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Law, Planning, and the
Development of the
Brazilian Capital Market

A Study of Law in
Economic Change

by David M. Trubek

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Law, Planning and the Development of the Brazilian Capital Market

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I. Introduction and Background

Section 1—*Law, Policy and Economic Theory*

A. The Scope of the Study

Brazil is currently engaged in a major program of planned development of its domestic capital market. In 1964 Brazil's economic planners made a fundamental decision: that, since financial development was essential to continued rapid economic growth, the government should intervene in the economy to guarantee rapid expansion of financial institutions. This decision led to the design and implementation of an ambitious, imaginative, and comprehensive government program whose goal is to expand and improve all sectors of the nation's financial system. This program has sparked a phenomenal stock market boom.

The Brazilian program is one of the most important efforts in planned and "forced-draft" capital market development now underway in the developing world. In recent years, development theorists, planners, and international assistance agencies have paid increasing attention to the potentials of domestic capital markets as tools in world-wide efforts to cut through the vicious circles of underdevelopment. Brazil's planners, accepting the theory that a large and efficient capital market is essential for rapid economic growth, have devoted substantial resources to the capital market program.

In the six year history of its program, the Brazilian government has pioneered in creating new policies and techniques through which financial decisions in the private sector can be shaped to meet the needs of an economic development plan. It has experimented with a series of incentives designed to speed the pace of capital market growth. In the course of these experiments, the Brazilian government has encountered major problems and obstacles, and has often found ways to overcome or avoid them. From a study of these efforts, it is possible to learn a great deal about the difficulties and barriers to financial development that exist in Brazil, and similar developing countries.

In this study, I examine a key aspect of the Brazilian program—the policies designed to encourage growth of the equities or stock markets, and thus to increase the flow of funds to corporations through sale of equity securities. I shall trace the history and analyse the results of this program, exploring the goals selected, measures employed, and results. In particular, the study focuses on the development of two major sets of regulations and related tax incentives:

1. *The open capital companies program*, under which corporations and their shareholders receive substantial tax advantages if the corporation distributes shares to a wider public.
2. *DL 157 Fiscal Investment Funds* program under which taxpayers can purchase shares in special government approved mutual funds in lieu of paying taxes due; the special mutual funds, in turn, use the tax receipts to purchase new and outstanding issues.

The study probes the factors that shaped Brazil's financial development policy. Many institutional conditions in Brazil hampered financial growth and limited the government's ability to solve problems. These conditions determined the kinds of policies selected by the Brazilian government. Where financial institutions, the legal system, and planning mechanisms are all in some way "underdeveloped," how can a country begin a self-sustaining process of financial development? What kinds of government measures are best suited to capital market development in such situations? Can the Brazilian case teach us something about the proper choice of instruments in similar countries?

In order to explore these questions, and probe the role of economically relevant institutions in financial development, I discuss the effect the legal system had in shaping Brazil's capital market program. Here law is simply used as an example of the constraints created by the institutional matrix in which a policy evolves; it is one of many conditioning factors.

Law is important to the study for other reasons. Law reform and economic regulation are essential elements of the Brazilian program; in many areas regulation is the sum and total of the program. The Brazilian planners, having chosen to intervene in the private sector to develop private financial institutions, had to rely heavily on law as a planning tool; and "planning,"

"law reform," and "regulation" intertwined in the history of the program. Thus the Brazilian case offers general insight into the role of law and legal systems in economic development.

B. Law, Policy, and Economic Theory: A Note on Methodology

In the next section I set forth a summary statement of certain theories of financial and economic development, with some speculations on the relevance of law to this process. While this theoretical background is necessary for the historical analysis, it has an especial importance in this study because, in the area studied, law, policy and "theory" form one inseparable whole. To understand one, it is necessary to understand the other. We cannot interpret laws and regulations without understanding the policies they are designed to "implement" and the theories which led to these policies. But, on the other hand, there is no way to say what the "policy" is without studying the law.

Thus the study is "policy-oriented." It analyses governmental goals and measures selected to reach them. Every first year law student knows that we must study "policy" in order to determine the meaning of specific legal rules. But the converse is also true: to understand "policy" we must make a close study of legal rules.

For the student of the Brazilian equities market program, legal rules frequently provide the best and often the only available data on "policy." This is partly a result of the creative but often chaotic law-making process Brazil adopted. The laws originated in the Ministries of Finance and Planning and the Central Bank. They were normally drafted by planner-technocrats, generally economists, within very general guidelines set by over-all policy documents such as the Castello Branco Government's "*Economic Action Program*."

These guidelines are often frustratingly ambiguous or hopelessly general. The laws have been made public with little or no accompanying explanation and adopted with little or no debate. There are few "white papers," presidential messages, background studies or other official documents through which "policy" can be identified. Indeed, the planners have normally used the process of drafting legal texts as the vehicle by which they shaped "policy"; goals have been defined in the context of preparing specific implementing measures. *The laws themselves, therefore, are usually the only manifestation of policy.*

To some degree this reflects real deficiencies in the

internal decision-making process, aggravated by extreme reliance on executive decree as a legislative tool. But even if clear statements of "policy" were available, they would generally have little economic significance until translated into law. In a market oriented economy, law is frequently the crucial and final manifestation of government policy. In such an economy, basic economic decisions are taken by private economic units, presumptively free to make any economic choice they wish except as constrained by law. The government may intervene in these decisions, but its intervention only is meaningful when translated into specific regulatory form. Thus, general policies only take economically significant shape when translated into specific legal measures, and a clear statement of "policy" without accompanying legal measures is frequently merely an academic exercise. Moreover, where legal provisions are in conflict with general "policy" statements, we must look to the law as the more authoritative source.

Not only is "policy" frequently meaningless until translated into specific legal measures; law can be a powerful tool of planning. Regulatory law attempts to control and channel behavior of economic units and thus affect the allocation of resources. It functions partly as a coercive mechanism—it may carry with it sanctions for non-compliance—and partly as means for creating conditioned incentives. But beyond these it serves a communication function. It informs economic units of government intentions and goals, and it also gives them a guide to predict *each other's* behavior. It is a form of language which permits members of a society to predict the behavior of others—government and private—and to adjust their behavior accordingly.

The Brazilian government has accepted this view of the role and importance of law in economic development policy. It has devoted vast amounts of time and energy to law reform and detailed regulations, manifesting an implicit belief in the efficacy of the legal technique as an efficient means of shaping and channelling economic action.

Thus in theory and practice we recognize the importance of law in defining what a government's economic development policy is. But what is the relevance of economic *theory* to the process of legal and policy analysis? Theory is important because it permits us to resolve the multiple ambiguities in the legal rules. One common technique for doing this is to search for the "legislative intent," i.e., the purposes that might have animated a hypothetical legislator. But in Brazil during the period studied, often the best evidence of the "thought" of such an imaginary legislator

lies in economic development theory and doctrine. In this period, law-making represented the crystallization and manifestation of theories about economic development and the role of the state in stimulating capital formation. These views—shared by the planners in the various ministries—were formed in studies and debates before and after the military takeover in 1964, and written into law in the legislative "blitzkrieg" that followed. Frank Lloyd Wright once said that architecture was "frozen music;" to borrow the metaphor, the law of the capital markets in Brazil is "frozen economic theory." Let us turn, then, to the theory.

Section 2—*Mobilizing Economic Surplus: The Role of Capital Formation and Capital Markets in Development*

A. The Relationship Between Savings and Growth

If a society is to achieve economic growth without heavy reliance on foreign capital, it must devote some of its real resources to increasing its stock of productive capital. Thus it must mobilize its economic surplus for optimum capital formation.

Much of the debate about economic development policies centers around the means of mobilizing a surplus. There are two analytically separate aspects of "mobilization." This process entails both increasing the gap between production and consumption (savings), and allocating these "surplus" resources to investors. Two ideal goals for a development strategy are (1) *to elicit* the maximum amount of savings and (2) *to allocate* these resources to the most efficient users. But the choice of development strategies, including the basic choice between a market or a command form of economic organization, may entail tradeoffs between these goals. A strategy which can expand surplus substantially may, at the same time, entail a relatively inefficient allocation process.

At one level, the problem for policy makers is not "what mix of investments?" but "what decision making process?" One of the issues present in the Brazilian case was whether it would be more efficient if the investment decisions were made by market institutions reacting to price considerations, or by planners following some positive theory of efficiency. The capital market program reflected a belief in the long run potential of the market-price system.

B. Selecting Alternative Strategies for Mobilizing Surplus: The Gurley-Shaw Model

(1) *Financial ratios and the alternative technologies*

There are various strategies which governments can adopt in shaping policies to maximize the amount of savings elicited and the efficiency of their allocation. In their article entitled "Financial Structure and Economic Development" Professors Gurley and Shaw set out four alternative "technologies" that may be employed for this purpose, and discuss the conditions under which these technologies are adopted by countries at various stages in the process of economic development.¹ The alternative "technologies" are: taxation, "self-finance," foreign aid, and the debt-asset system or finance via capital markets.

Taxation relies on the coercive power of the state to elicit savings from various segments of the economy. These savings are channeled to the state and then made available either to government or to the private sector for investment. Allocation is made by government decision: investment, i.e., the creation of new productive capital, may be carried out by government agencies or private organizations.

Self-finance employs a number of mechanisms, all involving adjustments in terms of trade on commodity, factor or foreign exchange markets. This technology aims to alter relative prices "to the advantage of an investing sector, forcing involuntary savings upon other sectors." This may be done by price controls over government or private enterprise, or through inflation. In either case relative prices and net incomes are affected and profits accrue to and are retained by those with a high propensity to invest.

Finance (debt-asset system) relies on the development of financial institutions or the creation of financial assets which are held voluntarily by economic actors.

Each of these technologies involves certain governmental policies and forms of economic organization. Each is associated with certain costs and benefits. The technologies are not mutually exclusive, but a basic choice must be made among them. Gurley and Shaw remind us that the four are substitutes. For example, "Self finance via inflation shrinks the real stock of financial assets, the real flow of funds through financial markets, and the real size of financial institutions. Inflation taxes the financial

¹ Gurley & Shaw, "Financial Structure and Economic Development," *Economic Development and Cultural Change*, Vol. XV, No. 3, April 1967, p. 257.

process." The choice of technology is related to, but not necessarily co-extensive with, the choice of basic economic institutions, i.e. between capitalism and socialism.

Countries make choices over time among these techniques. Because some chose taxation, self-finance or foreign aid, financial asset ratios (which measure the role of the debt-asset system in a society) are not directly correlated with levels of wealth or income. Gurley and Shaw assert that for each society at a given point in time, one or the other of the technologies (or a particular mix) will be most efficient. The determination of which technology or mix should be adopted depends on a number of factors. Chief among these factors is the nature of economic institutions in the society. This is obvious in the case of taxation; if taxing capacity is low because government is weak and inefficient, this alternative will be less attractive. Finance, on the other hand, depends on other institutional patterns; savers must be willing to hold financial paper in expectation of future returns. This in turn depends on a certain level of economic sophistication, and confidence. Finance also requires a system of intermediation, and a relatively efficient private law system; Gurley and Shaw conclude:

"Finance depends on law, the courts, and processes of litigation between debtors and creditors. It depends on forms of land title and on the various aspects of bankruptcy. The institutional paraphernalia of modern finance, inconspicuously represented in high finance-income ratios, are accumulated only in long periods of social evolution, and this accumulation proceeds at varying rates in different countries."

In selecting among alternative "technologies," societies should consider the contribution of each alternative technology to future output. The Gurley-Shaw model permits us to identify the basic variables that must be considered in making this evaluation:

- (i) the relative savings eliciting capacity of the technology.
- (ii) the relative allocative efficiency of the technology; including the relative factor cost of real inputs and externalities.
- (iii) the welfare effects, e.g., the effect of the technology on income distribution.

2. Finance as an Institution

The Brazilian planners made explicit and implicit choices among these "technologies." Basic to their policies was the belief that finance or the "debt-asset" system was an appropriate technology for Brazil. They decided to encourage and expand the institutions necessary for this system. Before turning to a description of the measures they took, let us examine the institutional features of "finance."

The debt-asset system is an institutional mechanism which transfers resources from net savings units to net investing units. Such a system is normally associated with specialization of financial institutions. A key feature of relatively mature financial systems is intermediation; i.e. the existence of financial institutions which specialize in transferring resources from net savers to net investors. Intermediaries acquire primary securities (e.g. corporate bonds) from producing units and issue financial assets or indirect securities (e.g. savings deposits) to savers.

According to the theory of financial development, intermediation leads to more efficient allocation of resources. This is true because from the issuer's point of view the optimum characteristics of primary securities may not coincide with the characteristics desired by savers. Savers may wish to hold financial assets or securities which offer substantial liquidity, safety, divisibility, possibility for diversification of assets, or are associated with services such as insurance. Producing units may have conflicting interests; producers for example, may wish to control invested capital for a long time period without a repayment obligation. Where interests of savers and investors are not reconciled, the result is a misallocation of resources. Since savers cannot find securities which meet their demand for liquidity, they will save less than they otherwise would. Since producers can't issue long term securities, they will not be able to raise external funds in the amounts they could profitably employ; they will produce less. Resolution of this conflict can speed economic growth.

Intermediation functions to resolve the conflict, thereby increasing the efficiency of resource allocation in the society. Intermediaries acquire primary securities from productive units on terms that meet the producers' needs, and in turn issue secondary securities designed to satisfy savers' demands for liquidity, etc. A simple example of this function is a commercial bank which loans funds to industry on term and attracts funds from savers through demand deposits. In addition, intermediaries can effect economies of scale in transferring savings to investors; for ex-

ample, intermediation centralizes allocative decision making, thus lowering the costs of such decisions; savers need only select among the indirect securities of the intermediaries.²

Finally, a word on terminology. This study deals specifically with equity markets; these are institutions which transfer funds from investors to corporations through the sale of securities whose yield depends on corporate profits. There are really two equities "markets." The first is the "market" through which funds are transferred directly to corporations in return for securities of various types. This is the "primary" market, in which primary securities are issued by producing units in return for cash. Since the volume of transactions in the primary market measures the net flow of funds from savers to users, the success of any policy designed to enlarge the capital market must be measured by its success in expanding this "market."

The bulk of transactions on the Stock Exchange are not primary market transactions. Rather they represent the purchase and sale of *outstanding* corporate securities. In such cases the flow of funds is from one saver to another; such transactions reflect changing preferences of investors about the assets they wish to hold in their portfolios. While these transactions bring no new funds into the corporations whose securities are being traded, they help ensure liquidity. The primary market would be weak if savers were uncertain that they could in turn sell the stock for cash to another saver. The organized market for such intra-investor exchanges is referred to as the "secondary market."

Section 3—Financing Brazilian Economic Development 1947–64

The period immediately preceding the series of policy decisions which I shall analyse in the main portion of this study was in all respects an extraordinary chapter in Brazilian economic history. It was marked by three crucial features: rapid growth and industrialization; high and increasing rates of inflation; and stagnation or decay in financial institutions and markets. By the end of the period, inflation had reached runaway proportions, real growth had declined, and the country found itself in a political crisis partially caused or at least aggravated by these economic factors. In this section, I shall briefly trace the main outlines of

² Patrick, "Financial Development and Economic Growth in Underdeveloped Countries," *Economic Development and Cultural Change*, Vol. XIV, No. 2, Jan. 1966, p. 174.

this period, with special emphasis on what appears to have been its characteristic savings-investment technology.³

The years from 1947 to 1962 were boom years in the Brazilian economy. These were the years of Brazil's great import-substitution surge. In this period the country underwent a major industrialization drive, and recorded extremely high growth rates. From 1947 to 1961, GNP grew at an average rate of 5.8%, reaching 7.7% in 1961; per capita income went up on an average of 3% per year. The real product increased by 128%; more significantly, perhaps, industrial product grew by 262%. The share of industry in net domestic product increased significantly.⁴ And gross fixed investment rose by over 150%.⁵

Financial development did not keep pace with real economic growth in this period. According to calculations made by Raymond Goldsmith, the assets of Brazilian financial institutions represented 70% of GNP in 1948, and declined to 55% of GNP by 1963.⁶ Financial assets grew in real terms by only 3.8% per year in the same period, significantly less than the rate of GNP growth. Not only did the growth of financial institutions appear to lag behind economic growth in the period; the rate of financial growth during the period of rapid real growth (3.8%) was lower than Brazil experienced during the 1939-1948 period when financial institution assets grew at 5% per year.

