Industrial policy in check


JUCA VARELLA / FCA / PUBLIC PHOTOS

Fiat Chrysler factory in Goiana, Pernambuco State

In response to a ruling by a WTO panel, the Brazilian government considers changes in laws and in the ways in which it encourages R&D

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The Brazilian government announced that it will appeal to the World Trade Organization (WTO) Dispute Settlement Body to try to reverse the conclusions reached by a panel that found several of Brazil's industrial policy programs to be illegal—they had been formally questioned by Japan and the European Union. The final report of the panel, established in 2014 and composed of three independent arbitrators, was received by the Ministry of Foreign Affairs (MRE) on December 20, 2016 but will probably not be officially released until around February 2017, after fulfillment of a formality: it must first be translated from English into the organization's other two official languages, French and Spanish, and circulated among the 160 WTO members. The document maintains that an important part of Brazilian industrial policy violated WTO rules and denounces the way in which Brazil has encouraged domestic production of automobiles, information technology equipment, and semiconductors—among other items—by granting exemptions or suspensions of tax on end-products that are not extended to imported competitors.

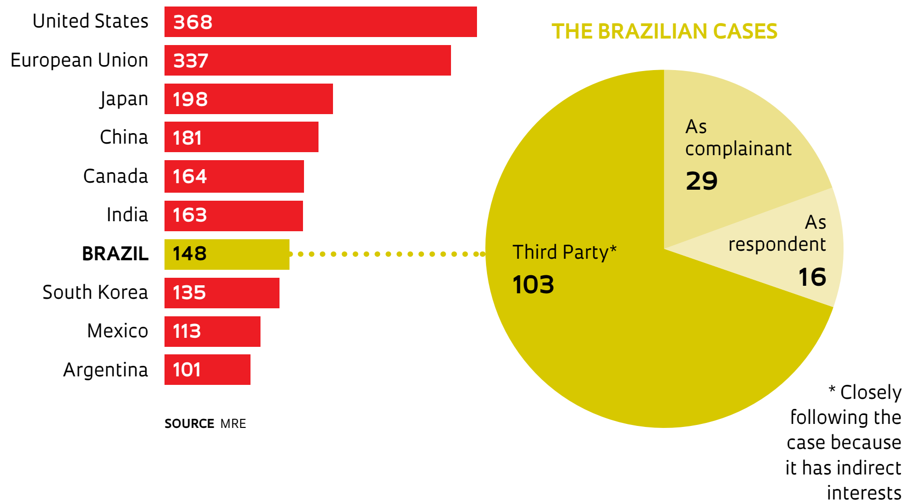
One of the points questioned in the dispute is a violation of the so-called principle of national treatment, understood to mean the granting of incentives to goods and merchandise manufactured in Brazil, in the form of tax exemptions that are denied to similar goods produced in other countries. Another matter involves the requirement that products that benefit from tax reductions contain a certain minimum percentage of Brazilian-made inputs. According to the panel, these problems appear in programs such as Inovar Auto, instituted in 2012 to stimulate the domestic production of automobiles, and the Information Technology Act, which has been in effect for 25 years and grants tax reductions to manufacturers of electronic hardware and components that invest in research and development (R&D).

Also censured in the report is the digital inclusiveness program, which was in effect from 2005 through 2015 and reduced to zero the rates of some mandatory contributions, such as the PIS (Social Integration Program) and Cofins (Social Security Financing Program), whose contributions are normally assessed on sales of computers, tablets, smartphones and other items. Also affected are programs that support technology development in the semiconductor industry (PADIS) and digital TV equipment manufacturing (PATVD), programs that offer tax exemptions in exchange for investment in R&D, and the special regime for the purchase of capital goods for exporters (RECAP), which cuts taxes paid by export industries when they purchase machinery and equipment.

