



Why doesn't Brazil grow?

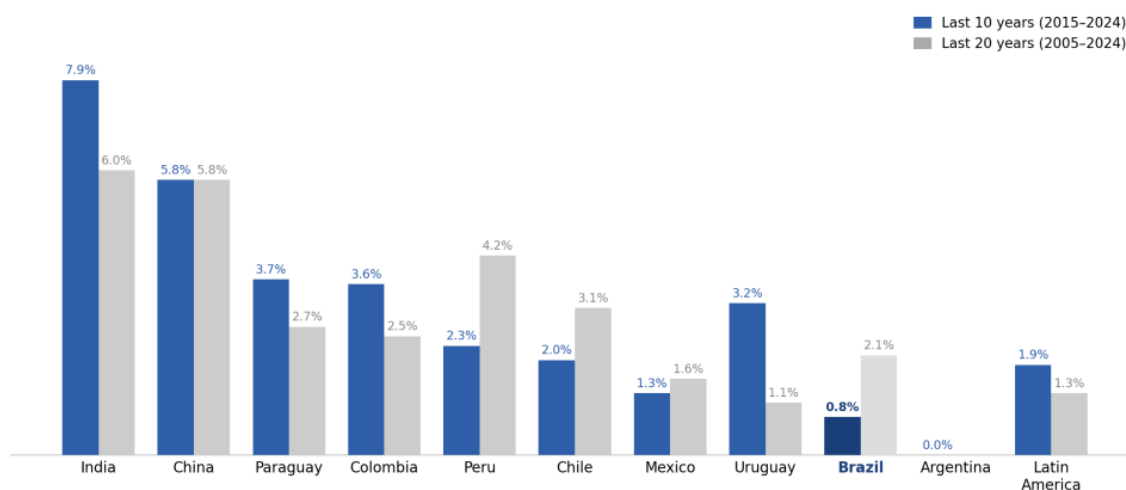
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Dear Investors,

In our last letter, we discussed ten crises Brazil has faced since the Plano Real and how the stock market behaved during each of them. The conclusion of that review echoes what we have learned over 12 years of investing here: Brazil is a good place to make money in equities not because of the strength of the national economy, but because stock price volatility is greater than that of our economy and generates excellent investment opportunities.

We cannot complain about the returns we have achieved in this context, but we nonetheless share the frustration felt by most Brazilians — a persistent sense of squandered potential. Why does a continental nation, rich in natural resources and free from major geopolitical problems, fail to develop? The comparison with other emerging countries reveals how much we are falling behind, especially over the last decade.

Average GDP Growth



Source: World Data Bank

The direct causes are well known. We have a deep education problem. Brazilian productivity has stagnated for decades. We live through near-constant political crises. But what are the root causes of these ailments? Why have other countries been able to

solve these problems and we have not? Without claiming to offer definitive answers, we will share our view.

The Education Problem

The most superficial discussions about education in Brazil blame a lack of resources. More sophisticated ones pay greater attention to teaching methods, institutional governance, and international best practices. It is rare to hear anything beyond this, but we believe there is a third layer — one closer to the heart of the matter and related to Brazilian culture.

Saint-Exupéry wrote: “If you want to build a ship, don’t drum up people together to collect wood and don’t assign them tasks and work, but rather teach them to long for the endless immensity of the sea.” Human performance depends first on motivation, then on method. An operation with well-designed rules and processes but disengaged people will rarely be more than an inefficient bureaucracy. The first step toward quality education is to genuinely value and desire knowledge. This seems obvious, but it is not what we observe in our country.

The average Brazilian wants the degree, understanding it is necessary to apply for certain positions, but cares less about the real knowledge the degree is supposed to certify. A widely known fact corroborates this: the majority of Brazilian students cheat on exams — the famous cola — so widespread it is no longer even morally condemned. The blame does not rest solely with students. In part, the contempt for academic activity stems from the low correlation many curricula have with real life. Students do not see how classes will help them succeed, interpret them as a waste of time, and end up developing a general prejudice against study. In part, it comes from a world in which a 15-year-old influencer suddenly explodes on social media and begins earning multiples of what a doctor, lawyer, or engineer with decades of experience makes — making it seem as though following traditional careers is a lack of cleverness. There is no simple solution, but at least two points could be improved in our culture.