There are other indicators of the decline or stagnation in the financial markets during the boom years. Stock prices were depressed throughout the period. Between 1951 and 1961 commercial bank deposits grew only 15% in real terms. More significantly, time deposits declined drastically; in 1951 time deposits represent 24.4% of all deposits; by 1961 they were down to 8.7% of all deposits.⁷ Eugenio Gudín estimates that bank loans to the private sector grew in real terms only 8.8% from 1951 to 1961 and by 1964 had returned to 1951 levels.⁸

This gap between financial and real growth seems all the more curious when we consider Goldsmith's finding, based on a study of a large sample of countries, that "periods of more

³ See generally: (ENGLISH): Baer, *Industrialization and Economic Development in Brazil* (Irwin, Homewood, Illinois, 1965) (hereinafter cited as Baer); H. Ellis, ed. *The Economy of Brazil* (Calif., Berkeley, 1969); Furtado, *Diagnosis of the Brazilian Crisis* (Calif., Berkeley, 1969). (PORTUGUESE): Mario Henrique Simonson; *O Mercado Brasileiro de Capitais* (EPEA 1965), and *A Experiência Inflacionária No Brasil* (IPES 1964).

⁴ See generally Baer.

⁵ Bergsman and Candal, "Industrialization: Past Success and Future Problems" in Ellis, ed., op. cit. Note 3 supra (hereinafter cited as Bergsman and Candal).

⁶ All the calculations in this paragraph can be found in Goldsmith, *Financial Structure and Development* (Yale, New Haven, 1969).

⁷ Ellis, ed. op. cit. Note 3 supra, p. 142.

⁸ *Ibid.*, p. 24.

rapid economic growth have been accompanied, though not without exception, by an above-average rate of financial development."⁹ Brazil in the period under discussion seems to be one of the exceptions.

If, as Goldsmith's figures seem to indicate, financial development did not keep pace with real growth during the industrialization boom of the 1950s, how did Brazil succeed, as it evidently did, in mobilizing surplus for growth? The answer, it seems, lies in the process of inflation. A large school of analysts believe that the predominant savings-investment technology employed during the period was inflation, supplemented by large inflows of private foreign savings.

Whatever the controversy surrounding the effects of the Brazilian inflation during the period under discussion, there is no disagreement over its extent. The annual rate of cost of living increase in Rio went from 4.5% in 1949 to over 33% in 1961; thereafter it climbed even more steeply. The case that inflation served as the dominant savings investment technology in Brazil during the import-substitution drive has been made by Werner Baer, Celso Furtado, and others. It is a complex and controversial argument; here we summarize the thesis in broad outline.

During the period under review, inflation served to transfer real resources from the consuming sector to the producing sector of the economy. The essence of the mechanism was the lag in wages behind increases in productivity. Baer points out that while real wages did not decline during the period, inflation redistributed the increment in the real product to the producing sectors: industry and government. Bergsman and Candal summarize these effects as follows:

"... inflation played several roles in industrialization. Perhaps the most important of these was to facilitate the transfer of resources from wages to profits, and from the private sector to the public. These transfers increased the resources for investment in industry and related infrastructure. In the 1949-59 period, physical production per worker increased 90 percent, real wages per worker increased 26 percent, and wages as a percentage of value added increased 18 percent. The government share in GNP rose from 17 to 20 percent in the same period. The inflation was partly caused by this increase in government spending. By inflationary financing

⁹ Goldsmith, op. cit. Note 6 supra, p. 209.

in the face of rising prices the government could achieve its desired real expenditures more easily than the private sector.¹⁰

While the government share of GNP grew slightly, its share in fixed capital formation more than doubled in the period 1947-50.¹¹ The private sector benefited from the inflationary surge largely through increases in profits; corporations relied heavily on retained earnings to finance new investment.¹²

Another main source of resources to finance the investment boom of the 1950s was private foreign savings. Encouraged by a number of government programs and incentives, and attracted by the profit opportunities created by the import substitution boom, private firms increased their investment in Brazil. Direct private foreign investment increased from an annual average of \$13 million dollars in 1947-54 to an annual average of \$102 millions in 1955-61.¹²

The industrialization boom ended in 1962. Industrial production, which had grown on an average by 9.8% during the 1948-1962 period, failed to grow at all in 1963, and only grew by 5% in the following year. In 1965 industrial production declined.¹³ At the same time, inflation accelerated.

Annual Rate of Inflation
(GNP implicit deflator)

Period	annual rate (percent)
1955-60	20
1961	35
1962	49
1963	72
1964	91
1965	57
1966	38

Source: Bergsman & Candal
(From Fundação Getulio Vargas—"FGV")

The "profitability" of inflation diminished rapidly. The inflation mechanism had functioned to increase savings and investment in the fifties because of the gap between real wages and labor

¹⁰ Bergsman and Candal, pp. 34-5.

¹¹ Baer, p. 84.

¹² *Ibid.*, p. 124.

¹³ Bergsman and Candal, p. 51. See also Morley, "Inflation and Stagnation in Brazil," *Economic Development and Cultural Change*, Vol. 19, No. 2, January 1971, p. 184.

productivity. A number of factors contributed to the maintenance of this gap: among the chief elements that have been cited were the inexperience of the labor sector and government control of unions. But, "in the early 1960s wages rose fast enough to make up almost all of the losses suffered during the 1950s."¹⁴

Not only did a series of wage hikes narrow the "gap" which had been an essential element of the inflation forced-saving strategy; they helped spur an inflationary spiral that soon was all but out of control. And at the same time, the rate of private foreign investment declined substantially.

Baer has written a strong defense of what might be called the "inflationary strategy." He considers that the Brazilian response was the proper one *given the institutional constraints* facing the government. The problems facing the government in this period were complex, and Baer has shown how inflation did help resolve them and ensure rapid growth. He says that while there might have been more direct measures that could have been taken to the same ends:

"in a relatively underdeveloped country, with inexperienced, inefficient and generally backward and cumbersome bureaucracies, with an underdeveloped and ineffective tax system, the inflationary method would, on the whole, be the more efficient one in the short run"¹⁵

Baer also points to "underdeveloped finance" as a factor that influenced the evolution of the inflationary strategy. Thus he points out that Brazilian firms do not "rely much on credit from financial institutions," relying rather on internal finance which Baer asserts cannot be attributed to inflationary conditions, but should be considered as a characteristic of *underdevelopment*.¹⁶

In his analysis of the costs and benefits of the Brazilian inflation, Baer does not focus on the financial stagnation which was associated with it. It seems clear, however, from the fragmentary data available, that Brazil paid an opportunity cost in foregone financial development during the inflation-fed boom of the fifties. As we shall see, this cost came to seem more and more important to policy makers as time went on, and was a fundamental consideration shaping the capital markets policy of the "revolutionary" government that took office through a military coup in 1964.

¹⁴ Bergsman and Candal, p. 49.

¹⁵ Baer, p. 116.

¹⁶ *Ibid.*, p. 133.

II. The Decision to Develop the Capital Market

PHASE ONE: Law Reform and Marginal Tax Incentives

Section 1—*The Castello Branco Government and the Search for a New Savings-Investment Technology*

A. Introduction

As we have seen, although Brazil experienced rapid growth during the 1950s, the capital market was relatively underdeveloped and made only a limited contribution to mobilization of surplus. The chief "technology" employed to mobilize resources for development was inflation, with private foreign capital also playing a major role. Inflation served admirably to transfer resources to productive sectors, and helped spur development. But over time the "net yield" of the inflationary device began to decline. Social groups began to become more and more sophisticated in their response to inflation; as a result inflation was not able to compel the kind of involuntary savings that were generated in the early years of the investment boom. As the rate of inflation increased, moreover, the social and institutional *costs* of this technique began to rise. By 1963 it was becoming clear that the potential of inflation as a development device was exhausted. The bout of uncontrolled inflation in the early 1960s not only generated severe political and social tensions; it also undermined the already weak debt-asset system. It was in this context that the Castello Branco Government took power in 1964.

The Castello Branco government was installed in April 1964 by a civilian-military coalition led by the Armed Forces. The coup was a response to growing political and economic instability in the country, and the apparent threat of radical moves by the Goulart government. The new administration recruited a team of internationally known economist-technocrats, led by Roberto de Oliveira Campos and Octavio Bulhoes, who proceeded to plan and implement a program of "stabilization, development, and reform."¹⁸

The new government rejected inflation as a basic savings-investment technology for Brazil. Acutely sensitive to the

costs of this strategy, they opted for a general stabilization program that would reduce and stabilize if not completely eliminate the inflation. A prime target of this program was reduction of the government deficits that had fueled inflation.

Having rejected inflation, the government had to seek alternative technologies to mobilize domestic surplus. It chose two: taxation and finance. Massive reforms were carried out in the tax laws, and tax administration was strengthened. A similar program was mounted in the area of financial development, with the goal of strengthening the debt-asset system and stimulating its rapid expansion.

The tax reform program was remarkably successful. The tax yield in real terms went up dramatically.¹⁹ This increase permitted the government to reduce its deficit, thus dampening inflationary pressure. Tax reform has continued, and the government has substantially increased its capacity to elicit savings, as the following table shows.

Tax Receipts of Government
as % of GNP

year	%
1963	18.1
1964	18.5
1965	22.0
1966	24.4
1967	21.7
1968	26.3*
1969	26.0*

*preliminary estimates

Source: Fundação Getulio Vargas-IBRE

Simultaneously, the government outlined the program under study, designed to strengthen finance as a developmental tool. Capital market development was given high priority in early planning documents. In 1964, the Castello Branco government's two year "Economic Action Program" listed capital market "reform" as one of its eight *major economic and social reforms*; others included agrarian reform and housing reform.²⁰

In developing its general capital market policy, the government was concerned with two issues. First, it wished to

¹⁸ See, e.g. Skidmore, *Politics in Brazil 1930-1964* (Oxford, New York, 1967); Stepan, *Patterns of Civil Military Relations: The Brazilian Political System* (tentative title) Princeton University Press (forthcoming).

¹⁹ Ellis, ed. *The Brazilian Economy* (Calif., Berkeley, 1969), p. 183.

²⁰ Ministério Do Planejamento e Coordenação Econômica, *Programa De Ação Econômica Do Governo 1964-1966*, May 1965 (2nd Ed.) pp. 243-4. (Hereinafter cited as P.A.E.G.)

cure what it viewed as *distortions* in the market; secondly, it aimed at resuming the process of financial *development*, which it believed to have been impeded by the long bout of inflation.²¹

In the government's view, inflation had created innumerable "distortions" in the credit markets. Capacity to elicit had been weakened; capacity to allocate had been distorted. Thus the planners pointed to the "famous gains of debtors in detriment of creditors," which discouraged lending, i.e., buying bonds or making deposits. Moreover, since interest rate rises had not matched the rate of inflation, "disequilibrium" arose between the supply and demand of credit; since the price system could not work, allocative criteria were "notoriously imperfect."²²

In the government's view, one manifestation of these "distortions" of the capital market was the creation of the *letra de cambio* as a substitute for bank credit.²³ The *letra* market developed as a device to circumvent the effects of the Brazilian usury law which forbade loans at more than 12% interest. As the inflation increased, this limit became totally unrealistic; as a strategy to evade the usury laws, the *letra* was developed. A *letra de cambio* is a bill of exchange issued by a company and normally guaranteed by its accounts receivable. The *letra* is accepted by a financial institution, the *sociedade de crédito e financiamento*, ("financeira") which in turn sells the paper to the public. While the borrower purports to pay only the legal interest rate, the *letra* is sold at a substantial discount, thus the cost to borrower and the return for the investor substantially exceeds the 12% fixed by law. *Letras* were usually issued for short terms, between 6 months and a year. *Letras* paid nominal rates of interest (including discounts) that ranged from 2% per month in 1961 to 4% per month in 1964; however, in real terms the return never exceeded 1% a month, and prior to 1966 the return was consistently negative in real terms, despite high discounts.²⁴

Despite the fact that *letras* did not maintain full value in the inflation, they quickly became the most attractive investment medium for Brazilian investors. Term deposits, limited by law to low interest rates, declined substantially. Moreover, sub-

stantial funds were invested in the parallel market, an illegal market through which business firms raised funds through the issue of paper directly to the public without guarantee by a financial entity.

The *letra* seemed to have three basic disadvantages. First, it was based on a discount which reflected an *anticipation* of inflation. Despite the fact that real returns were consistently negative, the government seemed to feel that this technique built an inflationary bias into the system of finance. Secondly, the *letra* system increased the overhead costs of finance. While the *letra* substituted for bank time deposits, it brought into being a costly parallel set of financial institutions. Finally, the *letra* provided only short term financing, while the government saw long-term finance as a necessity if industrial expansion was to be financed through the debt-asset system.

Minister of Finance Bulhoes diagnosed the situation as follows:

"Between 1960 and 1963, entrepreneurs invested relatively little and resorted heavily to credit. . . . The solution consists of reducing loans, and increasing corporations' own working capital and shareholder capital. . . . Firms heavily in debt must reduce loans in favor of an increase in share capital. . . . As long as we insist on basing the expansion of firms on short-term credit . . . we can be sure that inflation will always be a danger and promising economic development a dream."²⁵

The government encountered serious obstacles to reforming these "distortions." The art of juggling the three goals adopted by the Castello Branco Government—stabilization, reform, and development—was a subtle one, and nowhere did it appear more difficult, nor more important, than in the field of corporate finance. In this area, all the goals seemed to interrelate, and yet measures designed to achieve one purpose might threaten the achievement of another.

Thus, the government believed that one of the main causes of the inflation had been an excessive expansion of short term credit to business; one major aim of stabilization policy, therefore, had to lie in reducing this credit. However, the government at the same time wished to increase the growth rate, and this required a rapid recuperation of industrial growth; yet the credit squeeze threatened to cut back production. Indeed, given the traditional reliance of many firms on government credit at

²¹ Ministério Do Planejamento e Coordenação Econômica, *O Programa de Ação e As Reformas De Base*, Vol. II, p. 229 (1965).

²² P.A.E.G., p. 30.

²³ For a full discussion of *letras*, see Simonsen, *O Mercado Brasileiro de Capitais* (Epea, Rio, 1965), pp. 64-68; Deltac Pan America, *Os Mercados De Capitais Do Brasil* (Cemla, Mexico, 1968), pp. 57-70.

²⁴ Ministério Do Planejamento e Coordenação Econômica, *Plano Decenal De Desenvolvimento Economico e Social*, tomo II, Vol. 2, *Política Monetária e Mercado de Capitais* (versão preliminar) (March 1967) (Hereinafter cited as *Política Monetária e Mercado De Capitais*), pp. 61-73.

²⁵ Ellis, ed. op. cit. note 19 supra, p. 172.

negative interest rates, this policy could precipitate a serious recession.

The basic solution adopted to resolve this dilemma was to develop a *selective* credit expansion policy that would channel resources to the most important areas, and at the same time attempt to take selective fiscal measures that would increase the flow of personal savings to corporations through the capital market. Since achievement of the latter goal required structural reforms, the capital market policy reflected the merging of the government's three-fold efforts at stabilization, reform and development.

B. Creating the Institutional Structure—The Capital Markets Law

Thus a major aspect of the government's policy was to develop instruments and mechanisms which would increase the amount of savings elicited through the debt-asset system, and to assure that these resources would be channelled to business in the form of long-term debt or equity. The main policy instruments employed to achieve this goal were (1) general law reform and (2) tax incentives. In this study, we examine the evolution of two of the key tax incentive programs. But before turning to an analysis of these provisions, we must first examine the general capital markets reform which was inaugurated with the passage of the Capital Market Law of July 1965.²⁶ This omnibus bill, containing 84 articles, set the background against which subsequent developments have evolved.²⁷

The Capital Market Law served a number of key functions in capital market development. First, it introduced a sort of codification, consolidating a plethora of laws, decrees and regulations which had previously governed the field. Secondly, it eliminated or modified rules which had served to impede market development. Thirdly, it introduced a series of new concepts, financial instruments, and institutions which the reformers believed were needed for market development. Fourth, the law contained provisions designed to modernize existing institutions by releasing dynamic forces which had been held back under previous regulations. Fifthly, the Capital Market Law adopted a philosophy of regulation through disclosure and set up a new regulatory system through which detailed rules governing the markets could be

²⁶ Law 4728 of July 14, 1965, (Hereinafter cited as *CML*). For a full discussion of the capital market law see Poser, "Securities Regulation in Developing Countries: The Brazilian Experience," 52 *Virginia Law Rev.* 1283 (1966) (Hereinafter cited as *Poser*).
²⁷ See *Os Mercados De Capitais Do Brasil*, (Cemla, Mexico, 1968), p. 37.

evolved. Finally, by its broad sweep and bold innovations, the law had a profound impact on public opinion in Brazil, and thus focused attention on the markets. The law was not merely a codification; it was a sweeping, open-ended admonition to the Central Bank to legislate in broad areas; it is no surprise that it set off a debate on the markets that has grown with intensity over the years.