"Brazil had a lot of its industrial policy tools questioned, which is unprecedented," says economist Sandra Polónia Rios, director of the Center for Integration and Development Studies (CINDES) and a professor at the Pontifical Catholic University of Rio de Janeiro (PUC-Rio). "Initially, the European Union even questioned the existence of the Manaus Free Trade Zone but later abandoned that idea." From 1995 through 2016, Brazil itself had questioned the policies of WTO member countries on 29 occasions, mostly to challenge barriers to imports of industrial products, and was sued by other countries 16 times. In some cases, Brazil had to modify policies, as in the protest against the Export Financing Program (PROEX) during a late-1990s dispute over the regional aircraft production involving Embraer and Bombardier – a Brazilian and a Canadian manufacturer, respectively. The current litigation of industrial policy is the widest ranging that Brazil has ever faced in the WTO. "This time, several regimes are being questioned, and broader sectors are being affected," says Ambassador Carlos Marcio Cozendey, undersecretary general for economic and financial affairs at the MRE.

Disputes at the WTO

The 10 members of the organization that have made the most use of the dispute settlement system between 1996 and 2016 – by number of cases



The economic and social balance of the Information Technology Act has been quite positive, says Barbato of ABINEE

The ruling by the WTO panel caused a commotion in the R&D environment, as companies that had qualified under several of those programs have been investing in innovation in return for tax exemptions. As the panel proceeded with its work, Brazilian diplomats argued that the WTO rules do not prohibit the granting of incentives to local industry or ban encouragement of R&D investments. "These are consistent with WTO rules and objectives to promote development on a sustainable basis, as Brazil sees it," explains Rubens Barbosa, who was Brazil's ambassador to Washington from 1999 to 2004 and is an advisor to the

Brazilian Electrical and Electronics Industry Association (ABINEE).

The terms of the appeal that Brazil will file with the WTO will be discussed in the coming weeks by representatives of the Ministry of Science, Technology, Innovation and Communications (MCTIC), the Ministry of Industry, Foreign Trade and Services (MDIC), and the Ministry of Foreign Affairs. It is expected that the 11 judges on the Dispute Settlement Body will rule on the appeal sometime in September 2017. At any rate, the Brazilian government is now preparing to change the disputed programs and negotiate deadlines for implementing those changes. If it does not modify the criticized policies, Brazil will be subject to retaliation by its partners in all areas of world trade. "We are familiar with the case law, and although we believe some measures will be reversed, it is possible that several programs will have to be modified," says Ambassador Cozendey. Igor Nogueira Calvet, secretary of industrial development and competitiveness at the MDIC, says the new policies must preserve the requirement that favored companies invest in R&D. "We will discuss what the government will be able to offer the companies in order to demand a counterpart in the form of R&D. That is unlikely to take the form of a reduction in the federal value-added tax (IPI), as is now the rule," he states. "The future will be determined by working closely with the private sector."

In the case of the Information Technology Act, the government will attempt to preserve its essence by adapting it to WTO requirements. "This legislation was enacted in 1991. It predates the various treaties that form the foundation of the WTO and had never before been questioned," says Maximiliano Martinhão, secretary of information technology policy at the MCTIC. "The Information Technology Act has become part of Brazil's tradition and has helped its economic development." According to the secretary, the law directly created 100,000 jobs, including 15,000 connected with R&D. According to ABINEE data, the amount of revenue lost because of exemptions or reductions in the IPI amounted to R$25 billion in the years from 2006 to 2014, while taxes collected on the goods that benefited totaled R$50 billion. Sales by companies of benefited products from 2006 to 2014 added up to R$266 billion, while sums invested in R&D amounted to R$8.3 billion in that same period. Martinhão believes that it is possible to adapt the legislation while preserving the willingness of companies to invest in R&D. "Europe grants incentives for production within its territory, but they are given to companies, not products. The WTO allows that. One possibility is for us to change the target of the incentive while maintaining the investments in R&D," he explains.

Ericsson telecommunications equipment facility in São José dos Campos, São Paulo State

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Another alternative that may be evaluated, says Martinhão, is to accredit foreign companies to receive benefits under the Information Technology Act, requiring them to provide the same R&D counterpart by investing in companies that produce goods in Brazil. The main challenge, he says, is to modify existing programs as quickly as possible. "The worst thing in the world would be to take too long to approve the necessary changes in the law and leave manufacturers in legal limbo," he notes.

