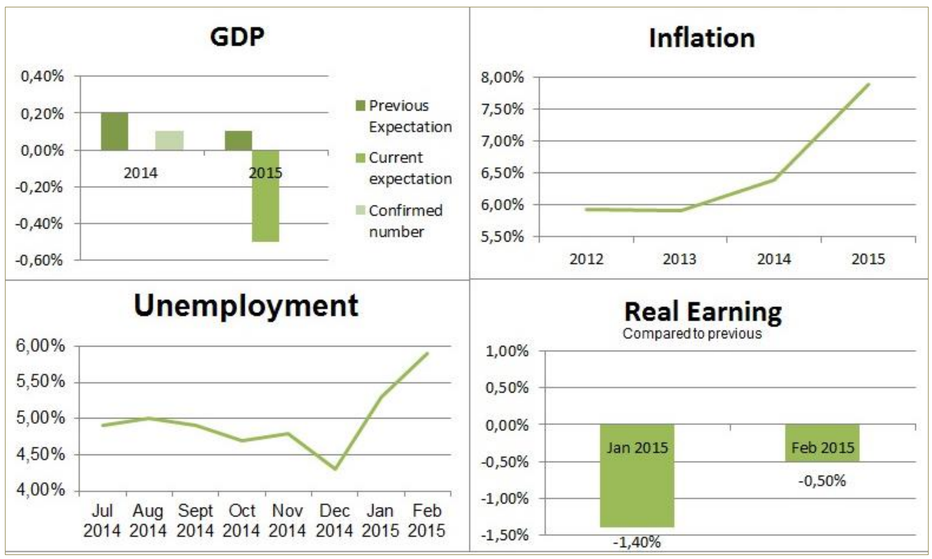
The Week in Review

On the Economic Front

Brazil Economic Scenario

Brazilian economic policy has seen better days. In addition to the devaluation of the Real, in general, all economic indicators have been revised downward by the Central Bank. The fiscal situation in Brazil worsened last year with a record deficit in the public accounts (government spent more than it raised in taxes). Brazil’s recession has been an important factor, given tax revenue estimates were built on the premise of at least small growth in the economy. Current estimates show a stagnant economy for 2014 and recession for 2015, with a predictable downward slide in tax receipts, making it even more difficult to reach the promised primary balance surplus of 1.2% of GDP for 2015.



In addition, inflation and inflationary expectations are rising, real earnings (adjusted for inflation) fell in 2015 for the first time in years, and the unemployment rate hit 5.9%, up 1.6 percentage points since November 2014. The combination of recession, fiscal fragility, economic interventionism, and economic recovery in the United States has not been good for attracting foreign investment, which although still positive, has fallen in 2015 compared to longer-term trends.

On the Political Front

Cabinet Reshuffle

On Wednesday, Minister Thomas Traumann resigned from the Ministry of Social Communications after criticizing the government's communication policies through an internal document that displeased President Rousseff. Traumann is the third minister to leave Rousseff’s administration only three months into her second term. The other two were Cid Gomes from the Ministry of Education and Marcelo Neri from the Ministry of Strategic Affairs. Today Edinho Silva was announced as Traumann’s replacement. Silva was a São Paulo

BRASÍLIA
SAF Sul Quadra 02, Lote 04.
Edifício Via Esplanada
Salas 103 a 106

CEP 70070-600
Fone: (61) 3327-2606
Fax: (61) 3327-1619

SÃO PAULO
Rua Olimpíadas, 134, 5º andar, Cj 52.
Condomínio Alpha Tower
Vila Olímpia

CEP 04551-000
Fone: (11) 3079-4533
Fax: (11) 3079-2202

WASHINGTON, DC
1101 17th St.
NW Suite 1010

Phone: (202) 822-6420
Fax: (202) 822-6423
www.patri.com.br
relgov@patri.com.br

State Representative in the last legislature and was also the Worker's Party treasurer for President Rousseff's 2014 campaign.

Petrobras

On Monday, Brazil's Superior Court of Justice (*Superior Tribunal de Justiça* - STJ) revealed a document stating that Workers' Party (*Partido dos Trabalhadores* - PT) treasurer Joao Vaccari is to stand trial on corruption and money laundering charges relating to the Petrobras corruption scandal. According to investigators, Vaccari, along with 26 others, is set to be tried for demanding "bribes in the form of electoral donations" for the Workers' Party. Several top executives are already in jail and the country's top prosecutor is investigating dozens of influential members of congress in connection with the corruption. Vaccari is alleged to have received donations totaling more than US$1.2 million (1.1 million euros). He is one of the most prominent leaders yet to be accused in the scandal.

Vaccari and the president of the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico* - BNDES), Luciano Coutinho, will testify before the Petrobras Parliamentary Investigation Committee (*Comissão Parlamentar de Inquérito* - CPI). Coutinho is being summoned to investigate irregularities between *Sete Brazil*, a drilling rig company, and Petrobras. The president of BNDES will be asked about loans granted by the bank to the company in the period in which it had contracts with the state and its subsidiaries. The dates of their depositions are still to be determined by the President of the CPI, Hugo Motta (PMDB-PB).