(i) *Elimination of Specific Barriers*

Many provisions of the law eliminated legal barriers to market development. Typical and noteworthy among these were the authorization of monetary correction for debt instruments and bank deposits, and the introduction of authorized but unissued shares. Prior to the Capital Markets Law, lenders were not allowed to index loans to foreign currency or to the price level, nor to charge more than 12% interest.²⁸ The *letra* circumvented these prohibitions, protecting the lenders against inflation, but could only be used for short-term loans. Thus the legal prohibitions were thought to create a bias in favor of short-term lending. The Capital Markets Law attempted to end that bias by authorizing monetary correction on loans over one year.²⁹

Another "distortion" caused by legal barriers were obstacles to issuance of *convertible debentures*. Brazilian company law did not permit companies to authorize shares prior to subscription. This deterred the creation of convertible debentures, since this instrument requires authorized but unissued stock which can be taken by debenture holders upon conversion. By allowing authorized but unissued shares, and explicitly sanctioning convertible debentures, the Capital Market Law attempted to remove another obstacle to long term corporate finance.

(ii) *Introduction of New Institutions*

The second function of the Capital Market Law was to introduce new institutional concepts to the market. A key example of this was the authorization of *investment banks*, an institution which one study has called "the new dynamizing force in the Brazilian capital and finance markets."³⁰ The Capital Market Law set some of the basic outlines of these institutions and a subsequently issued Resolution filled in the details.

Resolution 18 is a detailed and comprehensive charter for Investment Bank operations. Not only does it define the activities which the investment banks can engage in; it also includes

²⁸ Ellis, *op. cit.* note 19, *supra*, pp. 133-34.

²⁹ *CML*, Arts. 26-27.

³⁰ *Os Mercados De Capitais Do Brasil*, *op. cit.*, note 27, p. 115.

a great deal of material that seems designed to tell them how to conduct their activities. Its style is a curious mixture of the regulatory and the didactic.

The resolution authorizes the investment banks to carry out two basic types of operations:

- (1) direct financial activities, such as lending, acceptance of letras, purchase of shares, and issuance of guarantees;
- (2) financial intermediation and services, including underwriting of stocks and bonds, brokerage, operation of mutual funds.

The banks are authorized to raise funds in various ways including: sale of their own shares; time deposits; foreign loans; domestic loans; sale of letras or debentures guaranteed by the bank; and sale of mutual fund shares.

Resolution 18 stresses project appraisal and analysis. It contains numerous requirements and admonitions to the banks to loan money or underwrite issues *only* after careful appraisal of the company, and more specifically, of the "project" for which funds were to be used. Feasibility studies and financial projections are specifically required.

These admonitory and didactic passages point to a paradox in the Government's attitude. While the planners seemed to believe that the market-price mechanism was the most efficient device to allocate resources, they were not confident that private institutions would make the "right" decisions.

(iii) *Modernization of Existing Institutions*

Another function of the Capital Market Law was to encourage the modernization of existing Capital Market institutions. A prime example of this can be found in the efforts to reform the stock exchanges. A major part of the government's efforts in the capital market area have involved strengthening the secondary markets.

Prior to the Capital Market Law, *brokerage functions* on major exchanges were in the hands of a small group of individuals who dealt in foreign exchange as well as shares. The law governing the exchanges specified that brokerage functions would only be carried out by 40 of these brokers, with life tenure in the position. Through custom, these jobs became almost *hereditary* rights, passed from father to son. Not only did these "hereditary" brokers have a monopoly on brokerage; they also dealt in other

transactions more lucrative than stock brokerage. Thus, they had little incentive to develop share trading.³¹

The Capital Market Law broke the traditional monopoly and required the separation of stock brokerage and other transactions. A large number of new brokerage companies were formed, groups which had previously been excluded from stock trading. One of the most significant results of the new rules was to give access to the market to groups linked to the "*financieras*." These groups had pioneered in developing investor interest in securities through the aggressive expansion of the *letra*. They had technical and sales staffs which were prepared to provide similar services for stocks. These new elements were better prepared than the traditional brokers to exploit the possibilities inherent in the government's efforts to develop the market; in fact, they have led in the continued efforts to modernize the securities markets and expand trading. By reforming the rules governing eligibility of firms to operate on the markets, the law liberated dynamic forces which were prepared to propel capital market growth.

(iv) *Registration and Disclosure: The New Regulatory Philosophy*

The Capital Market Law also introduced registration and disclosure requirements for companies whose securities are traded on the exchanges, and for new issues. Stock exchanges could only deal in the securities of companies which were registered at the Central Bank; no new issue could be made until the issue was registered with the Central Bank.

A subsequent Resolution established rules governing registration and disclosure for trading and new issues. Firms are required to submit balance sheets for the previous three years, data on corporate operations and financial structure, and insider stock holdings. This data must be submitted through a financial institution or a registered independent accountant, accompanied by certification to the authenticity of the financial data contained in the registration. In the case of registration for trading, the Central Bank can refuse registration of securities and issues if it judges that the financial data is "inexact," or if the companies "promote the dissemination of documents and information that do not correspond to reality." In the case of new issues, registration can be denied or suspended if:

the documents and information . . . (required) . . . or any other item made available to the public are false, manifestly

³¹ Poser, p. 1289.

partial, tendenciously imprecise or inconsistent, or, if (The Central Bank) . . . judges that the issue is . . . fundamentally illegal or fraudulent.³²

C. Summary

With the passage of the Capital Market Law, the government had defined the basic institutional structure through which financial development would take place. It is fair to say that the government rested great hopes on this act of law reform; it was obviously felt that this "Magna Carta" of corporate finance would spark a spontaneous development in the markets. Some of these hopes were realized, and some were not. In part, the slow pace of market response to the government's initiatives were due to delays in the issuance of regulations by the Central Bank—itsself a newly created institution—in exercising the powers granted to it to implement the reform. Response was also slow because while the law created *opportunities*, it did little to restructure the basic economic *incentives* governing the decisions of investors and savers. This task was also essential to successful development of the capital markets; to achieve it, the government relied on two techniques: (i) *general monetary and fiscal policy*, which aimed at stabilizing the inflation without excessively curtailing demand, and (ii) *specific tax incentives*. These tax incentives became the principal tool of the program as it evolved.

Section 2—*The Conceptual Scheme: A Matrix of Measures and Goals Over Time*

A. Introduction

The capital market program is complex and often confusing. It will be useful to set forth a framework through which the various dimensions of the subject can be grasped. Consider four separate dimensions: goals, intermediate targets, measures and time. Thus the government has adopted a complex set of measures in a series of fields, all apparently relating to the overall goal of capital market development. Given the nature of policy making described in Part I, these measures, largely specific laws and regulations, are often the only authoritative indications of the planners *goals*. Therefore "measures" must be analyzed to determine the basic goals and to identify intermediate targets. Finally, this proc-

³² Resolution 88, §XVII.

ess must be carried out at several points in time if we are to trace the evolution of this complex policy.

Most crucial is the effort to identify the possible goals of government policy. Naturally, the overall goal was to "develop the capital market." But what does this mean? And why should this be a high priority goal of policy?

From an appraisal of the historical record, interviews with key decision makers, and analysis of concrete measures adopted, I conclude that the Brazilian government's attempts to develop a "capital market" have been animated by three basic goals.³³

- (1) to support efforts to curb runaway inflation;
- (2) to increase the propensity to save, thus increasing the size of the surplus;
- (3) to increase the allocative and productive efficiency of the private sector. This involved:
 - a — strengthening the system's capacity to channel funds to efficient users; and
 - b — modernizing the management and plant of business firms, thus increasing productivity.

A series of intermediate targets have been articulated in attempts to reach these goals. Frequently, these targets are mutually inconsistent: specific measures often seem designed to counteract rather than complement other measures.

B. Reducing Inflation

Capital market policy has been related to the anti-inflationary goal in several ways. First, the government believed that the equities market could provide working capital financing to firms at a lower cost than prior sources. More important, a capital market would provide sources of financing that would replace inflationary government credit. Finally, the government believed that traditional sources of financing were beyond the reach of government credit controls, posing a threat to stabilization policy; equity financing would provide a viable but controllable alternative.

³³ The three policy goals have been distilled from a variety of sources. For specific discussion of these motives, the reader should examine specifically (1) the P.A.E.G., especially pp. 74, 184-6; (2) Ministério do Planejamento e Coordenação Econômica, *Situação Monetária, Crédito e Do Mercado De Capitais, Diagnóstico Preliminar* (May 1966) (Hereinafter Cited As Diagnóstico); and (3) Mario Simonsen, *O Mercado Brasileiro de Capitais* (EPEA, 1965) (Hereinafter cited as Simonsen) and (4) Octavio Gouvea De Bulhões, *Dois Conceitos De Lucro* (Rio, APEC EDITORA, 1969).

C. Increasing the Propensity To Save

The targets related to the second goal are also relatively easy to identify. Thus the government hoped to create investment instruments that would attract investors and reduce the tendency for net savers to hold foreign currency, invest in real estate, or even to purchase durable goods as a form of "savings" in an inflationary climate. This required the creation of investment media (1) that would produce a return sufficient to compensate for loss of value due to inflation and provide an attractive yield in real terms; (2) would be liquid, and (3) reasonably secure. Moreover, once such an instrument was available, measures had to be taken to *convince* potential investors that the instrument had the desired qualities and was superior to other assets.

The government also had to convince firms that financing of this type was more attractive than conventional sources. Thus targets in this area were to

- 1 — increase the profitability and liquidity of corporate shares as investment media
- 2 — decrease the cost to the firm of relying on this type of financing
- 3 — increase investor confidence in shares and awareness of the advantages of this medium.

D. Increasing the Allocative and Productive Efficiency of the Private Sector

The third goal or set of goals represent important if ill-defined aims of the capital market program. Nowhere have the relationships of measures to targets and goals been more speculative than in the area of increasing the efficiency of the savings-investment process.

The Government's most basic decision to increase the allocative efficiency of the financial system was to reduce reliance on government credit, believed to have been largely allocated on non-economic criteria, and to expand the role of the price system as an allocator of capital funds. "Artificial barriers" and "distortions" impeding development of a long-term capital market were removed, reducing reliance on inappropriately short-term finance.³⁴ Finally, measures were taken to *ensure* that the private market would allocate funds according to the relative profitability of

³⁴ P.A.E.G., p. 74. See also Waddington, "Democratização Do Capital De Sociedades Anonimas" (Centro de Estudos Do Boletim Cambial, Rio, undated) (Hereinafter Cited As *Waddington*).

alternative firms and ventures; Brazilian planners showed some skepticism about the actual efficiency of the Brazilian private financial sector.

In addition to measures designed to reach the aforementioned goals, the Brazilian capital markets program contains a series of measures which seemed to be aimed at changing the behavior of the managers of industrial and commercial enterprises.³⁵ This goal, in short was to "modernize" management.

There are really two types of provisions that are aimed at influencing management behavior. One type is directed at changing the behavior of controlling shareholders vis-a-vis outside investors. Most firms in Brazil are managed by a small group of shareholders frequently representing a family or group of families, who are unused to public participation and unwilling to share profits or information with outsiders. The capital markets program has tried to encourage these groups to deal more fairly with public stockholders in part as a way of increasing the attractiveness of equities to the general public and thus the propensity to save.

But the second type of behavior-influencing provisions take as their target the investment and productive decisions of corporate management, their "business" not their "financial" behavior. These provisions assume that many Brazilian firms are operated in a "precapitalist" fashion. By contrast to the ideal capitalist who presumably aims rationally to maximize profits, is driven to unlimited accumulation and constant attempts to expand production and exploit all available technological opportunities, the Brazilian capitalist is assumed to be either (1) non-rational, (2) non-maximizing, (3) uninterested in accumulation beyond a certain point, or (4) all of these.

The explanation for this alleged deviation of the typical Brazilian capitalist from the capitalist ideal is found in history and the failure to differentiate firm from family. Thus, it is argued that the special conditions of Brazilian industrialization did not encourage the rise of a bourgeois or capitalist class. Rather, groups that had dominated traditional Brazilian agriculture and commerce came to gain control of industrial assets, but carried over to the new sphere of activity habits, attitudes and beliefs formed in traditional pursuits. They are pictured as more interested in speculation and exploitation than rational production

³⁵ This discussion is based on interviews with Roberto de Oliveira Campos, Minister of Planning 1964-1967, Celso Lima Araujo, former Director of the Capital Market Section of The Central Bank, and Pedro Leitão da Cunha, one of the members of the capital market working group. (Interview Transcripts are on file in the Yale Law School Library).

for a market. In addition, these groups represent closely-knit families who presumably use industrial resources to foster familial goals (status, leisure, security) rather than to increase output or to compete vigorously.

To the extent that these "precapitalist" proclivities exist, resources will be inefficiently employed. Moreover, these "traditional capitalists" cannot be expected to favor the "progressive" governmental policies needed to stimulate growth desired by the planners.³⁶ These criticisms merge into the more familiar complaints about monopolistic or oligopolistic behavior.

It was presumed and was intended that development of a capital market would weaken the power of such "precapitalist" groups, or force them to change their orientation. Presumably, if they had to share ownership with others, and to account to outside shareholders for their stewardship of corporate assets, they would be forced to differentiate family from firm, and to operate the firm solely for profits. A simple example of the expected behavior-changing effects of a capital market is seen in the pressures it could create for improved accounting and financial practice; the planners attributed part of the financial crisis of the 1964-66 period to the low level of accounting sophistication prevalent in Brazil, and believed that if firms were forced to rely on outside financing they would willy-nilly improve their accounting and thereby their technical efficiency.

Viewed in this light, forced capital market development can be seen to be designed in part to achieve an "agrarian reform in the corporation." I use this admittedly curious expression to describe an attempt to change the institutional structure of an area of the economy to encourage increased productivity. True agrarian reform aims at changing the legal and social relations of land tenure in order to increase agricultural productivity. "Agrarian reform" in the corporation aims at changing the legal and social structure of ownership of industrial and commercial resources in order to increase the productivity of these resources.

A clear statement of this viewpoint can be found in a report prepared by the Ministry of Planning in 1966 which concludes that the development of a capital market would "tend to dissolve the control of family firms or small circles, with their characteristic preference for high profits and small output."³⁷

This technocrat-economist vision of the possible effects of capital market reform merges with another strain of thought

³⁶ See Cardoso, "O Empresário Brasileiro e o Desenvolvimento Econômico," (São Paulo, Difusão Europeia Do Livro, 1964).

³⁷ Política Monetária e Mercado De Capitais, p. 23.

which can be expressed as "peoples capitalism" which emphasizes widened stock ownership to increase political stability by widening the group with a stake in the status quo. Others stress the intrinsic value to the individual of participation in corporate decision-making. In either case, capital market developments are fostered to stimulate the rise of modern capitalistic entrepreneurs.

Section 3—*The "Open Capital Company": Background, Antecedents and Early Development*

A. The Varieties of Tax Incentives

Before turning to a discussion of the evolution of tax incentive policies, it is necessary to distinguish among the varieties of tax incentives that were employed in the Brazilian program. For one of the lessons of this study is that there are "tax incentives and tax incentives." That is, there are very different ways to structure the granting of fiscal favors in an effort to influence the behavior of private economic units. As we shall see, the type of incentive selected influences the nature and success of any program.

Tax incentives are a planning tool used by government with basic confidence in the market as an allocator of resources. Tax incentives influence, but cannot determine, economic decisions by private economic units. They function as an effective planning tool only if (i) basic economic decisions are made by private economic units, constrained primarily by price considerations, and (ii) the tax system is effective, and its incidence is normally economically neutral. In such situations a government may influence resource allocation by selective tax exemptions, deductions, or credits which are tied to certain types of desired economic activity.

The Castello Branco government adopted the philosophy that planning was meant to supplement, not supersede, the market.³⁸ Thus tax incentives were a congenial tool to this government, and the number of "tax incentive" schemes has prolifer-

³⁸ It was consistent with the basic economic philosophy of that Government that fiscal incentives were selected as a major policy tool. In the opening paragraph of its Program of Economic Action, the Government stated the essence of that philosophy: "Government action in democratic political systems should be oriented to establish conditions which assure the most efficient possible functioning of the free enterprise or price economy." P.A.E.G., p. 13. The Government recognized, however, that free market forces alone may be inadequate to realize important community goals. Among the reasons for this in less developed societies the Government cited, *inter alia*, the fact that free market forces do not "necessarily guarantee the formation of a desirable volume of savings," and "the efficiency of the price system can be appreciably distorted by spontaneous or institutional distortions in the market." In such cases, the Government must complement, not substitute, the market. One device to complement market forces is the granting of tax incentives for desired economic activity. *Ibid*, p. 14.

ated in Brazil in recent years; tax incentives are available for everything from Northeast development to reforestation.