The Information Technology Act grants tax incentives to manufacturers of electronic hardware and components that invest in R&D. The incentive, which is to remain in force until 2029, consists of an 80% reduction in the federal value-added tax (IPI). Depending on the type of product, R&D investment must be equivalent to 3% or 4% of annual sales of favored goods. Investments can be made within the company itself, at universities, or under contract with third parties—which has led to the establishment in Brazil of a number of private research institutes that conduct custom-ordered studies for other companies (*see* Pesquisa FAPESP *Issue No. 248*). The law also requires that some of the funds be invested in formal agreements with institutes in the North, Northeastern and Central-West regions of the country. To receive benefits, a company must also adhere to the so-called Basic Production Process (PPB), which determines the amount of domestic content required for each kind of product.

"The Information Technology Act was the result of lengthy debates and legitimate negotiations in the National Congress, where legislators were concerned about maintaining the financial and economic equilibrium of the factories that opted to work under national information technology policy," says Humberto Barbato, executive president of ABINEE. "The economic and social balance of the Information Technology Act has been quite positive. The scenario designed with the Internet of things will make digital inclusiveness even more present in people's lives, and the legal framework for information and communications technologies will become more and more essential," he argues.

The Inovar Auto program was created by a legislative provisional measure in April 2012. It established a regime that grants temporary tax advantages to automobile assembly plants. The WTO panel rebuke focused principally on the benefits offered in the form of credits against a presumed IPI tax of as much as 30 percentage points per product to companies that satisfy criteria such as the installation of new industrial plants in Brazil or the adoption of new models of production. R&D outlays are among the counterparts required of recipients. According to MDIC data, between 2013 and 2015, approximately R$15.3 billion was invested in research, development and engineering as a result of the program. Ambassador Rubens Barbosa believes it will be difficult to make modifications to Inovar Auto. "The government will probably have to abolish the program. It was already intended to end in 2017," he says. Igor Calvet of the MDIC says that a new policy for the automobile industry is beginning to be discussed. "Inovar Auto fulfilled its purpose, which was to attract investment. Several companies established factories in Brazil and set up R&D support structures."

To economist Sandra Polónia Rios, the outlook for auto assembly plants is the most troublesome of the effects of the WTO ruling. "The automobile industry has enormous idle capacity, which was actually encouraged by Inovar Auto, but there are no prospects of it being absorbed within a reasonable time frame," she says. "This is a very serious problem because Brazil is not in a position to become an auto export platform, and there is little chance of growth in the domestic market."

According to Rios, the announcement of the Inovar Auto program in 2012 may have been the catalyst that bred displeasure with Brazil in the WTO. "In recent decades, we have established several other industrial policy tools that preserved local content, such as the Free Trade Zone and the Information Technology Act, but they were less aggressive and not challenged," she says. During the Rousseff administration, however, the use of these tools intensified as part of the 2011 Bigger Brazil Program, to which Inovar Auto was connected. "That made Japan and the European Union uncomfortable," she suggests.

According to Counselor Daniela Benjamin, general coordinator of dispute settlement at the MRE, the concerns in Japan and the European Union about the proliferation of these programs in Brazil influenced their decision to take the issue to the WTO. "At the time, there had been an important discussion in Brazil about extending those regimes to other sectors, such as chemicals, and the complainants were worried that an expansion was going to occur," said the diplomat at a public hearing held on December 15, 2016 in the federal Chamber of Representatives on the subject of the WTO panel. Soraya Saavedra Rosar, director of the International Negotiating Unit of the National Confederation of Industry (CNI), said at the same hearing that the ruling by the WTO panel creates a new scenario for negotiations about the country's industrial policy. "Hereafter, when we draft a new law, we will need to more carefully examine the coverage of treaties on international trade that need to be respected," she said. Redesign of those legal instruments will be a determining factor in shaping the future of the entrepreneurial R&D effort in Brazil, a topic that has gained greater importance since innovation became a key topic in both Brazil's industrial policy and its science and technology policy. ■

Representatives of World Trade Organization member countries meet at its Geneva headquarters in 2013

WTO / STUDIO CASAGRANDE