Car Wash Investigation Leads Brazilian Construction Firm to File for Bankruptcy Protection

Brazilian construction firm Galvao Engenharia, one of the 23 companies being investigated in the so-called Car Wash Operation, filed for bankruptcy Protection in the State Court of Rio de Janeiro. The company has faced financial difficulties since the end of last year when Petrobras suspended contracts with Galvão and other contractors. These companies have been accused of forming a cartel to rig contracts with Petrobras, the state owned oil company, and divert public money to cover illegal payments or "kickbacks" to both politicians and business leaders. In total, BRL$7.7 billion in contracts with Galvão Engenharia are being investigated. The investigation has increased the credit risk of the company and dried up its sources of credit. Since November, the construction firm has been trying to construct a 620 km highway, which connects the states of Goiás and Tocantins, but BNDES has not approved the loan requested by the company.

Assessment: The case of Galvão Engenharia may be the worst, but it is not the only one. Although most contractors refuse to admit it, these investigations have hindered their business, which was already shaken by Brazil's current economic situation. Should other companies also face bankruptcy, the repercussions could be serious and far reaching. In addition to short-term effects such as lost jobs and reduced incomes, it would hinder the construction of much-needed infrastructure in Brazil that would not only be a key component of economic recovery but a critical pillar of the country's long-term development.

National Confederation of Industry's Legislative Agenda

On Tuesday, the National Confederation of Industry (*Confederação Nacional da Indústria* - CNI) announced its legislative agenda for 2015. The document is intended to provide advice on balancing public accounts, controlling inflation, and improving competitiveness. Minister of Development, Industry and Foreign Trade Armando Monteiro praised CNI stating, "The industry's agenda directly reflects the country's agenda." CNI's response concentrated on the following issues: 1) Promoting investment in infrastructure through concessions; 2) Modernizing labor relations; 3) Prioritizing bureaucracy reduction; 4) Re-setting the regulatory models; 5) Simplifying the tax system, and; 6) Stimulating exports.

CNI also named 18 bills to be closely monitored, highlighting:

- **PLS 559/13** – New Procurement Framework;
- **PL 4330/04** – Outsourcing;
- **PLS 130/14** – Tax Benefits Validation;
- **PL 3729/04** – Environmental Licensing;
- **PLC 2/15** – Genetic Patrimony;
- **PL 5442/13** – Regulatory Agencies Framework;
- **PDC 1408/13** – Labor Safety for Heavy Machinery Use;
- **PEC 231/95** – Reduction of working hours;
- **MSC 59/08** – New Rules on Employees dismissal.

Task Forces

Innovation

General Law of Antennas: On Wednesday, the full Senate approved Bill 293/2012, which establishes general rules for implementation and sharing of telecommunications infrastructure. The bill will go to presidential approval to become law. Highlights of the bill include:

- Provision of a simplified licensing system to support infrastructure installation in urban areas;
- Determining a maximum period of 60 days to analyze antenna installation requests. This new rule determines that when the 60 day period expires and no decision was taken from the agency responsible, the antenna provider is authorized to perform the installation regardless of the license;
- Making the sharing of excess capacity of the infrastructure mandatory, except when technical reasons prevent sharing.

Tax and Investment

Minimum Wage: On Tuesday, President Dilma Rousseff signed Provisional Measure 672 (*Medida Provisória – MP)*, which extends through 2019 the formula to adjust the minimum wage. The minimum wage adjustment will continue to be based on the previous year's inflation rate plus gross domestic product growth from two years prior. The same adjustment will not apply to retirees earning more than minimum wage salary. The MP was published in the Official Gazette on Wednesday and a select committee composed of senators and representatives will now examine it. If Congress does not vote on the MP within a 45-day window, the measure will halt voting on other bills.

Payroll Exemption Bill: Last Friday, President Dilma Rousseff sent to Congress a bill with the same content as Provisional Measure 669/15 (*Medida Provisória – MP),* which had been rejected by Senate President Renan Calheiros and returned to the executive branch at the beginning of the month. The bill would amend corporate tax exemptions currently in place on payroll (social security) taxes. The tax rate on companies in the 1% category would see their tax rate increase to 2.5% of gross revenue. Companies currently in the 2.0% category would see their tax rate rise to 4.5% of gross revenue.

Calheiros rejected the MP as unconstitutional, arguing that it would cause legal uncertainty for the country by invalidating a previous Provisional Measure, MP651/14, which was signed into law at the end of last year. He said the measure should be introduced to Congress as a bill rather than an MP. The previous MP, among other things, created tax benefits intended to stimulate national industries and capital markets by continuing the existing payroll tax relief and extending it to the retail sector. It replaced a 20% tax on payroll resulting in reduced business tax liabilities.