There are a variety of tax benefits. First, there is the *deduction*. For example, taxpayers in Brazil may deduct from gross income a percentage of sums spent acquiring certain securities. The effect of the deduction is to lower the acquisition cost of the security, thus increasing its effective yield. If market forces operate, securities for which such incentives are available will be more attractive to investors than non-benefited securities that are otherwise identical in yield and risk.

A second form of tax incentive that figures in our story are *exemptions*. Assume that a general tax is imposed, say on corporate profits. A government wishing to favor selected forms of economic activities may exempt them from the general tax. This increases the after-tax profitability of the favored venture.

The general type of tax incentive represented by exemptions and deductions can be called "marginal incentives." They operate to change the marginal profitability of a venture or the effective yield of a security. They can only influence decision making if economic units have already calculated the profit potential in a situation, and are prepared to change their investment decisions based on the marginal difference created by the incentive.

There are other types of tax incentives, however, and these may be more important in development, i.e. to get major new industries and institutional complexes underway. In his famous study of the Brazilian tax credit system for the Northeast, Albert Hirschman draws our attention to forced-savings types of incentives which work in very different ways.³⁹ Tax exemptions or deductions that make a marginal difference in the entrepreneur's calculations do not overcome the basic uncertainty that may exist as to whether the investment will be profitable *at all*. In Hirschman's view, the Northeast scheme overcame this deficiency, for instead of increasing the *profit* an entrepreneur would make, it reduced the *loss* he could conceivably suffer. It did this by allowing investors to apply funds to investments in the Northeast *in lieu of paying taxes otherwise* due. While this did not reduce the cost of capital to zero, it did lower it substantially, thus overcoming decisional barriers to investment in this region which, he theorized, stemmed more from fear of total loss than inadequate profitability.

The Northeast system allows firms and individuals who invest in approved projects to submit evidence of such investment

³⁹ Hirschman, "Industrial Development in the Brazilian Northeast and the Tax Credit Scheme of Article 34/18," *The Journal of Development Studies* Vol. 5, No. 1, p. 5 (1968).

in partial satisfaction of taxes due. In evaluating the nature of these "incentives," however, it is necessary to make a further distinction between the firm that utilizes the funds to carry out new projects, and the taxpayers in general who take advantage of the tax credit.

Hirschman describes the system as creating a "captive Capital Market." Taxpayers who wish to take advantage of the system do not have to associate themselves initially with specific projects. Rather, they deposit funds in the Bank of the Northeast of Brazil; it is the making of the *deposit* that relieves the taxpayer *pro tanto* of tax liabilities. These deposits may then be employed by firms who develop approved projects. The deposit holder will ultimately receive an equity participation in the venture, usually in the form of non-voting preferred stock. While the system requires that the *entrepreneurs* contribute some free funds to the project, the non-entrepreneur depositor merely exchanges a *tax liability* for a speculative but possibly profitable *financial asset*. From this point of view, there is no marginal calculation involved; the choice is between receiving something of value, i.e. the preferred shares of the Northeast venture, or nothing, i.e. paying his full tax bill. For this type of depositor, the tax credit scheme represents a form of forced savings; therefore, I shall refer to "incentives" of this latter type as "forced savings incentives."

Note that this system differs from the conventional model of forced saving through taxation. Rather than allocating these funds through governmental decisions, the system relies on a mixed government-private allocative mechanism in which private entrepreneurs propose projects, secure government approval, and then tap the "captive capital market" represented by the deposits. Of course, the same basic output effect could have been achieved if no tax credit was available to non-entrepreneur taxpayers, but the government used general tax revenues to buy preferred stock in approved ventures.

B. The Open Capital Company—Introduction and Early Development

In the first phase of its capital market development program, the government relied heavily on marginal tax incentives rather than forced savings incentives to achieve its goals. These marginal incentives were developed via the new technique, the "open capital company."

The government has adopted a basic policy of en-

couraging what it calls "democratization of capital." To encourage "democratization," it created a special category of corporation—the "open capital corporation" (sociedade anonima de capital aberto—SCA)—the essential element of which is that a significant proportion of the companies' shares be held by the public. If a corporation can qualify as an SCA, both the corporation and its shareholders receive special tax treatment, which includes both exemptions and deductions. In the remainder of this section, I will analyse the origins of the idea of granting fiscal incentives to "open" companies, discuss the evolution of the conditions which companies must meet to qualify as SCAs, and set forth the nature of the incentives available to SCAs.

One of the earliest economic measures adopted by the Castello Branco government was designed to encourage sale of shares to the public. Within four months of taking office, and before it had published its two year "Program of Economic Action" (PAEG), the government issued a decree creating "The Fund for the Democratization of Capital of Corporations." (FUNDECE).⁴⁰ Despite its title, FUNDECE really functioned to solve a very short-run problem—that of furnishing working capital to industrial firms. The anti-inflationary credit squeeze created a working capital crisis for industry. FUNDECE was designed to alleviate this crisis; at the same time an attempt was made to ration funds to companies which would:

1. accept formulas involving the sales of shares to the public ("democratization of capital");
2. produce for export; or
3. whose production was needed to eliminate economic "bottlenecks."

However, FUNDECE failed effectively to condition credit on some form of public sale of shares. Obstacles appeared to discourage firms willing to comply with this requirement. Companies had difficulty registering issues with the Central Bank, underwriting costs appeared high, and there was little market interest in such issues. As a result, FUNDECE allowed companies to satisfy the requirements for "democratization" by having existing shareholders subscribe to a new issue in an amount equal to the amount of the loan. While this was a sensible way to force companies to "recapitalize," it did not foster "democratization."⁴¹

While FUNDECE was being created, the government

⁴⁰ D.L. 54105, of August 6, 1964.

⁴¹ Política Monetária e Mercado De Capitais, pp. 172-173.

took another measure to encourage "democratization" of capital by introducing the idea of the "open capital company," (1964 Law 4506) and exempting such companies from a special surtax on distributed profits. To secure this special tax treatment, a corporation had to meet four requirements:

- a. *negotiability*—its stock must be negotiable.
- b. *distribution*—the stock must be distributed among a certain minimum number of public shareholders.
- c. *substantial percentage of voting shares held by public*—the public shareholders must hold 30% of "voting capital."
- d. *continued expansion of public shares*—the number of public shareholders and the percentage of capital they hold must increase over time until they reach certain limits.

The requirements of Law 4506 were quickly superseded. The Capital Market Law left the *incentives* standing, but eliminated the earlier law's definition of the criteria by which tax exemptions would be granted. The new criteria were set forth in a 1966 *Central Bank Resolution 16*⁴² which made fundamental changes in the definition of an SCA. Law 4506 had centered its concept of open capital on the number of public shareholders, and the percentage of voting shares they held. For this relatively simple concept, Resolution 16 substituted the core idea of *negotiability* of the company's shares. Very specific tests were established to measure "negotiability:" the shares must be sold on at least one exchange; minimum requirements were set for the number of transactions in the stock, the cruzeiro volume of trading and, the percentage of total issued stock that had to change hands. In addition, Resolution 16 eliminated the requirement that the public hold *voting* shares, lowered the minimum required percentage of public shareholders, and weakened the requirement for continued sale of stock to the public.

The main emphasis of this confusing regulation was on creating a trading market. The authors of Resolution 16 were little concerned with the impact of outside stockholders on management or in affecting "control." For them, "democratization of capital" meant merely the placing of a certain percentage of equity shares in the hands of the public, and maintaining the liquidity of the shares. The inadequacies of this concept quickly became

⁴² Central Bank Resolution 16, § I and II (all Central Bank Resolutions will be cited simply as "Resolution").

apparent for the "democratization" program was designed to secure two different goals. The first (which Resolution 16 emphasized) was a basic aspect of capital markets policy—to enlarge the total volume of funds available to finance corporate investment, thus allowing corporations to expand rapidly to take advantage of technological opportunities and economies of scale. The second goal was rather different in that the incentives for expanded public shareholding were also designed to encourage more "democratic control" of companies, some change in the internal structure of corporate power.⁴³

The idea that the SCA system might in part be aimed at making structural changes in corporate decision-making was confirmed by a later government study on the Capital Markets, prepared by Mario Henrique Simonsen and published by the Ministry of Planning. This document suggested that one of the legal obstacles to development of the capital market was the lack of protection of the rights of minority shareholders, and stated that

"a revision of the corporation law, giving greater guarantees to groups of minority shareholders, could serve as a considerable incentive to the mobilization of private savings. . . . Mandatory representation of minority groups on the Board of Directors would have the advantage of making Brazilian corporations more democratic, thus reducing the tendency of family control."⁴⁴ (Emphasis supplied)

The current SCA Regulations emphasize *both* goals of the democratization process: negotiability and control.

Section 4—Open Capital Companies Through 1970: Requirements, Benefits, Goals and Problems

In December 1968, the Central Bank issued Resolution 106, which completely altered the conditions under which corporations could qualify as SCAs. At the same time, additional tax incentives were given to shareholders who held SCA shares. With these measures the SCA system assumed a relatively mature form, which remained substantially unchanged until early 1971.

In general, to qualify as an SCA, the corporation must meet the tests established by the Central Bank and secure a certificate of eligibility which must be periodically renewed. Once

⁴³ P.A.E.G., p. 84.

⁴⁴ Simonsen, p. 82.

the *company* complies with the requirements, the law grants very substantial benefits (i) to the company itself, (ii) to its existing shareholders, and (iii) to new shareholders who acquire its shares. Some benefits to the shareholder depend on his acquiring new shares of the SCA through subscription; others are available to all shareholders and continue as long as the corporation retains its eligibility.

A. The Eligibility Requirements

The requirements for eligibility adopted by Resolution 106 are clearcut and relatively simple. To qualify as an SCA, a corporation must:

1. *have 20% of its common stock (açoës ordinarias) distributed to the public.*

The resolution sets minimum standards for the number of shareholders, and the size of their holdings, which constitute "the public." These vary in accordance with the company's size and the area of the country in which it is located. The highest requirement for corporations with capital over NCR\$1,000,000 in Rio or Sao Paulo, is 500 shareholders each with at least 100 shares. These are not onerous requirements.

2. *continue to increase the number of public shareholders until 49% of the common stock is publicly held*

Every two years the SCA must renew its certificate of eligibility. To continue eligible, the corporation must show that it has continued to expand the number of public shareholders and the percentage of the corporations' common stock held until 49% of the common stock is "publicly held." Each two years this percentage must increase by 10% of the previous percentage; thus if the company starts with 20% of its shares in the hands of the public, it can take almost 20 years to complete the process of "opening" without losing eligibility.^{44a}

3. *maintain conditions favorable to the negotiability of shares*

SCAs must register their shares on at least one stock exchange in the country, and must not restrict the free sale of stock, either by contract or in the charter or by-laws.

Thus Resolution 106 introduced three key modifications in the concept of the "open capital company." First, the

^{44a} This requirement was recently modified. See text at fn. 48a.

notion of "negotiability" as a basic test of "democratization" was dropped. Secondly, by specifying that the public must hold *common stock*, Resolution 106 introduced the idea that "democratization" required transfer of *voting* shares to the public.⁴⁵ Finally, the Resolution revived the idea that SCAs must continue to expand not only the number of public shareholders, but also the percentage of common stock held by the public.

B. The Tax Benefits

The tax benefits available to SCAs and their shareholders are of the type I have styled "marginal." Their effective function is (i) to reduce the cost to the company of distribution of profits to its shareholders, and (ii) to raise the effective yield of SCA securities to the stockholder.

The principal tax benefits are:

1. *taxpayers may deduct part of any purchase of new issues by SCAs.*

Taxpayers can deduct from gross income 30% of all sums applied to such stock purchase, up to 50% of gross income.

2. *distribution by SCAs are taxed at lower rates than other corporate distributions.*

Taxpayers who receive corporate dividends in Brazil have a choice of two tax options. They can receive the dividends free of tax and include them in their declaration. In this case, they can deduct the first NCR \$1,980. Alternatively, and more importantly, taxpayers may opt to have taxes on dividends withheld at the source. In this case, they pay a tax of only 15% on SCA dividends, as opposed to 25% on dividends of "closed companies." This latter option is important because taxpayers who elect for withholding at the source may also hold *bearer* shares which Brazilian investors prefer for their anonymity.

3. *SCAs which distribute profits are given special tax benefits*

Not only are SCAs exempt from the surtax on distribution of profits cited above; the corporation may also *deduct* a portion of any dividend payments from its gross income.⁴⁶

⁴⁵ Non voting common stock is not permitted under Brazilian corporate law.

⁴⁶ For a full analysis and perceptive policy discussion of all the tax benefits available to SCAs, see Oliveira, (Coordenador), "A Política Fiscal Como Instrumento de Dinamização do Mercado de Capitais." Revista de Política e Administração Fiscal, Vol. 2, No. 1, Jan/Feb 1970, p. 47.

Note that the bulk of these benefits are available to shareholders of SCAs regardless of the class of stock they hold, and regardless of whether their purchase of shares provided new funds to the company. Except for the partial deduction for amounts applied to new issues, the fiscal benefits are available to all shareholders as soon as the company qualifies as an SCA.

As a result of these incentives, everything else being equal, it is more attractive for an investor to hold shares in an SCA than in a closed company, and frequently more attractive to have share income than income from other sources. For a large investor in a high bracket, the difference between receiving dividends from a SCA and from other, less favorable sources is substantial.⁴⁷

C. Goals of the SCA System

The SCA system is very complex, and undoubtedly will undergo further modifications. However, it is sufficiently well established to permit us to analyse the goals that it is designed to achieve. In this analysis, I shall rely on the scheme set forth in Section 2.

1. *Increasing the Propensity to Save and Reallocating Existing Savings towards the Corporation*

The government hoped to overcome investor resistance to stocks as a medium of investment and company resistance to the primary equity market as a source of financing. This, in turn, required that the necessary institutional structure of a primary and secondary market for shares be created, and that a functioning capital market be developed.

This concern with encouraging capital market development explains certain features that were common to all the attempts to define the SCA requirements. Law 4506, and Resolutions 16 and 106, all included provisions aimed to assure a relatively broad distribution of corporate shares and more direct attempts to guarantee that these shares would be relatively liquid. Thus, the net impact of the SCA system has been to create in-

⁴⁷ For example, let us assume a hypothetical investor whose taxable income is NCR-\$100,000. If all his income is from non-favored sources he must pay NCR\$50,000 in taxes. If, however, he receives dividends of NCR\$50,000 from an SCA and the rest from non-favored sources he will only pay NCR\$27,500, i.e. his tax will be reduced by 45%. If he receives dividend income from a *closed* corporation, he must pay \$32,500, less than from other sources but significantly more than in the case of an SCA. At the same time, in the case of SCAs the benefits to the company allow it to pay higher dividends on the same gross profit than could a closed company in similar circumstances.

centives to transfer a significant percentage of the shares of corporations from their existing owners to a relatively large group of public shareholders who can freely buy and sell the securities.

Note that the system encourages the *transfer* of existing shares and not necessarily the raising of new capital from the public. The requirements for continued "opening" can be met by gradual transfer of the shares of the controlling (majority) group to the public.⁴⁸ Moreover, the structure of the tax incentives themselves give primary emphasis to transfer, not to new issues.

2. "Modernizing" Business Management: *The Curious Story of "Agrarian Reform in the Corporation"*

In the interest of "modernizing management," SCAs are required to distribute *voting* shares. This requirement has been bitterly criticized, and has discouraged some firms from qualifying for the benefits, thus slowing the spread of the SCA system. The government must consider that "agrarian reform in the corporation" is important.

The Argument Against the Voting Rights Requirement

Resolution 106 required that SCAs must initially distribute 20% of their common (voting) stock to the public, and then continue transferring common stock over a long time period until 49% is held by the public. The basic argument against these requirements is that they discourage firms from making new public issues. It is alleged that a large number of companies which might be willing to raise capital through the primary market will not do so if they must sell *voting* shares. Thus, it is argued, as long as tax incentives are linked to sale of voting shares, they will be inadequate to attract such firms into the primary market. If, on the other hand, these fiscal incentives were available to firms who sold preferred stock to the public, these companies would begin to rely on equity financing. Despite these arguments, the Government maintained the requirement, although in 1971 some modifications were finally introduced.

Possible Explanations of the Requirements

It is possible to identify at least four possible policy targets which might explain the continuance of the voting rights requirement; two are predominantly political, two predominantly

⁴⁸ The requirements for continued "opening" are not quantitatively very onerous, and a firm may take over 18 years to reach the maximum requirement for public shares. This seems a small price indeed to pay for the fiscal advantages that it brings to the existing shareholders, considering that (1) it does not involve even serious threat of loss of control, and (2) the price that investors should be willing to pay the existing shareholder for the shares will be increased by the effects of the tax benefits they will receive.

economic. For analytic purposes, however, we can boil these down to two basic aims.