The first is to abandon the immature ambitions of easy, fast success that seem to have become the modern standard. It is true that there are successful 15-year-old influencers, but the average income of all aspiring 15-year-old influencers is certainly far below that of doctors, lawyers, and engineers. Just as playing the lottery every week is a poor plan for getting rich, career strategies based on extreme exceptions tend to go wrong. Mature ambition is the “American Dream”: the conviction that anyone can succeed in life through determination, hard work, and initiative. Studying and training until one becomes skilled at something useful remains a wise plan.

The second is to re-establish the understanding that knowledge has practical utility and is therefore immensely valuable. Humanity does not seek knowledge out of bureaucratic obligation or academic pomp, but driven by problems and ambitions of epic proportions. Those responsible for the great intellectual advances are the true heroes of the human race. Everyone has heard of Aristotle, Isaac Newton, and Albert Einstein. Aristotle lived ~2,400 years ago. The celebrity of the moment, who today receives more popular admiration, will hardly be equally remembered 24 years from now. Intellectual splendor is one of the highest ambitions within human possibility.

How to change this is the great question. There appear to be no tricks or shortcuts available. A nation's culture is spread by public figures and those in positions of power in society. China's Jack Ma, founder of Alibaba, goes to great lengths to cultivate his image as that of a teacher and is called Ma Laoshi (Teacher Ma). The case illustrates well the cultural chasm between China and Brazil, which we believe contributes to their respective levels of economic success. If our elites devote more effort to cultivating erudition, the tendency is for the rest of the population to follow.

The Efficiency Problem

Productivity stagnation is a different problem. Increasing economic efficiency is a clear and perpetual objective in the business world, so the cause is not a lack of motivation. All indications point to a significant portion of the problem stemming from dysfunctional rules in Brazilian society: the tax system, the judiciary, and multiple interventions in the economy. However, the theoretical solutions to these problems are reasonably well known. The OECD, the international organization that seeks to improve economic and social well-being worldwide, has conducted dozens of studies and publishes detailed reports with a range of public management best practices. Even so, many of these suggestions are not implemented here. The reason for this seems to lie in the prisoner's dilemma trap manifesting on a national scale.

In the classic dilemma, two accomplices in a crime are arrested and pressured to confess. If both stay silent, they face 1 year in prison. If one confesses and the other does not, the one who confessed goes free and the other is imprisoned for 10 years. If both confess, they each face 5 years. The theoretically best solution would be to cooperate and face 1 year, but, driven by fear of ending up the worse off, both end up confessing and face 5 years. The rules of Brazilian society are determined under a similar dynamic.

Taking Brazil's fiscal problem as an example, the best way out would simply be to cut spending — what one does at home or in business when income is insufficient to cover expenses. The government clearly knows this and understands the alternative perfectly. It does not follow this path because it is not what society actually demands. In speeches, the majority may even advocate for spending cuts. In practice, the majority pressures the government to obtain advantages for themselves, which directly imply public spending. The average citizen wants social benefits and income tax exemptions. The business owner wants differentiated tax rates for their sector and various subsidies. Together, these interest group pressures inflate public spending, distort the rules, and create a dysfunctional tangle. The main consequence is the misallocation of capital in the country.

The free market principle holds that the economic system is too complex to be centrally controlled, and that it is therefore more efficient to allow the free fluctuation of prices — formed by the balance of supply and demand — to generate the incentives needed to optimize the functioning of economic activities in general. Companies that efficiently deliver products or services valued by society, relative to their competitors, will be profitable and will thrive. Inefficient ones will be doomed to failure. This dynamic is what should guide the best use of the country's available resources so as to produce the maximum of what society desires. When the government legislates different rules for

each sector, this principle of market self-regulation ceases to apply. With subsidized financing and differentiated tax rates, inefficient companies can survive and grow more than efficient businesses that receive no government favors — and there goes the long-sought increase in national productivity.