The bill must be analyzed by two House Committees at the same time, and in both cases, the rapporteur will be Representative Leonardo Picciani, PMDB House Leader. The bill is under constitutional urgency and will halt other votes on the House Floor from May 5th onward. Under the Brazilian Constitution, tax measures should have a 90-day window after they are approved by Congress to take effect, in order to allow time to adjust to changes in tax rates and rules.

Injunction Against IPI Increase on Cosmetics: On Tuesday, a cosmetics distributor in Minas Gerais state was the first to receive an injunction against the Tax on Industrialized Products (*Imposto sobre Produtos Industrializados* - IPI) levied on cosmetics. Under the Brazilian Constitution, tax measures are required to have a 90-day window following approval to allow affected parties to adjust to changes in tax rates and rules. As such, the company in question was not subject to the IPI increase, which will take effect on May 1st.

The Tax on Industrialized Products is a federal tax that is applied to all national and foreign products that have been modified in some material way in Brazil for domestic consumption or use and was announced as one of the Rousseff Administration's economic austerity measures in January. The changes increased the IPI tax rate for cosmetics distributors to a rate equal to the rate charged at the manufacturing level, which is intended to level out the tax charged throughout the chain from production to sales. In Brazil, most of the companies in the cosmetic sector separate their productive and distribution activities.

State and Municipal Debt: The Rousseff Administration is in a difficult negotiation with Congress over changing the index used to calculate the debt owed by states and municipalities to the federal government. Last year, President Rousseff approved a law that would change the formula in a way that would lower the repayment cost of state and municipal governments.

The calculation was changed from the IGP-DI price index plus between 6% and 9%, to the broader IPCA price index plus 4%. However, on Tuesday, facing declining economic growth and tax revenue, the Rousseff Administration decided to postpone the change, stating that the federal government cannot afford to renegotiate this debt because it would compromise reaching the fiscal adjustment targets.

Congress reacted swiftly to the decision. The House approved, under urgency status, a bill forcing the government to adopt rules that would reduce the state debt in the next 30 days. However, before the Senate managed to vote on the same bill, which was what was agreed upon between both House Speaker Eduardo Cunha (PMDB-RJ), and Senate President, Renan Calheiros (PMDB-AL), Finance Minister, Joaquim Levy asked the Senate to postpone the voting.

In return, Levy agreed to personally go to the Senate next Tuesday (31) and discuss a new model of redistribution of federal funds and move forward with the tax reform, an issue that has dragged on in Congress for seven years. In addition to the debt renegotiation, the government should resume negotiations for the ICMS equalization (Tax on the Circulation of Goods and Services) and to validate or disallow tax incentives already granted by states, an issue that would end the fiscal war between states. According to senators present in the meeting, if no alternative is presented, the senate will move forward and approve the bill on Tuesday to force the government to reduce the states' debt.

In addition, Attorney General Luis Inácio Lucena Adams warned that the federal government will fight in court to overturn actions filed by governors and mayors. The National Mayors Coalition is also considering taking court action. The confrontation highlights the difficult moment in the relationship between the Rousseff government and Congress, now extending to governors and mayors, including many who are political allies.

The Pulse

Fiscal Adjustment—Steady But Shaky

The good news on the economic front is that Standard & Poor's maintained Brazil's investment grade credit rating (with a stable outlook), which provides a marginal increase in the government's bargaining power with Congress. S&P believes that despite growing outward disagreements between the Executive and Legislative Branches, congressional leaders will continue to support the difficult fiscal adjustment being undertaken by Finance Minister Joaquim Levy.

Indeed, Congress was able to pass the 2015 budget law, which was a fundamental step towards any successful economic policy this year. Also, the President of Congress, Renan Calheiros, accepted a plea by Minister Levy to postpone until this coming Tuesday a crucial decision that would oblige the government to revise state and municipal debts within 30 days, which has become another big problem for the government. The government is also negotiating with union federations, congressional leaders, and industry associations for changes in the executive orders of the fiscal adjustment. Those negotiations, however, could lead to reducing the much-needed revenue required to meet fiscal targets.

So Brazil's ability to pull off a fiscal adjustment still faces a difficult future. The country is virtually in a recession according to recently revised economic indicators, causing federal tax revenues to decline in February. It is becoming increasingly clear that Minister Levy will not be able to deliver the primary surplus target of 1.2% of GDP this year without a new package of tax hikes or new taxes, which would be politically costly for President Rousseff. Her approval rate, according to a new poll released this week, is a little above 10%, and it is possible it could fall to the single digits.

An analysis made by the director of the most important public opinion institute in Brazil, Datafolha, argues that the impact of the economic adjustment on the daily life of Brazilians will be the key factor in a future public evaluation of Rousseff. Congress, in turn, will respond to public opinion. The situation could become worse or improve in the legislature depending on the Executive Branch's capacity to coordinate with Congress, which, so far, has been extremely small. On top of that, new public demonstrations both for and against President Rousseff are being scheduled for March 31 and April 12, respectively, which will also reflect the President's success in managing the economy's recovery.