The four "targets" that may be identified are:

i. *Political*

1. "Agrarian reform in the corporation." The political version of this idea suggests that current corporate owners exercise political power and use this power to support antidevelopmental policies at the national level. Voting rights would undermine their corporate position and thus their political power.
2. "Peoples capitalism." This concept suggests that voting rights may be important to give a broad group in the population a stake in the capitalist system and thus reduce potential sources of political instability.

ii. *Economic*

3. *Increasing the Attractiveness of Shares.* This theory starts from the assumption that controlling groups in Brazilian firms are unused to dealing with shareholders, accustomed to finance their operations through loans, with no wish to share profits with "outsiders." There is a fear, therefore, that if such groups, because of fiscal incentives, sell shares to the public, they will pay as little as possible in dividends to outsiders. This will, in turn, disappoint investors who will turn away from share ownership.

Voting rights, it is alleged, alter this expected "misbehavior" in two ways. First, with the vote, the outside shareholders will be able to force the payment of adequate dividends. The second alleged effect is more subtle; it is based on the idea that the willingness to tolerate even minority *voting* shareholders is a litmus-paper test of a "modern" mentality towards outside capital. If controlling shareholders are willing to accept outside shareholders with the vote, the government is safe in assuming that these majority shareholders will behave in ways consistent with the development of the capital mar-

ket, and thus "deserve" the fiscal benefits. (The vote here is a test of the attitude of dominant shareholders; it is not crucial whether or not the vote gives public shareholders a real voice in company affairs.)

4. "Agrarian reform in the corporation." The economic version of this argument is that controlling groups in closed corporations—the "precapitalist" capitalists—do not use corporate assets in the most "efficient" way possible. Presumably, the outside shareholder will serve to "educate" management by appearing at annual meetings, by demanding more profits, by asking for financial data, and by proposing new corporate strategies. The outsider will thus force increases in the efficiency of Brazil's productive plant.

The political targets, however, can be subsumed under the economic. In the first case, the aim is to reduce the political power of the "pre-capitalist capitalists." This can only be achieved if the voting requirement in fact has an effect on the role of these groups within the corporation, i.e., if it achieves its economic target. Thus, it does not serve as an independent justification of the voting rights requirement.

The second political target is to change political attitudes of the public toward capitalism by making them shareholders. Again, if, and only if, the voting requirement accomplishes what the economic targets are designed to accomplish—i.e. to improve corporate attitudes toward shareholders and the overall efficiency of corporate management—will it further the political goal. Otherwise, the mere paper right to vote would seem to have little effect one way or another on the public.

Both "economic" targets are really aimed at changing management behavior. "Agrarian reform" however, stresses the kind of shift in attitudes most closely linked to increasing the efficiency with which corporate assets are utilized, while the other stresses enhancing the attractiveness of shares. There is no way to determine which of these economic "targets," analytically separate but merged in practice, represents the "real" aim of the government's policies. However, there is evidence that some groups in the government believe strongly in what I have called "agrarian reform in the corporation."

D. The SCA System Today: Problems and Prospects

The debate over the voting rights requirement is not the only issue surrounding the SCA system. But, the goal of "modernizing management" has an importance in capital market development that transcends the debate over formulation of Resolution 106's awkward attempts to achieve it.

Resolution 106 has been attacked on other fronts. Most criticized are the initial requirement that twenty percent of the common shares be issued to the public, and the requirements for continued "opening" as a condition of maintaining SCA eligibility. Both requirements are alleged to exact a high cost in deterring companies from going public, without yielding corresponding benefits in terms of government policy goals, such as modernizing management.

The relatively slow pace of the SCA program has made the government more sensitive to the critics. As this study went to press, the Central Bank announced a relaxation in the voting rights requirements, allowing SCAs to transfer some preferred stock.^{48a} It seems to have realized that the measures were not achieving the goal of "modernizing management," and yet were delaying the expansion of SCA benefits. Other changes will undoubtedly follow, but the SCA will remain important in capital market development policy. As we shall see, the potential interrelationship between this program and the other major tax incentive tool, the D.L. 157 Fiscal Investment Fund, comprise a formidable program in the development of the equities markets. In the following sections, I shall discuss the origins, development, and possible future of D.L. 157, and its relationship with the SCA program.

PHASE TWO: The Introduction of Forced Savings Tax "Incentives"

Section 5—Introduction to Phase Two: The Crisis of 1966 and the Search for "Strong" Incentives

A. Introduction

I have shown how the Castelo Branco Government made a basic decision to develop finance (the debt-asset system)

^{48a} Resolution 176 of March 9, 1971 allows SCAs which have distributed 20% of their voting shares to maintain eligibility if they continue to transfer either common (voting) or preferred (non-voting) shares to the public. (This decision is consistent with recommendations made by Paulo Sá, Jorge Hilario Gouvea Vieira and me in a Portuguese version of this study submitted to the Central Bank in 1970.)

as a major savings-investment technology for Brazil. This fundamental decision was followed by a series of measures to develop the capital markets. Chief among these measures were a complex system of tax incentives such as the "open capital company" program which exclusively utilized "marginal" type tax incentives.

In the following sections I shall discuss a very different kind of tax incentive program. This program was inaugurated by the passage of Decree Law 157 of February 10, 1967. (D.L. 157). Passed in the last months of the Castello Branco Government, this law introduced into the capital markets program the type of "forced-savings" tax incentive originally developed for the Northeast of Brazil.

In identifying two separate "phases" of capital market policy in Brazil, I do not mean to make a strictly chronological division. The elaboration of "marginal" tax incentives, and the refinement of the requirements linked to these incentives, has continued to the present. But D.L. 157 did introduce a fundamentally new element into the overall program, modifying the basic saving-investment technology choice originally made by the Castello Branco government in 1964. In this analytic sense, the use of the "forced" rather than "induced" savings can be considered the beginning of the second "phase."

B. The Crisis of 1966

The crisis that spawned D.L. 157 was in part a reflection of the failure of the first phase of the program; an understanding of that crisis can tell us much about the problems of capital market development under the conditions that prevailed in Brazil in the mid-1960s. Moreover, D.L. 157, like so many of the capital market measures adopted by the Government reflects a compromise between short term emergency measures and long-run developmental goals. Many of the problems that D.L. 157 encountered stem from the conflicts involved in its original conception. For both these reasons we must examine more carefully two developments during 1966 which led to the creation of D.L. 157: the aggravation of the working capital crisis and the disappointing performance of the stock markets.

The 1964-1966 period was a time of tight money for many Brazilian firms. In its attempts to control inflation, and to reduce the role of government in the economy, the Government cut back on official credit to the private sector. A general policy of restricting the money supply further curtailed credit.⁴⁹ The result

⁴⁹ Política Monetária e Mercado de Capitais, p. 128, Morley, op. cit note 13, supra.

was a credit squeeze or "working capital crisis." Many firms were hard hit during the inflation. Misled by accounting practices which failed to keep pace with the runaway inflation, some had recorded false profits which were quickly distributed to their shareholders; these firms found themselves seriously undercapitalized.⁵⁰

In addition, some firms had invested heavily in plant, machinery, buildings and land. These investments had been partly justified as a technique to preserve the real value of the firm's assets during the inflationary period when no financial medium was available in which temporarily unneeded funds could be held. When the inflation began to slow down, these firms found themselves with an over-supply of non-productive assets but desperately short of cash to meet current needs.

The government had realized that a cutback in government credit would require creation of alternative sources of working capital. The first such effort was FUNDECE; the second was Central Bank Resolution 21, which channeled funds from the sale of government bonds through private financial agencies to corporations for working capital. Neither was completely successful.

Most important of all, the government had expected that the primary equities market would develop as an alternative source of funds for hard-pressed firms. It hoped that the Capital Market Law and the marginal incentive systems would stimulate the development of this market. However, stock market performance in 1966 was disappointing. An unofficial but important government report published in March 1967 by the outgoing Castello Branco regime admitted that "the hopes expressed in 1965 with the publication of the Capital Market Law . . . did not materialize." The report indicated that volume on the stock exchange declined in 1966, and equity prices rose more slowly than the cost of living. The number of persons investing in shares declined. And perhaps the most disheartening news was that there were few new issues during the year. The report stated that the paucity of new issues was due to the fact that prices on the exchange were below par value; since new issues are traditionally issued at par, this market condition discouraged firms from trying to raise capital by public offerings. In 1966 only one new company entered the thin ranks of firms whose shares were regularly traded on the exchange. The report concluded that "considering the conditions of the market, the incentives for the opening of corporations have proven totally insufficient and unsatisfactory."⁵¹

⁵⁰ Mario Henrique Simonsen, "O Mercado De Capitais"; Eugenio Gudim, "Perspectiva Da Inflação Brasileira"; Correio da Manhã (Rio), Jan. 22, 1967.

⁵¹ Política Monetária e Mercado De Capitais, pp. 137-138.

Others also were reaching this conclusion, and in January 1967 Mario Henrique Simonsen, one of the leading commentators on the development of the capital market and a close advisor to the Government, concluded that the only way to develop the equities market as a source of urgently needed working capital funds would be through the creation of "strong fiscal incentives."⁵²

By the end of 1966, it had become apparent that the early attempts to create an equities market had failed. Simultaneously, the government was subjected to increased pressures to alleviate the deepening working capital crisis, which had helped bring on a worrisome recession.⁵³ In the transition period between the end of the Castello Branco regime and the beginning of the Costa e Silva government, a working group consisting of officials of the outgoing government as well as representatives of the new administration and private financial institutions was formed to study the problem and propose solutions.⁵⁴

The working group accepted Simonsen's judgment that the problems of capital market development could only be solved by introduction of "strong fiscal incentives." They found the solution in the system which had already yielded positive results in transferring resources to the Brazilian Northeast. The working group decided to apply the same "forced savings" incentive system to purchase of securities generally. *Taxpayers would be allowed to purchase securities in lieu of paying a portion of their tax bills.*

To understand the system that emerged from these sessions, we must understand the thinking of the participants of the working group. The working group was really addressing two different problems: long run development of the primary and secondary securities markets and short run provision of working capital to companies in serious financial difficulty. There were serious conflicts between those two goals but these conflicts were apparently not perceived by the authors of D.L. 157. Apparently the working group believed that (1) either there was only one problem, or (2) that the solution of one problem (e.g., depressed stock

market) would automatically solve the other (e.g., working capital shortage.)

Thus, those most interested in market development took the position that development of the primary and secondary markets was a direct solution to the working capital problem.⁵⁵ It was alleged that measures which increased share prices would guarantee a flow of funds to companies needing working capital. This would occur, the argument ran, because the major factor discouraging new issues was that existing shares were trading below par. To raise the price level on the exchange, would bring forward a spurt of new issues.

This approach seemed too indirect for those who were primarily concerned with transferring additional funds to corporations in financial difficulties. Thus, the then Minister of Finance, Dr. Octavio Gouvea Bulhoes, insisted that the tax funds had to be channeled directly to those firms who would use them to resolve financial difficulties. Taxpayers would receive securities of these firms. Bulhoes, whose views were obviously influential, saw D.L. 157 primarily as a device to resolve the working capital crisis.⁵⁶

While the working group failed to realize it, there was a built-in conflict between a program to assist firms in serious financial difficulty and one to develop the equities markets. Firms in need of emergency assistance would hardly seem to be the best available investments. If tax incentives were used to channel investors' funds to such firms, there was a great risk that the investors, who would eventually receive securities of such companies, would become disillusioned about the attractiveness of share ownership. The working group failed to see this because it believed that the shaky firms were in fact very sound ventures which were experiencing short run problems due to "artificial" situations created by inflation and the stabilization program. The government considered that the high costs of working capital in the *Letra* market were "abnormal" and masked the real profitability of the company. Thus, it was argued, if the expensive short-term financing were replaced by cheaper, long term financing, the companies would be highly profitable and represent good investments.⁵⁷

⁵² Simonsen, "O Mercado De Capitais," op. cit. note 50.

⁵³ Bulhões, op. cit. note 33, p. 124.

⁵⁴ a Morley, op. cit. note 13, supra.

⁵⁵ Bellini Cunha, "Sistematica Dos Incentivos Fiscais Para Investimento" Supplemento Econômico, Correio Da Manhã, April 28, 1969, p. 10. (Hereinafter cited as Bellini Cunha). The following discussion of the genesis of D.L. 157 is primarily based on Bellini Cunha's article, supplemented by interviews with Ex-Ministers Campos and Bulhões, Mario Simonsen and members of the working group.

⁵⁶ Note that Simonsen, writing in January 1967, during the discussion that led to 157, felt that market development and greater incentives to "open capital" were essential to resolve the working capital problem.

⁵⁷ In his recent book *Dois Conceitos De Lucro*, Bulhões gives the following description of the decision to create D.L. 157: "during 1966... companies needing working capital found themselves in great difficulty given the restrictions on bank credit. As a way of solving these financial problems, arose the idea of using fiscal incentives to strengthen working capital" (emphasis supplied) Bulhões, op. cit. note 36, p. 124.

⁵⁷ Interview with Roberto De Oliveira Campos

Whatever may have been the reasons which explain the decision to attack the two problems simultaneously, the working group did draft a bill which was submitted to President Castello Branco in the last weeks of his administration and was signed into law as D.L. 157. The "forced savings" system was to be applied to the capital markets of Brazil.

C. Why Did Early Attempts at Equity Market Development Fail?

In one sense it is overdrawn to say the original policies "failed." When the crisis of late 1966 emerged, the capital market program was but two years old. Considering the long years of inflation, and the consequent decay and stagnation in the financial markets, it is small surprise that immediate results were not forthcoming.

Moreover, there were important short term factors that influenced the behavior of the markets in this period. Stock prices were depressed in 1966; the real value of the SN index (Brazil's Dow-Jones average) fell almost 7% that year. This in turn, dampened interest in new issues. But this result was directly related to the credit squeeze caused by the stabilization efforts. As Mario Simonsen has pointed out, the Brazilian stock market is extremely sensitive to general credit conditions; Simonsen attributes the fall of stock prices in 1966 to the tight money conditions.⁵⁸ Once again the stabilization and developmental goals were in conflict, and capital market development had to give way to general stabilization efforts.

Another short run factor that probably contributed to the "failure" of the first phase effort was the continued high inflation. Despite notable successes, the stabilization program fell short of its goals for 1965-66. While the P.A.E.G. had predicted a 25% inflation rate for 1965 and a 10% rate for 1966,⁵⁹ the actual rates were 57 and 38% respectively.⁶⁰

Had the planners evaluated the program in 1966 in terms of a long run effort to create an equities market they might not have rendered the harsh verdict of "failure." They reached this conclusion because they had hoped that the program would yield short term results in alleviating the working capital crisis; when it did not they concluded that their efforts were inadequate and went on to develop more powerful tools to stimulate the economy.

Yet this linkage of the long run to a short run prob-

⁵⁸ Ellis, ed. *The Brazilian Economy*, p. 155.

⁵⁹ P.A.E.G. p. 35.

⁶⁰ Ellis, op. cit. note 58, p. 52.

lem may have been a blessing in disguise. For had the government not looked to the equities market to solve a short term problem, it might well have been years before a serious appraisal of the original strategies was undertaken. Instead, the working capital crisis forced a complete reappraisal of the program and the conditions under which it was operating. This appraisal and critique is contained in the measures adopted to cure the "failure," and these tell us a great deal about the problems of forced draft capital market development under conditions such as those that prevailed in Brazil. Let us examine the implicit and explicit criticisms of past efforts that impelled the move to D.L. 157.

The working group all agreed that the existing incentives were not "strong enough." The authors of D.L. 157 felt that in selecting this mechanism, they were employing "stronger" incentives; but this is not what they did. They did not propose to increase the marginal incentives already available to companies that issued stock to the public, or to amend these incentives to put greater stress on the sale of new issues rather than the transfer of existing shares to the public. Rather, the working group introduced a fundamentally different type of incentive, the "forced savings incentive." This really is not an "incentive" at all, but rather a special technique for channeling tax revenues into specific sectors or regions through mixed private-public allocative mechanisms.

D.L. 157 wasn't a stronger dose of the same medicine; it was a new remedy altogether. The dramatic shift to the forced savings system suggests that the working group without realizing it had made a radically new diagnosis of the problems confronting the capital market program.

The essence of this diagnosis seemed to be that the debt-asset system could not be relied on as the sole method for eliciting savings for application through the capital market. A forced-savings system relies on taxation for this purpose, not on voluntary savings; by introducing this system into the capital market, the working group indicated a belief that current efforts to elicit savings through voluntary means were failing, and that a dose of forced savings might get the patient on his feet.

The government relied on law reform and marginal tax incentives to get the capital market going, but both have inherent limitations. Moreover, there were deficiencies in the formulation and application of new rules and incentives. Finally, a dimension of "law reform" essential to the growth of a debt asset system was simply ignored in the first phase.

