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DEPARTMENT OF STATE

AIRGRAM

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MAR 31 1967

FROM : Amembassy RIO DE JANEIRO

DATE: March 30, 1967

SUBJECT: Analysis of Brazil's 1967 Price Restraint Program

REF : Rio 5864 11-2466 E
Embassy's A-873 of March 30, 1967

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Summary and Conclusions

1. The price restraint program adopted for 1967, as promulgated by Decree-Laws 38 and 156 (November 18, 1966; February 10, 1967), constitutes a rather sharp departure from the substance of the programs adopted for 1965 and 1966. (For a discussion of the 1965 and 1966 programs see A-873 , pp9-13 .) The new legislation offers one reward, a 20 percent reduction in the basic income tax for 1967, and one penalty, a fine of 2 percent of gross revenues, for firms which hold their price increases within, or exceed, limits defined in terms relative to changes in the general price level. The incentives for 1967 are far less -- in number and in substance -- than those offered under previous programs. Another notable departure from prior schemes is that the application of rewards and penalties depends on the relationship of a firm's price increases to the increase in the general price level; there are no pre-determined absolute limits on price increases by individual firms, nor is there any requirement that price increases be justified and authorized by the price control agency.

2. Under the terms of the new legislation, firms which increase their (general weighted average) sales prices by no more than 70 percent of the increase in the general price level during the period from October 1, 1966 - December 31, 1967 will be eligible for a 20 percent reduction in the basic income tax rate applicable to their 1967 incomes (which is payable in 1968). Firms which increase their prices by more than

Attach.: Decree-Law 38 (Free Translation)

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Drafted by: FINATT: RCWilliams/tw

Contents and Classification Approved by: DESyvrud-FINATT

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110 percent of the increase in the general price level at any time during this 15-month period will be subject to a fine of 2 percent of gross income (sales) received during the period by which their prices are excessive under this definition. Several interesting possibilities arise from the fact that the reward is based on an end-to-end change in firms prices relative to the general price level, whereas the penalty is applicable at any point during the period; it thus is not inconceivable that a firm which was subjected to a fine early in the year might end up eligible for the tax reduction.

3. There is room for serious doubt as to whether the new legislation will make any significant contribution as a price restraint device; from the psychological point of view it may well be self-defeating. On the objective level, the usefulness of the 1967 scheme would appear to be severely restricted because the incentives offer insufficient stimulus to firms to hold price increases below amounts which, taking all other factors into account, would be profitable. From the subjective viewpoint, the program does not appear to be one which makes any contribution to the reversal of inflationary expectations, and to some extent may have quite the opposite effect. The linking of rewards and penalties to a relationship between a firm's price increases and the movement in the general price index is not dissimilar to the application of "monetary correction" factor. This aspect of the scheme reinforces the tendency of firms to speculate on the future rate of inflation in making their own pricing decisions. If the system does not dissuade firms from speculative price increases at the outset it becomes even less effective, since this will bring pressure on the general price level, to which the incentives themselves are directly tied.

Discussion

4. The outline of Decree-Law 38, as regulated by Decree-Law 157, is as follows: All commercial and/or industrial firms which are subject to the (federal) tax on industrial products and/or the (state) circulation tax, and whose registered capital exceeds NCr$40 thousand (Cr$40 million) or whose annual gross receipts exceed NCr$200 thousand (Cr$200 million) are required to maintain a record of the prices of commodities sold in the domestic market for a 15-month period beginning October 1, 1966. Firms which increase the general weighted average of their sales prices by no more than 70 percent as much as the increase in the general price index over the 15-month period will be eligible for a 20 percent reduction in the basic income tax rate applicable to 1967 incomes (payable in 1968). Firms which increase their sales prices by more than 110 percent of the increase in the general price level during any time during the 15-month period will be subjected to a fine equal to 2 percent of gross income received during the period its prices are excessive, as defined herein.

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