This issue will not be resolved through the initiative of private entities, since no one has an incentive to give up lobbying first, there is no coordination among all parties to negotiate an agreement in which equal rules are adopted simultaneously, and the path to implementation necessarily runs through Congress. The government itself must lead the reforms, and the role of the private sector is to fairly evaluate what is proposed and to push for equal treatment — not for special benefits.

We had the opportunity to improve significantly in the recent tax reform, but took a more timid step than intended. As far as we can tell, not because of the politicians' fault. The original proposal was excellent, but it was deformed by pressure from multiple groups, and the enacted law came with a series of special regimes, differentiated conditions, and the like. The analogy with the prisoner's dilemma is clear: by acting individualistically, all sectors will end up subject to a worse set of rules and will have their long-term growth potential compromised by the poor performance of the national economy. For a way out to exist, good collective will from both the public and private sectors is required.

The Political Problem

Here we elect both the president and senators and deputies, linked to one of 29 parties, by direct vote. This political arrangement, known as presidentialism with fragmented multipartyism, is less common than we might imagine. Countries with similar regimes are concentrated in Latin America and Africa, and even within this group Brazil is an extreme case of party fragmentation. There is no developed country that adopts the same system.

It is as if we had a huge company where all the executives are constantly fighting each other. Governing is already difficult by nature, and this structural misalignment among the politicians involved in government makes the situation even more complicated. With so many active parties, the president's party rarely holds a majority in Congress, and it is necessary to strike deals with other parties to form a coalition and manage to govern. Even so, there are frequent impasses between the Executive and Legislative branches, and any proposals for major changes end up being diluted during negotiations for approval of measures in Congress. For better or for worse, changes in Brazil are slow and gradual.

Meanwhile, most developed countries are parliamentary, a political system in which the head of the Executive branch — the Prime Minister — is indirectly elected by members of Parliament (the equivalent of Congress in presidential systems). Alignment between branches is guaranteed, since Parliament can call at any time for a vote to recount the number of votes for or against the current Prime Minister. If a majority votes against, the Prime Minister steps down and Parliament elects a new one, or Parliament is dissolved and new elections are called to form a new Parliament. In other words, one of the two branches is replaced and alignment is restored.

An alternative is two-party presidentialism, of which the United States is the best example. The existence of only two predominant parties simplifies the governability

question. Either the president has a majority in Congress and implements their own party's plans, or they do not and are forced to negotiate with the other party. Alignment between branches is not guaranteed, but negotiating with just one opposition entity is far simpler than multilateral negotiations. There is also semi-presidentialism, a hybrid system in which a President and a Prime Minister share Executive power. France, Portugal, and some other countries are semi-presidential.

Changing Brazil's political system is far from simple. The reform would likely require a Constituent Assembly to draft a new constitution — a process that opens Pandora's box and may be better deferred until the population has somewhat greater political maturity. In any case, "a journey of a thousand miles begins with a single step," and it seems appropriate to start by openly discussing the existence of this structural problem.

The Rise of Populism

This is not an exclusively Brazilian problem. The entire world has been experiencing a new populist wave, driven by the immediacy characteristic of modernity combined with the communication style of social media. The quality of public debate has always had room for improvement, but it is clearly deteriorating. Electoral contests have become "meme wars," in which digital content rapidly reaches millions of views and shapes public opinion.

The issue is delicate because the problem does not lie in the communication style itself. Symbolic elements have always been part of political contests and sometimes synthesize legitimate messages that many people lack the eloquence to express clearly. The problem is that this viral communication is used as a tool to amplify populist rhetoric, which always spreads faster than its cure: raising the educational level of the population.