(i) *Inherent Limits of Law Reform and Marginal Incentives*

Law reform of the type employed by the Brazilian government depends on the existence of economic units ready to take advantage of the opportunities created. Laws may be passed which "eliminate specific barriers" to economic activity or authorize the creation of new economic institutions (e.g., investment banks) or new financial instruments (e.g., convertible debentures). But these opportunities will only be exploited if economic units are already frustrated by the barriers or ready to employ the new instruments. Law reform may be a necessary, but it never can be a sufficient, condition of fundamental economic change.

In a sense, law reform suffers from the same limitations as marginal tax incentives. If the obstacles to new economic activity are fundamental or "real" rather than monetary, e.g., strong fear of loss, lack of a basic factor of production, etc., no amount of marginal manipulation of institutional constraints through marginal tax incentives can call forth new forms of economic activity.

Under the conditions prevailing in the Brazilian capital market in 1964-1966, it seems apparent that a number of such "fundamental obstacles" prevailed. Investors were deeply chary of financial assets, firms fearful of outside shareholders, key aspects of the structure of financial intermediation highly underdeveloped, and the supply of skills needed to operate such a system extremely limited.

(ii) *Deficiencies in the Formulation and Application of New Rules and Incentives*

Even if the necessary conditions for effective application of the tools of law reform and marginal incentives are present, deficiencies in the formulation of rules and incentives can hamper their impact. Such deficiencies abounded in the period under study.

My analyses of the zig-zags of policy in the open capital company program highlight one aspect of these deficiencies. Laws and policy statements were vague and imprecise. The process of turning these general guidelines into precise requirements that economic actors could respond to was inefficient. Important resolutions were not issued until long after basic laws were passed. When they were issued, they often reflected a basic failure to understand the facts of the marketplace, and an inability

to frame useful working rules. These deficiencies were due in large measure to the great shortage of skilled personnel in the appropriate government offices, as well as the failure of top level administrators and policy makers to develop sufficiently clear-cut doctrines and policies which might serve to orient the activity of the lower echelons.

But the problems went deeper than a shortage of skilled personnel or lack of adequate guidance from above. The technocratic reformers went on a kind of "legislative jag" that reflected a strange mixture of almost religious belief in the efficacy of law with a deep contempt for the traditions and techniques of Brazilian law. While they subjected the country to an incredible quantity of legislation, the technocrats paid little attention to its quality, and showed no concern for traditional processes of law-making.

No attention was paid to careful drafting. Words were used with reckless abandon, technical terms introduced without definition, and no attempt was made to harmonize the new with the existing body of law. It was almost as if a parallel legal system of economic regulation were being constructed that would bypass preexisting legal channels. Economists in government would communicate with economists in business through the highly esoteric language of the new regulatory law.

The law-making process gave little opportunity for participation by regulated groups. The key legislation was framed in the form of decree-laws or Central Bank resolutions; these were prepared within the ministries and no orderly processes of public consultation or debate were developed. As a result, many key measures had to be amended shortly after publication, when business protests forced reconsideration of especially egregious or inept sections. This process of "consultation by amendment" added to the sense of general confusion surrounding the regulatory process, and undoubtedly reduced its overall effectiveness.

But the deficiencies of the regulatory system were not wholly on the government side. On the private side there were too few lawyers and others trained to handle the new systems. The new regulatory law demanded a combination of legal, economic and accounting skills that were in short supply in private enterprise as they were in government. Modern regulation is in part a complex communication system; many of the key elements of such a system were simply absent in Brazil in the period.⁶¹

⁶¹ For a discussion of the deficiencies in the regulatory law, see Steiner "Legal Education and Socio-Economic Change: Brazilian Perspectives" *Amer J. Comp. Law* (February, 1971).

(iii) *What the Law Did Not Reform: An Excursus on Missed Opportunities in Law Reform*

In order to discuss these "missed opportunities" of law reform, we must identify different effects "law" may have in economic change and different dimensions of law reform efforts. First we must distinguish between regulatory law and law as a formal order. Regulatory law is a technique through which governments intentionally attempt to influence the allocation of resources in an economy. Law as a formal order, fixes specific rules within which economic actors may establish a wide range of economic relationships. In the simplest form of formal order, the only areas of law truly needed are contract and property law. Contract law allows parties freedom of bargaining, subject to certain constraints but then enforces the agreements that result from bargaining. Property law defines the relationship between individuals and groups on the one hand and economic assets on the other. It specifies with precision what resources an economic unit controls, and protects the fruits of economic activity from depredations of others.

We must also distinguish two dimensions of law, which apply equally to these two functions: the law has a formal rule dimension and a sociological dimension. Legal systems contain large bodies of rules which proscribe certain behavior, and command or permit other behavior. For law to be an effective formal or regulatory order, certain rules must be present. But law will not have an effect on economic activity unless it is also sociologically "effective." By this term, I mean that the rules of the legal system in fact actually condition the behavior of economic actors. We are all familiar with laws that are passed but remain on paper; Brazilians have a succinct way of describing such laws; they say that this kind of law doesn't "take."

An effective legal system with appropriate rules can have an important impact on the development of finance. Let me give an example of this by examining the effect of law on dividend payments and hence on the decision to invest. A potential investor will assess the prospects for return and the risks entailed in the investment. Among the risks are the possibility that profits will not be distributed. If he values dividends, an absolute guarantee of his right to receive dividends should lead to a higher rate of investment in equities and increase the flow of funds in the primary market.

A "legal order" can provide such a guarantee in two ways. As a "formal order," it can ensure that any agreements reached between the firm and investors governing payments of

dividends will be enforced. If, as a condition of investment, investors insist on dividends under certain conditions, a formal legal order can guarantee that firms must make the stipulated payments. In addition, or alternatively, "regulatory law" may dictate that dividends are payable regardless of any specific agreement between the parties.

To have an economic effect, however, the legal order must be *effective*. It is not enough that rules are enacted guaranteeing the rights of minority shareholders, and the potential investor must have confidence that the majority will in fact observe the rights of the minority.

We know very little about the relative economic importance of "law" in the sense used here. And there have been no empirical studies in Brazil of the dimensions of "law reform" suggested by this analysis. We do know, however, that the capital market program generally ignored these matters. While the Brazilian government paid a great deal of attention to "law reform," its efforts were focused almost exclusively on developing a complex system of detailed regulation. No attention was given to the role of law in structuring and improving the process of bargaining among groups in the economy, nor efforts made to increase the sociological effectiveness of the legal order.

Why was reform of this type not undertaken? Early in the history of the capital markets program, Mario Simonsen called attention to the need to strengthen the legal protections of the rights of minority shareholders; but little has been done to date to implement Simonsen's call for reform of the *rules*. Even if this has been done—and there are indications that some efforts along this line are underway⁶²—they will have little economic effect unless reforms are also made in what I have called the "sociological" dimension.

In his pioneering study of the Brazilian Capital Market Law, Norman Poser, commenting on the Simonsen's recommendation, observes that the Corporation Law provided some minority stockholder protection already, for the law allowed shareholder's derivative suits. However, Poser points out, the legal order was not effective because (i) few shareholders knew about their rights and (ii) if they did know of their rights they were reluctant to go to court to enforce them.⁶³ The reasons for this reluctance are complex, but include the following factors:

⁶² See, e.g., Law 5.589 of July 6, 1970. (requiring publication of certain information prior to stockholders meeting). See also A. Lamy Filho, "A Reforma da Lei de Sociedades Anônimas" *Revista Bancária*, May 30, 1970, p. 28.

⁶³ Poser, pp. 1300-1302.

- (i) court costs and lawyers fees are high;
- (ii) there are very substantial court delays;
- (iii) judges are ill-trained to deal with complex financial matters and thus the prospects of a fair outcome are low;
- (iv) a general reluctance to litigate not entirely explained by all of the above;
- (v) lack of confidence that even just decisions will be enforceable.

It is of course no wonder that the government did not embark on a major reform program in the areas outlined. Rule changes in this area is very time-consuming; changes must be made with care and integrated carefully into the existing corpus of law. "Sociological" reform takes even more time, because it involves major educational efforts and institutional reforms.⁶⁴ Such efforts will appear to have very high time costs to a government facing short-run crises and anxious to speed up the slow historical process through which the financial systems of mature capitalist states evolve. The move to "forced-savings" techniques through D.L. 157 reflect, *inter alia* a desire to cut through these barriers and force the pace of capital market growth.

Section 6—Decree Law 157 and the Fiscal Fund System

A. The 157 System

Decree Law 157 emerged from the crisis of 1966. The system established by this decree has played a crucial part in the rapid development of the primary and secondary equities markets in the past three years. Using "forced savings" techniques, D.L. 157 has pumped substantial sums into the equities market. It was partly responsible for a major stock market boom that began in 1967 and continued through 1969. A substantial percentage of all new issues made in the period have been purchased with funds made available through this system.

The key feature of the D.L. 157 system is a special "fiscal investment fund." The law authorized financial institutions (*financeiras*, brokers, and investment banks) to create special mutual investment funds ("157 Funds") At the same time it gave a tax credit to all taxpayers for sums applied in purchasing shares of these mutual funds ("CCAs"). The credit

⁶⁴ For a discussion of such an effort in Brazil, see Steiner, *op. cit.* note 61 and Rosenn, "The Reform of Legal Education in Brazil," 21 *Journal of Legal Education* 251, 1969.

is limited to a specific percentage of the tax bill: it is currently 12% for individual taxpayers. To qualify for the credit the taxpayer must hold the CCAs for a specified time, originally two years.⁶⁵ After that, he is free to redeem them for cash.

Let me give an example of how the system works. Assume that an individual taxpayer owes the government NCR \$1,000.00 for a given year. D.L. 157 allows him to buy up to NCR \$120.00 in shares of *any* 157 Fund (i.e., 12% of his taxes *due*); he can then submit evidence of such purchase in lieu of paying the tax. The 157 Fund, a private entity administered by an authorized financial institution, receives the money. The money is deposited in the Bank of Brazil, until the Fund applies it to purchase of equities. At the end of the holding period the taxpayer redeems his CCA, receiving in return its cash value, which is his prorata share of the Fund's current market value.

Originally, the system did not apply to taxpayers whose tax was withheld at the source. Recently, an ingenious device has been developed to extend the system to this group, which includes the vast majority of Brazil's taxpayers. When a taxpayer has all or part of his income withheld at the source, and he wishes to participate in the 157 system, he may elect to receive "157 checks." These are checks issued by the government in amounts equal to 12% of the taxes withheld; the check can only be cashed by exchanging it for 157 Fund shares.⁶⁶

The 157 system uses the tax power of the government to create a pool of *potential* savings which may be mobilized by private financial institutions. The various 157 Funds compete for the taxpayers' money, offering price incentives (the increase in Fund market values) and services (e.g., 157 Funds will prepare income tax forms for shareholders). The pool of savings created by the system is allocated among financial institutions by decisions of individual taxpayers, presumably maximizing expected returns. The taxpayer has nothing to lose by entering the system; but his potential gain depends on his ability to pick out the best performers among the Funds.

The 157 Fund allocates the receipts among shares largely on price and expected profit considerations. There are, however, certain restrictions on how the tax receipts may be spent. These fall into two classes:

First, there are limits on the percentage of receipts that

⁶⁵ This has recently been extended to four years, with partial redemption allowed in years two and three. Decree Law 1.109 June 26, 1970.

⁶⁶ Portaria GB 96/70.

may be used to acquire stocks on the secondary market rather than *new issues*.⁶⁷

The second type of limitation affects the *type of company* whose shares may be acquired. Article 7 specifies requirements companies must meet to become eligible to issue securities to the 157 Funds. ("Article 7 companies.") The original provisions of Article 7 reflected a clear concern to restrict the system to financing companies which *reconstitute* their capital, i.e. improve their working capital position.

Thus the decree requires that existing shareholders must subscribe to 20% of each issue or the company must agree to sell surplus real estate. In addition, the financing had to result in an improvement in the firm's debt-equity ratio.⁶⁸ As we shall see, these restrictions have only had a limited effect on the system's functioning.

B. D.L. 157 and FUNDECE Compared

FUNDECE and 157 reflected the same diagnosis of the financial problems in Brazil and up to a point used the same tools to deal with these problems. Both systems identified three basic "problems" and set targets which would solve these "problems". The targets were:

- (i) provide working capital on a non-inflationary basis;
- (ii) correct distortions in financial structure caused by inflation and inconsistent with efforts at stabilization and
- (iii) develop a broad primary equities market where firms could seek relatively cheap long-term financing.

⁶⁷ The percentage of receipts that must be used to purchase new issues has varied. Currently it is set at 33%.

⁶⁸ To satisfy Article 7, a company must commit itself to fulfill two conditions:

- a. *either*: (i) place on the market newly authorized shares to be subscribed by the public, or convertible debentures repayable in no less than 3 years; in both cases the existing shareholders had to subscribe at least 20% of the issue,
or (ii) sell real property in an amount equal to at least 15% of its stated capital; and

- b. use the funds arising from the increase of paid up capital for "working capital," thereby improving its debt-equity ratio over that set forth in its last balance sheet prior to January 1, 1967. The resulting debt equity ratio had to be maintained for at least 3 years.

The idea behind the decree seems clear; the resources made available through the fiscal incentives would be channeled to firms who *reconstitute* their capital, either through a public offering in which the existing shareholders subscribe a significant portion of the issue, or by sale of superfluous real property that had been acquired as an inflationary hedge. In either case the companies had to improve their debt-equity ratio.

Both systems assumed that by achieving the third target, i.e. by creating a primary equities market, the other targets would also be achieved. Both also assumed that this could be done by making available government funds conditioned on certain measures by the recipients.⁶⁹

But the differences between the systems were profound. In its original form 157 reflects less confidence in the capacity of the private market than did FUNDECE. FUNDECE was based on a hope that a pool of voluntary savings existed or could be tapped by primary securities issuers. Of course these hopes were quickly dashed. On the other hand 157 made no such assumptions; it relied exclusively on two sources of "forced savings": tax funds and mandatory subscriptions by existing shareholders. The primary market would be a captive one.

The framers of the 157 system were clearly pessimistic about the eliciting capacity of the Brazilian financial system, at least in the short run. On the other hand they seemed to be more optimistic about its allocative capacity. Thus unlike FUNDECE, which gave tax funds to the Bank of Brazil (a semi-governmental institution) to allocate, 157 transferred the tax receipts to a large number of individual financial institutions who were to make the choice among potential recipients. It also left to the individual taxpayer the task of choosing which financial institution would receive his funds. These differences assumed great importance as the 157 system developed.

C. The Impact of the 157 System

(1) 157 as a Device to Stimulate the Stock Exchange

While D.L. 157 was designed to channel funds directly to corporations in need of financial aid, in the very first year of its operation it was used for radically different ends. The new government that took office in March 1967, led by President Costa e Silva, decided to give 157 a different role—that of directly stimulating the stock exchange. In the early months following passage of D.L. 157, it was much easier to raise funds from taxpayers than to find companies prepared to issue securities to the Funds. While business firms eagerly took advantage of the tax credit and bought CCAs, few companies qualified under Article 7. At the

⁶⁹ There was another similarity. Both decrees reflected the government's efforts to force firms to reduce their heavy investment in real property. Thus the FUNDECE decree indicated that one factor to be considered in granting loans was the company's effort to correct "imobilizacão exagerada." Decree 54105, August 6, 1964, Article 6, while 157 gave a more specific incentive to such actions by exempting firms which sold real property from the requirement that existing shareholders subscribe to at least 20% of the issues made to the Funds. Decree Law 157, February 10, 1967, Article 7.

same time prices on the stock market continued at the low levels of the previous period, and this situation further discouraged companies from making new issues.⁷⁰

In response, the government issued Central Bank Resolution 60, of July 24, 1967, which waived Article 7 and allowed the 157 Funds to apply ½ of their receipts in the purchase of any stock traded on the stock market for four months. Thereafter, they could continue to apply ⅓ of the receipts to purchase of existing shares in the secondary market, but were limited to acquisition of shares of registered Article 7 Companies.⁷¹ The policy had an immediate impact on the stock market. By August the daily volume of trading on the Rio exchange had doubled over the previous six months' average and the price index rose over 15%.⁷² In this period, the financial community learned a lesson: 157 had a strong potential to effect developments on the stock exchange; the future of 157 in its relation to the stock exchange, has continued to be a source of debate in Brazil.

The first major controversy over the role of the D.L. 157 occurred in 1968. During this year 157 continued to influence prices on the stock exchanges although the impact was not as dramatic as in 1967.⁷³ However, in mid-1968 the financial community began to fear that the 157 system was to be either phased out or limited to purchase of new issues. Apparently to protest this possibility, the stock markets in Rio and Sao Paulo were closed.

The financial community demanded that the system be continued, with three basic changes.⁷⁴ First, they wanted assurance that tax receipts would continue at high levels. Secondly, they asked that the 157 Funds have greater freedom to acquire existing shares on the stock exchanges. Finally, they requested change in the rules governing redemptions of CCAs.⁷⁵

⁷⁰ Bellini Cunha, pp. 10-11.

⁷¹ Resolution 60, July 24, 1967. Brazilian lawyers were surprised, to say the least, that the government had used a *regulation* to amend the governing law. This is far from an isolated example of the slapdash regulatory techniques used in this area.

⁷² Conjuntura Econômica, January 1968, p. 20 (English Edition).

⁷³ See Luiz Tapias, "Bolsa de Valores Aumenta os Negocios em 21% Durante 68" Jornal do Brasil, January 19, 1969, p. 31.

⁷⁴ Carlos Alberto Wanderley, "Financeiras Fixam Quatro Opções Básicas" Jornal do Brasil, November 24, 1968, p. 41.

⁷⁵ The final item of concern involved the problems that many feared would arise when investors began to redeem their CCAs. With the end of the first two year waiting period drawing close, the 157 Funds and others interested in the market began to worry about the possible consequences of these redemptions. D.L. 157 had provided that redemption would be effected by transfer of a pro rata allocation of securities in the Fund's portfolio. But, what would the investors do with these securities? The fear arose that the investors would dump the shares on the market, thus depressing prices. This was considered especially dangerous in the case of companies whose shares were not widely traded or familiar to investors. Proponents of this line of thought believed that the problem could not be solved by redemptions in cash, since the 157 Funds would have to sell shares to secure cash, similarly depressing prices on the market.

The government responded to all these requests through Decree Law 403 of December 1968. This law extended the tax credit for firms. It made absolutely clear that at least one-third of receipts could be used to buy stock on the stock exchanges rather than through new issues. Finally, it set up a new redemption system. With the passage of D.L. 403, the 157 system seemed to be definitively established on the Brazilian scene. Moreover, it seemed to have been decided that one function of the system would be to channel tax-generated savings into the secondary market for corporate equities. Secondly, the way the redemption problem was resolved eliminated any fears that the 157 Funds were merely temporary or stop-gap devices.⁷⁶

Subsequent events have confirmed the importance of D.L. 157 to the exchanges. In 1969 when a series of short run technical problems depressed prices, the President of the Rio Stock Exchange called for release of more 157 monies to add buying power.⁷⁷ While the government did not respond to this request, during 1970 they did find it necessary to allow increases in the percent of 157 receipts that could go into the market.

(2) *Emergence of an Integrated System of Fiscal Incentives*

The history of Brazil's market development program has been one of zigs and zags, advances and retreats. Programs have been tried and abandoned, others have been radically restructured. Short-run policies have been linked with long-run goals, and then as pressures mount, the long-run aims are sacrificed. The speed of creative experimentation is rapid; by the time

⁷⁶ The solution offered by Article 10(b) of D.L. 403 was to allow the 157 Funds to issue negotiable shares in the Fund, which could be exchanged for the CCAs or certificates of deposit. Instead of redeeming in cash or shares, investors would leave their monies in the 157 Funds, becoming free investors. Of course, there was the risk that they would try to sell the negotiable shares in large volume, thus depressing the market quotation of these securities. To avoid this, the Funds were allowed to stabilize the market in free shares.

These regulatory changes seemed to reflect an awareness on the part of the government that the 157 Funds might become permanent financial institutions which would have the main function of bringing new investors into the stock market. Thus the two-year period (now extended to four) would seem to be a kind of forced learning experience in owning mutual fund shares; if the experience proved profitable, the investor would decide to keep his money in the Fund, simply receiving a negotiable title for the non-negotiable CCA or certificate of deposit. Moreover, other investors would be free to buy shares of the 157 Fund as some taxpayers sold their negotiable shares and a market in 157 Fund shares would develop.

⁷⁷ Starting in late 1969, state governments began to sell large blocks of Petrobras shares on the exchanges. Petrobras is the government owned oil corporation; the states had been forced to acquire its shares under federal law. Now with the price of the stock relatively high they saw a chance to secure additional funds for state purposes. But the sale was not well organized. When the shares became available, they were so attractive that investors liquidated other positions to acquire Petrobras; the result was a decline in stock prices. In this situation, the President of the Rio stock exchange called on the government to release additional 157 monies for application on the exchange. See, e.g., "Bolsa Sugere a Liberação dos Recursos do 157," Jornal do Brasil, Nov. 12, 1969, p. 15.

the observer understands a program, it may have been scrapped or changed beyond recognition.

In the course of this process, policy has often been confusing and full of conflicts. Anomalies abound; one program seems inconsistent with the other. For example, while the government insists on linking SCA benefits with the sale of voting shares to the public, no such restriction is placed on sale of stock to the 157 Funds; they can and normally do buy preferred stock. Similarly, the SCA system encourages transfer of ownership, by giving incentives to existing shareholders to reduce their share of capital. D.L. 157, on the other hand, requires existing shareholders to subscribe to 20% of each new issue, thus diluting the effect the issue would have in "democratizing" structure of ownership.⁷⁸ The two systems here seem to work at cross-purposes. Finally, programs are internally inconsistent as we have seen in the case of 157.

In the recent developments in the 157 system, however, one can begin to see the outlines of an integrated structure that might make a concerted attack on the problems of underdevelopment in the equities market. This structure would interrelate three separate facets of the capital market program; the SCA system, the 157 system, and the investment banks.

It is important to understand the crucial role of the investment banks in the 157 system. They grasped the opportunities of the system most fully, and have captured the lion's share of the tax monies. As of the end of 1969, investment banks controlled 82% of the total resources of the 157 system. They were responsible for 81.5% of the sums collected in 1969.⁷⁹

⁷⁸ The following table shows the type of shares that were issued under D.L. 157 up to July 1, 1969. Note that Class C represents the type of situation in which existing shareholders probably took up all the ordinary shares. Moreover, of the companies in classes A and B, at least 14 and probably more were already companies whose voting shares were already widely distributed. Thus 157 made little contribution to the policy of transferring a part of the voting shares of companies to the public.

TYPE OF SHARES ISSUED BY FIRMS
REGISTERED UNDER 157
(To July 1, 1969)

	Companies	Issues
A. Only Common	15	20
B. Mixed-Common more than 25% of issue	38	43
C. Mixed-Common 25% or less of issue	24	31
D. Only Preferred	62	76
E. Only Convertible Debentures	5	5

Source—Central Bank Records
The explanation of these dramatic conflicts between 157 and the SCA system lie in history. Although the SCA rules have always been viewed as part of a market development scheme, 157 was originally aimed at solving the working capital crisis.

⁷⁹ Banco Central, Inspeção do Mercado de Capitais. (Analysis of 157 Funds for 1969). See also Roberto Braga "Pesquisa Sobre A Posição Das Financeiras e Bancos De Investimentos Nacionais" (ACREFI. 1969) ("Braga report"). Braga's study confirms the central role of investment banks in the 157 system. As of

Almost all the fastest growing 157 funds were controlled by investment banks.⁸⁰

Their motives for developing this business have varied. For some banks, the 157 Funds were established merely to accommodate clients. But for others, the 157 system offered a base for the development of a real underwriting operation. It offered contact with investors, and created a captive pool of low cost funds. These monies gave the banks entree in initiating relations with firms requiring financing, as well as leverage which allowed them to be selective in choosing firms to underwrite. In 1969, 157 receipts represented the main source of funds used to purchase new issues underwritten by the investment banks. That year investment banks organized underwritings in a total amount of NCR \$241.5 million, of this, NCR \$193.6 million, or 80%, represented tax funds channeled to firms through the 157 system.⁸¹ (By 1970 the banks attracted substantially more free savings and the role of 157 receipts in bank-led underwritings declined.)

As the market began to grow, however, a problem arose which highlighted some of the internal inconsistencies of the 157 system.⁸² Many business firms were anxious to make issues to the 157 Funds, and the Funds, in turn, were anxious to secure new investors. As a number of Funds entered the market, competition developed among them to capture the 157 tax receipts. The only basis on which 157 Funds could compete for new investors was market performance and dividends; fees are fixed by the Central Bank. Thus the Funds began to place emphasis on the potential market performance and profitability of the shares they purchased. The Funds that were most effective in this process tended to attract the most new investors and thus the process had a cumulative effect.

The imminence of the first redemptions also altered the perspective of the 157 Fund managers. Anticipating large cash redemptions, the Funds began to worry about the liquidity of their portfolios. Since many of the securities they had purchased

June 30, 1969, investment banks controlled NCR\$266.7 million and financeiras NCR\$33.5 million in 157 monies. Nine out of ten largest 157 Funds were administered by investment banks.

⁸⁰ Of a total of NCR\$300.2 million in 157 Funds administered by the institutions covered by Braga's study, NCR\$231.0 million were controlled by investment banks and 21.1 million by independent financeiras. Of the ten largest 157 Funds, seven were administered by investment banks linked to commercial banks, and one by a financeira linked to a commercial bank.

⁸¹ Associação Nacional dos Bancos de Investimento (ANBID) Boletim Informativo Estatístico, Feb. 1970.

⁸² The following discussion of the role of investment banks in development of 157 is based on extensive interviews with bankers, government officials, representatives of the Rio stock exchange, and others. For obvious reasons, I have not identified individual sources.

were not well known or widely negotiated, the Funds became apprehensive about their ability to meet large demands for withdrawals. To guard against this problem, they tried to acquire a significant amount of "blue chips," which would provide liquidity in case of large withdrawals.

The new tendencies to emphasize immediate profitability, market prospects and the liquidity of shares acquired, however, began to generate conflicts with the assistential or "bail-out" goals of 157. As would be expected, the firms most in need of assistance rarely were the most promising investments for a performance-minded Fund in a highly competitive situation. Nor did they promise a satisfactory degree of liquidity. Nevertheless, some Funds began to acquire stocks on these criteria, forgetting the firms most in need of financial relief. Other Funds, more faithful to the letter of 157, were forced by competitive pressure to follow the lead. Given the vagueness of Article Seven, there was little way for the government to control this tendency. Moreover, the development was consistent with the goal of market expansion. Therefore, the Central Bank made no attempt to curb this shift in the prime emphasis of 157.

This de facto redirection of the focus of 157 was observable in 1969; at the same time developments in the SCA system set the stage for possible harmonization of the two programs. The possibility arose that 157 might work to reinforce, not undermine, the SCA goals. The reasoning follows.

Dividends from SCAs are taxed at a little over 1/2 the rate applied to dividends of closed companies; as a result, investors place a high premium on shares of SCAs. In turn, the 157 Funds naturally are anxious to hold shares of SCAs, which on the average are more liquid than other shares. At least one Fund has tried to condition 157 financing on a commitment by the recipient firm that, after the 157 operation has increased its profitability by reducing financial costs, it will make a public offering of voting shares which will qualify it as an SCA. In this way, the shares required by the 157 Fund will not only become more liquid, they will also increase in value at least by an amount equal to the discounted value of the fiscal benefits. If such practices take hold, the 157 Fund may become an active agent encouraging the achievement of the goals of the SCA system.

While events during the first half of 1970 confirmed the existence of this de facto shift in the 157 system, counter pressures began to emerge. The "shift" meant an end to the "assistential" role originally conceived by 157 as 157 monies are chan-

neled only to the larger and more profitable firms, which can afford to meet the substantial costs imposed by the SCA requirements. Moreover, a firm must be in reasonably good financial condition before it is an attractive underwriting prospect; it appears that the investing public is not ready to gamble on small or very risky ventures. As a result, if the 157 Funds allocate their monies to SCAs or potential SCAs, the small or financially necessitous firms who originally saw in 157 a source of cheaper credit, will be denied by the system.

This conflict had become crystal-clear in mid-1970. In July, 1970 the Commercial Association of Rio sent a telegram to the President of the Central Bank, complaining that the 157 system was working to benefit the more financially stable firms who had no trouble securing funds through "normal means." The Association requested that the Central Bank *require* that a specific percentage of the 157 Funds receipts be applied to "small and medium size" companies, subsidizing the underwriting of their shares and stabilizing the market in these shares over a two year period.⁸³ This request came against the background of Decree-Law 1,109 of June 26, 1970, which specifically authorized the National Monetary Council to "*permit*" the Funds to use a portion of their receipts for this purpose.

The campaign to reinstate the assistential goals of 157 was not met with enthusiasm by the investment banks. They felt that "market" considerations and not government priorities should determine the allocation of the 157 receipts. Otherwise, they contended, 157 will not serve its "market-development" role.⁸⁴ Three years after its inauguration, the conflicts built into the 157 system continued to haunt it.

⁸³ "Comercio sugere alterações no sistema de aplicação dos recursos do fundo 157" *Jornal do Brasil*, July 23, 1970, p. 21.

⁸⁴ Conversations with investment bankers, Rio, July 1970. The bankers pointed out that such restrictions would make it difficult for the 157 Funds to make the same kind of market performance records they had achieved in the past. This, it was alleged, would discourage the tax-payer investor, for whom the 157 experience represents in part a "trial run" in the delights of investing in shares.

III. Appraising the Results and Implications of the Brazilian Capital Market Development Program

Section I—*An Analysis of the Functions and Prospects of the 157 System*

A. Introduction

It is premature to judge the success or failure of the Brazilian government's efforts to develop an equities market. The program is barely five years old, and the key measures only began to take definitive shape in 1968 and 1969. The goals of the program are not sufficiently defined, nor is sufficient data available to permit a precise measurement of success in achieving targets or a final evaluation of the costs and benefits of the program. Indeed, the very nature of the program is not yet fully understood.

In this section, a framework is developed to guide ultimate evaluation and a preliminary appraisal of the results of the Brazilian program is made.

B. The Benefits and Costs of the 157 System

The 157 system can only very loosely be described as a tax incentive system. Rather it is a mechanism that employs the taxing power of the government to create a captive pool of savings which can be used for only one purpose; investment in corporate equities.

In terms of the Gurley-Shaw model, the 157 system is a mixed form of savings-investment technology. It uses taxation to elicit savings, but relies primarily on the market and the price system to allocate the savings within broadly defined areas. While the savings must be used by the 157 Funds to purchase equities (and convertible debentures), no other major restriction is placed on the allocative decisions as the system is currently administered.

To date the system has served several important functions. First, it has been used as a pool of money readily available to stimulate and support the secondary market. In the first phase of the 157 system, the bulk of the tax receipts came from business firms, and a large proportion were used to acquire existing equities of listed companies, thus sparking a stock boom. This boom, in turn, overcame barriers which were discouraging new issues.

Secondly, the existence of the 157 "captive primary market" led to an increase in new issues and encouraged development of underwriting in Brazil. Because D.L. 157 tax receipts were available *only* for this purpose and were relatively easy to collect, the system encouraged the investment banks to enter the underwriting business sooner and on a larger scale than they otherwise would have done.

Third, the system also serves to "educate" the investor who, after the period of forced savings should have increased his propensity to hold financial assets, having learned the value of investing in equities.

This model of the 157 system suggests that it has the following important characteristics:

- (i) it is a government tool that can encourage the development of the debt-asset system, but does not, as a precondition of effectiveness, require that the basic institutional "prerequisites" of a mature financial system already exist;
- (ii) it separates the task of developing the allocative capacity of the debt-asset system from that of expanding its eliciting capacity. Under the conditions prevailing in Brazil in the period, it was clearly easier to develop the underwriting mechanism and increase the sophistication of the financial community than to generate wide public interest in holding new and dubious forms of financial assets;
- (iii) at the same time, if it is successful in its educational mission, it will gradually increase the eliciting capacity of the system.

But what are the costs of the 157 system? The tax credit schemes now being used in Brazil apparently *increase* the eliciting capacity of the taxation system. The Brazilian government, recognizes that it can raise more funds through taxes if it combines a tough tax collection program with "benefits" of the type presented by the 157 system. Presumably, the presence of the benefits reduces the incentive to evade taxes and increases the legitimacy of the taxation effort.

Are we to include the full tax revenues diverted to the system as part of the opportunity cost of the mechanism? Not if the Brazilian government's thesis is correct. Rather, we need a concept of the "net tax cost," i.e. gross revenues diverted less

"untaxable" resources which could only be tapped by this form of quasi-tax channeling device.

Does the 157 scheme have high *opportunity* costs? Would voluntary savings be forthcoming if 157 had not existed? Has the existence of the easily collected 157 funds diverted the energies of the financial community from the task of creating an eliciting mechanism?