It is as if we wanted to elect a school principal by student vote, and while one candidate tries to convince them that extending study hours and maintaining rigor is best for them in the long run, another simply distributes stickers reading "More vacation, fewer exams! Students deserve respect!"

Despite the problem, we do not believe that any attempt to control communication is appropriate. Freedom of speech is a fundamental pillar of democracy for good reasons, and abandoning it can lead to worse problems. The fact that the world has oscillated between populism and austerity for millennia indicates there is no definitive solution. The return to austerity comes when populist measures go wrong and the people are forced to understand certain realities through the practical imposition of circumstances. What we can do is try to spread a minimum level of political awareness and be careful not to support initiatives that turn into populist traps for all parties. One such trap is the broad distribution of welfare benefits that we have in Brazil.

Today, 12 of Brazil's 26 states have more Bolsa Família recipients than formal workers — a result of actions from both sides of our political spectrum. It has become common for workers who no longer want formal employment, as they earn more working informally and underreporting income to receive state benefits. The arrangement is harmful on multiple levels. It reduces the availability of labor for Brazilian industry and diverts people's productive time toward less productive informal activities, which only work economically when the state collects money from the formally employed population

— since informal workers pay no taxes — and redistributes it to the unemployed or underemployed. In parallel, it instills in the popular imagination the notion that it is advantageous to conceal income, collect benefits, and work in flexible arrangements. Instead of encouraging a work ethic of dedication and regular employment within a productive economic framework (i.e., companies), we are incentivizing low-productivity independent micro-initiatives and the practice of fraud against the federal government.

This is not an easy trap to dismantle. The party that speaks out against it will be doomed to lose elections. There is a risk that we will still see benefits being expanded during election cycles, in populist campaign bidding wars. The most likely way out is to wait for the real value of benefits to be eroded by inflation, or for some external crisis to serve as justification for faster corrections.

Is There Hope?

Singapore proclaimed its independence in 1965 after being expelled from Malaysia in a political maneuver designed to destroy the dominant party in Singapore and subsequently reclaim the city-state under total submission. The small country of ~2 million people had a GDP per capita of ~\$500, a population divided among 3 main ethnic groups in conflict with one another, speaking more than 10 different languages, with ~35% of people illiterate. Today, Singapore's GDP per capita is \$85,000, and the country leads the international education ranking (PISA 2022) in all three categories: mathematics, reading, and science.

Deng Xiaoping took power in China in 1978 (not officially — but we will save that story for another occasion). At the time, China's GDP per capita was ~\$200, ~35% of the population was illiterate, the country's education had been devastated by Mao Zedong's Cultural Revolution, and the economy was the result of the period the Chinese call the "Century of Humiliation." Today, China's GDP per capita is ~\$13,700, even with its 1.4 billion inhabitants. Mainland China does not participate in the international education ranking, but Macau, Taiwan, and Hong Kong rank 2nd, 3rd, and 4th — behind only Singapore.

One small example and one gigantic one — both countries whose starting point was far worse than Brazil's current situation. It is therefore perfectly possible to transform Brazil into a developed nation. We even have the impression that the country has been improving over recent decades, albeit slowly. Accelerating this process would require greater contribution from our intellectual, economic, and political elites — the people best positioned to lead significant movements. On this point, we will leave a provocation.

It is common to hear bitter criticism and comments made with contempt for our own country. The vast majority believes they bear no responsibility for Brazil's condition. Many have an escape plan to go abroad should Brazil fail to improve, in their view. In a sense, this is a democratic ailment. Each citizen is so small before the State that they end up alienated from public affairs and come to see every ill as someone else's fault. But it is worth recalling: "Ask not what your country can do for you — ask what you can do for your country." Collective transformations come from collective efforts. Each person contributes their seemingly irrelevant effort, and the sum of all initiatives reaches enormous proportions. We need to replace the dream of moving abroad with the dream of improving Brazil.