Another dimension that must be considered is the relative efficiency of the allocative capacity of government versus the private sector. If we assume that the tax revenues are being channeled more efficiently by the private decision makers than they could be by government, then we must include this increase in allocative efficiency as a benefit of the type of system selected.

A final issue is the welfare cost of the path selected by the government. The tax incentive route obviously means that the initial distributive efforts will be regressive, since the tax structure is progressive. This is compounded by the absence of a capital gains tax; at the end of the holding period, the Brazilian taxpayer gets his tax monies plus capital appreciation, free of any tax liability. Until the 157 check was instituted, the system served exclusively to benefit the large taxpayer, since the small taxpayer, whose tax is deducted at the source, could not participate.

A final analysis would have to sum the benefits of the program and compare them with tax, welfare and opportunity costs. At this stage neither can be quantified, so that appraisal is premature. Moreover one can look on 157 as a technique with a very high opportunity cost and regressive welfare implications, or it can be argued that the opportunity cost was low because the actual alternative *opportunities* were in fact severely limited. Were they?

Given a decision to rely on the market and to expand the financial system, was the "forced-savings" route the best choice? This question must be analysed before any final appraisal can be made.

C. The Choice of 157 and Available Alternatives: A Speculation

The government has obviously made a basic decision to develop 157 as a forced savings technique and to rely on it as a major tool of capital market policy. Why did the government find it necessary to employ such a radical device? And will the system be phased out quickly as "free savings" grow?

There are indications that savings-eliciting thru taxation will be an important part of the equities market in Brazil in

the immediate future. There have been two basic changes in the 157 system in 1970 that support the notion that such a decision has been taken. First, the mandatory holding period has been extended to four years, with partial payouts allowed in the last three. Secondly, the 157 check has been instituted. Meanwhile, a number of studies are underway within and without the government designed to study the future implications of 157. One such study is based on the assumption that 157 will continue for at least five years, and that increasing amounts of savings would be captured by the system. Finally, the Government's recently published three year plan states its intention to "perfect" and "extend" the 157 system.^{84a}

How might we explain continued official commitment to this system?

First, inflation as a way of mobilizing resources was yielding diminishing or negative returns by the time the Castello Branco government took office. Thus another "technology" was essential. Second, the program of tax reform was extremely successful, and demonstrated that the eliciting capacity of the tax system was strong. This suggests that the government could rely basically on taxation and government allocation to finance development. (This is certainly in part what has happened in Brazil; as successful as the capital market program has been, its contribution to gross capital formation is relatively small, and the public sector has continued to expand.)

Nevertheless, the capital market program is essentially an effort to develop the private financial sector. Why might the government have wished to do this? Why didn't it use the revenues applied to 157, for example (assuming they would have been available) to expand the role of the government controlled National Development Bank? Why wasn't another attempt made to make something like FUNDECE work?

The first explanation is ideological. Both the first wave of military reformers who put the technocrats in power, and the economists who developed the policies shared a common belief in the efficiency of the free market system. While they believed in "planning," they said that planning should strengthen the price system, or cure defects in it, not substitute for it as an allocative mechanism.

More specifically, the architects of the capital market policy were concerned with what they perceived to be severe shortages of entrepreneurial skills in Brazil. They felt that the

^{84a} Presidência da República, *Metas e Bases Para a Ação de Governo* (September 1970).

associated traits of economic rationality, profit maximization, and willingness to take risks were essential to economic development but scarce in Brazil. The "agrarian reform in the corporation" program can be seen as an ill-conceived attempt to "legislate" these traits into being. The 157 system, on the other hand, can be seen as a way to conserve the scarce supply of such talent and maximize its impact on the economy by concentrating the small supply existing into financial institutions. Given adequate resources, these institutions could take the lead in developing new projects and sectors, rationalizing management techniques, etc. History has shown that financial institutions have played this developmental function; Patrick has labelled this role of financial intermediation "demand leading finance."⁸⁵ The investment banks armed with 157 Funds and staffed with bright young economists, would provide centers of economic rationality whose effects would radiate throughout the economy. To an extent, this has happened, as the architects of the capital market policy, such as Roberto Campos and Mario Simonsen, after leaving government service, have set up investment banks staffed by economists who were first trained in the Ministry of Planning and related offices.

But why should this "demand leading" finance be centered in the private sector? Partly, the explanation is again ideological. Partly, it seemed to be a response to real problems of government organization in Brazil. While the government instituted substantial administrative reforms, the Brazilian government bureaucracy remains extremely cumbersome and inefficient, and salaries are relatively low. Not only would it be difficult to recruit the cadre of "economic whiz kids" to government; once they were there, their impact would be blunted by the forces of inertia and tradition.⁸⁶ If, however, they were located outside the government in *newly created* private institutions, the planners believed they would be free to exercise their skills unhampered.

But why were tax revenues necessary to the scheme? If the whiz kids were so good, why couldn't they raise a large pool of voluntary savings? The explanation seems to be that experience had taught the government that the time costs of trying to create an effective debt-asset eliciting capacity were great. In part, there was "low level equilibrium-trap" problem: the barriers to developed finance were skills, attitudes, experiences and

⁸⁵ Patrick, "Financial Development and Economic Growth in Underdeveloped Countries" *Economic Development and Cultural Change*, Vol. XIV, No. 2, Jan. 1966, p. 174.
⁸⁶ See Campos, "A Retrospect Over Brazilian Development Plans" in Ellis, ed., *The Brazilian Economy*. Op. cit. note 3 supra.

institutions, yet the only way to overcome these barriers was to get the finance going.

The problem of law reform is illustrative. There were aspects of law reform that the government found either too difficult, too time consuming, or didn't understand. These reforms were important to develop the eliciting capacity of the debt-asset system. Yet without a group of sophisticated law reformers and time, these reforms could not be carried out. However, without a functioning financial system, it would be hard to develop the cadre of skilled men necessary to conduct the reform, identify the priority areas, draft effective statutes and man the courts, agencies, etc., all of which is needed to make the reforms "sociologically" effective. What was needed for law, (and other institutional aspects of finance) was a device that would be "law-leading" i.e. would help develop a self-sustaining process of skill development and law reform that would not require a large initial "supply" of law. The forced savings solution of 157 may have served this role. Not only did the system conserve scarce economic talent, it reduced the minimal supply of institutional support needed to get a process of growth started. It was law "conserving" as well as "law-leading."

Section 2—*The Results of the Program 1965–70*

In this final section, I will examine some of the few available indicators to determine in a very tentative fashion the results of the equities market part of the capital markets program.

A. A Word About The Secondary Market

One result of the policy has been an incredible boom in the secondary market; the program helped reverse a long period of depression in stock prices. One leading indicator, the SN index, shows a decline in the real average price of shares from 1963–1967; in 1968 however, this index rose 26.4% and in 1969 it soared 151% in real terms. The indexes continued to rise dramatically in 1970.

The growth of volume on the major exchanges in the nation is even more impressive. The rate of increase of the volume of trading on the Rio exchange is nothing short of stupendous. The following table shows that volume grew from an annual rate of NCR\$165.3 million in 1965 to an estimated NCR\$2800.0 million (US\$571 million) in 1970. Even when the nominal figures

are deflated, the growth is remarkable. A recent report shows that total trading volume on the Rio and São Paulo exchanges equalled 0.56 percent of GNP in 1965 and rose to 1.59 percent of GNP in 1969.

TABLE 1
Rio de Janeiro Stock Exchange
Volume in NCR\$ millions

	1965	1966	1967	1968	1969	1970*
1st Half	44.7	73.5	79.6	147.1	464.2	924.0
2nd Half	120.6	54.0	107.2	114.7	1183.2	1876.0
Total	165.3	127.6	186.8	261.8	1647.4	2800.0

* estimate

B. The Primary Market

All this trading activity would be of little importance if it did not serve to widen the primary market, i.e. the market for primary securities issued for cash by corporations. It is clear that this market has grown in the past five years. Unfortunately, it is much more difficult to measure growth in this market than to see the development of the secondary market.

The Brazilian government has not evaluated the program's impact, and does not maintain adequate indicators. Three series of available data, however, are of some help.

The first series to examine are the Central Bank figures on registration of new issues. Since all issues to the public and to 157 Funds must be registered, these statistics give some indication of the pace of primary market activity. Since they measure registration, not sale, however, they may well overstate the actual flow of funds.

TABLE 2
Cruzeiro Volume of Registered New Equity Issues
(Nominal figures — NCR\$ millions)

	1967	1968	1969	1970
157 Funds	54.7	114.5	283.2	105.4
Public Offer	*	263.2	143.1	341.7
TOTAL	(54.7)	377.7	426.3	447.2

* Registration requirements not in effect.

Source: Central Bank

The first conclusion to be drawn from these figures is the important role the 157 Funds have played in the market. During 1968-70, 40% of all registered issues were offered exclusively to these Funds. Assuming that all issues were subscribed, the Funds purchased NCR\$503.1 millions, or a little over one hundred million dollars at current exchange rates. In 1970, however, the importance of the Funds declined. This was due to a big jump in public offers and a sharp drop in 157 registrations. The increase in public offers indicates that the program has succeeded in increasing public demand for equities. The drop in 157 registrations is attributable to several factors. First, 157 receipts undoubtedly declined in 1970. This reflects the end of the tax credit for corporations. It is too soon to see if the 157 check system will provide substitute funds; this system only began in mid-1970. Secondly, the Funds were allowed to apply 2/3rds of their receipts in the secondary market in 1970; undoubtedly this diverted monies from the new issues area. It is still too soon to tell whether the 1970 performance indicates a temporary or permanent reduction in the role of the 157 mechanism.

A second conclusion to be drawn is that public offers are growing. The 1968 figures include several large and atypical transactions that really occurred outside the "market;" if these are taken into account the increase in public offers is even more dramatic.

However, if the two types of issues are taken together, results are less heartening. The figures given in nominal terms show a slight increase, but if we deflate them to take into account inflation of over 20%, we see that total issues in real terms declined substantially in 1970. Moreover, the economy was growing at about 9% in 1970, so that the relative importance of registered new issues in the economy declined even more dramatically.

This decline is due, of course, to the drop in 157 registrations. It may, therefore, indicate that any decision to abandon this system is premature. On the other hand, if the fast growth of public offers continues, 1970 may be the year in which the market was successfully "weaned" from the forced savings system.

Another salient aspect of the figures in Table 2 are their small absolute size. In 1970 total registrations were less than US\$100 millions, a very small amount in an economy with a GNP of US\$44 billions. However, there are other transactions which could be included in a definition of the "primary market." If these are included, the size of the market is larger and the growth trend clearer. Brazilian corporations raise large sums through sale to

existing shareholders; these transactions are not included in the registrations listed above. Table 3 shows the volume of such sales for major corporations, and demonstrates a clear upward trend. Table 4 is an index of cash subscriptions for *all* corporations, and confirms the increase in real terms.

TABLE 3
Subscriptions In Cash By Existing
Shareholders of Companies Listed
On the Rio de Janeiro Stock Exchange 1965-1970

Year	Total	% Change over previous years
1962	NCR\$ 81.856.161,00	—
1966	NCR\$ 42.700.920,00	- 47,8
1967	NCR\$ 465.724.135,00	+ 990,7
1968	NCR\$ 553.701.341,00	+ 18,9
1969	NCR\$ 1.176.010.964,00	+ 112,4
1970*	NCR\$ 888.255.787,00	—

Source: Organizacao S.N. LTA (Nominal Terms)

* First Half

TABLE 4
Index of Subscription of New
Shares in Cash — All Corporations

Year	Cash Subscribed
1960	71,5
1961	56,3
1962	84,4
1963	66,5
1964	54,3
1965	104,1
-966	110,8
1967	126,0
1968	163,3
1969	177,2

Source: BIB

Deflator — general price index

C. Growth of Financial Institutions

Another crude indicator of financial development is the growth of the number of financial institutions and the differentiation of these institutions. The following table shows that the number and type of institutions have expanded considerably; the exceptions are *financeiras* and commercial banks where government policies have encouraged consolidation:

TABLE 5
Financial Institutions Registered With The Central Bank¹

	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
1. Sociedades de crédito, Financiamento e Investimento — (Financeiras)	46	59	70	91	110	113	134	202	275	257	245	213
2. Sociedades de Investimentos	—	—	—	—	—	—	—	—	—	9	6	3
3. Investment Banks	—	—	—	—	—	—	—	—	\$7	21	21	29
4. Real Estate Credit Societies	—	—	—	—	—	—	—	—	\$2	22	25	34
5. Savings and Loan Associations	—	—	—	—	—	—	—	—	—	—	\$ 21	32
6. Sociedades Distribuidoras (stock distributors)	—	—	—	—	—	—	—	—	—	—	\$556	576
7. Broker-Dealers (corretoras)	—	—	—	—	—	—	—	—	—	\$254	377	394
8. Commercial Banks	399	385	359	349	344	335	336	331	313	261	231	213

¹ to 10/31. 69

[§] Beginning of operations or of mandatory registration

TABLE 6
Selected Financial And Real Indicators
(Percentage Change)

Year	GNP ^a	Industrial ^a Production	Average ^b Stock Price	Subscription in Cash	
				All ^c	Listed ^d
1966	5.1	11.7	-21.0	6.4	-47.8
1967	4.8	3.0	- 8.5	13.7	990.7
1968	8.4	13.1	26.4	29.6	18.9
1969	9.0	10.8	151.0	5.5	112.4

Sources: a. FGV

b. SN index deflated by general wholesale prices—FGV

c. BIB Boletim Economico

d. Organizacao SN Ltda (Nominal terms)

Overall evaluation

D. Overall evaluation

This study has tried to clarify the goals of the market program, identify and analyse key measures, and explore the role of law reform in the overall effort. As the foregoing discussion indicates, a rigorous evaluation of these efforts will require a much more detailed study. A number of general observations, however, can be made at this point.

Government policy has succeeded in increasing demand for corporate equities. The tax incentive program, other tax reform measures not analysed, and a general policy of monetary expansion and easy credit, have combined to overcome traditional reluctance to hold savings in the form of corporate securities. This shift in demand, plus growing corporate profits reflecting a real industrial boom, has driven up prices on the exchanges.

While savers have shown an increased desire for equities, corporate response has been slower and the new issue market does not reflect the euphoria of the exchanges. Although the primary market is growing, the pace of growth is slow in contrast with the boom in the secondary market and the absolute amounts are small. One reason for slow growth in new issues may be that the incentives to corporations to sell shares are not as dramatic as the incentives to buy. Moreover, the economic boom has undoubtedly led to rising corporate profits, which have permitted

substantial self-financing. The equities market provides only a small part of the total funds for industrial investment. While all the transactions we identified as "the primary market" added together comprised a flow of NCR\$1,610 millions in 1969, total gross capital formation by the private sector in the previous year (the last for which figures are available) was equal to NCR\$12,419 millions.

The economic boom that began in 1968 continued through 1970. The economy is growing at rates around 9% per annum, with industrial production rising even faster. While planned financial development certainly has not brought this boom about, the capital markets program has helped reverse earlier patterns of rapid growth with financial stagnation. More remains to be done, however, if the basic goals of the program are to be met.

Finally, the study has suggested how law reform (or the lack of it) affected the shape of the capital markets program. Law reform set the program in motion, contributed to a restructuring of the constraints governing economic decisions, and helped chart a map for institutional change. At the same time, "deficiencies" in the legal order which were overlooked by the planners or were beyond their control help explain some of the lags and delays the program encountered. Thus the study identifies at least qualitatively some salient aspects of the role of law in financial development. I hope in this way it helps future researchers who try to explore the complex relationship between law and the economy.



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Selected Economic Indicators

GNP % increase	Industrial production (base: 1949- 7=100)	Annual % change in indus- trial pro- duction	SN average of stock prices base: 1965- 1967=100	Volume ^a on Rio stock exchange (NCR\$ million)	Subscriptions of new shares in cash-all corps. (1960 values) (NCR\$ millions)	Wholesale price index: (domestic use) Base: 1965-7=100
1960- 9.7	261.4	—	16.9	—	71.5	6.9
1961-10.3	289.2	10.4	20.3	—	56.3	9.7
1962- 5.3	311.81	7.8	30.2	—	84.4	14.6
1963- 1.5	312.4	9	63.0	—	66.5	25.7
1964- 2.9	328.5	5.1	67.4	—	54.3	46.6
1965- 2.7	313.0	-4.5	82.7	165.3	104.1	71.6
1966- 5.1	349.6	11.7	99.6	127.6	110.8	101.0
1967- 4.8	360.0	3	118.0	186.8	126.0	128.0
*1968- 8.4	407.4	13.1	188.0	261.8	163.3	157.0
*1969- 9.0	451.2	10.8	508.0	1647.4	177.2	187.0

* Generally these figures are estimates.

Source: FGV (except as indicated)

1. Data from Banco de Investimento do Brasil, Boletim econômico