Oil and Gas in Federal Systems – The Case of Brazil

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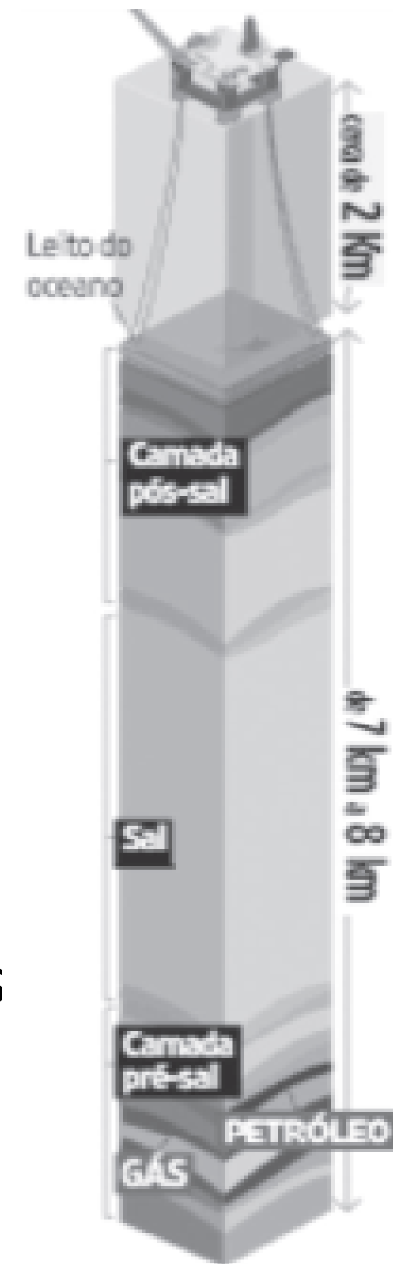
INTRODUCTION

- Recent oil discoveries in the off-shore geological stratum known as pre-salt may convert Brazil in one of the biggest oil producing countries (OPC’s)
- Current oil reserves = 14 billion barrels (95% off-shore)
- New oil reserves = 60-80 billion barrels (estimates)



INTRODUCTION

- This potential wealth has stirred up an intense debate about two kind of questions:

1. What regulatory and fiscal regime is more adequate to this new era?
   - Concessions or Producing-Sharing Arrangements?
   - What type and level of taxes/royalties?
2. How must this rent be shared with sub-national governments?
   - The federative conflict (our focus)

ROYALTIES AND FEDERATIVE CONFLICT

- The discoveries of pre-salt has intensified the conflict for the oil revenues among the 27 federal entities.
- Brazilian Constitution (1988) says that oil reserves belong to the Union, but grants to "producing" (and bordering) states and municipalities the right to receive a financial compensation (royalties), according to rules established in specific legislation.
- No-producing states also claim a bigger share of the revenues because production is off-shore, in which case the concept of "producing" has no sense.

FEDERALISM AND TAX SYSTEM

- Brazil is a federation of 27 states and 5.563 municipalities with full autonomy.
- Each level of government has its constitutional competence to tax, for example:

⇒Union: incomes, profits, production, exports, imports, payroll (social security) and natural resources (oil, hydro and minerals)

⇒States: Motorcar ownership and sales excise services (with a VAT-Value Added Tax)

⇒Municipalities: services and real state

TAX STRUCTURE

- There is a system of revenue sharing and grants

⇒Income taxes are shared in the following way: 52% for Union, 21,5% for states and 23,5% for municipalities (based on a population/income index).

⇒Royalties are also shared with states/municipalities

⇒Social contributions (including on oil profits) are strictly linked to the federal system of social security.

⇒VAT is shared between each state (75%) and its municipalities (25%).

TAX STRUCTURE

- Tax burden, including royalties, is about 36% of GDP (oil revenue is a little part of this: 1,3% of GDP).
- Union levies 70% of this amount, but transfers 17% to states and municipalities.

Tax sharing, before and after transferences (% total):

Level of Government	Before	After
Union	70,2%	53,5%
States	24,8%	27,0%
Municipalities	4,9%	19,5%

OIL TAX STRUCTURE

- The current tax structure of oil production (concessions) can be split in two main blocks:

Special taxes

⇒Royalties: 10% over gross value of production

⇒Special Participation Fee (SPF): medium aliquot of 20% over gross value of production minus cost

Corporate income taxes (CIT)

⇒Charged over net profits, with the same rates for oil and non-oil companies, but split in one traditional tax (25% aliquot) and a social contribution (9%).

OIL REVENUE SHARING

- The central government levies all these taxes, but transfers 45% to states and municipalities.

Revenues (2008)	US$ million	% GDP
Royalties	5.964	0,36
Union	1.667	0,10
States/Municipalities	4.297	0,26
Special Participation	6.386	0,39
Union	3.193	0,19
States/Municipalities	3.193	0,19
Corporate Income Taxes	6.374	0,39
Union	4.124	0,25
States/Municipalities	2.249	0,14
Others fees/dividends (Union)	2.935	0,18
Total	21.659	1,32
Union	11.919	0,73
States/Municipalities	9.740	0,59
Share of Union	55%	
Share of States/Municipalities	45%	

OIL REVENUE SHARING

- Each of these revenues follows a different sharing rule, depending on if production is on or off-shore in the case of common royalties.

Off-shore sharing rules

Type of tax on oil rent	Royalties	Special Participation	CIT (Income Tax)	CIT (Social Contribution)
Union	30,0%	50%	55%	100%
States	24,3%	40%	21,5%	
Bordering	26,3%	40%		
Redistribution to municipalities	-3,8%			
All states (entitlement fund)	1,8%		21,5%	
Municipalities	45,8%	10%	23,5%	
Bordering and producing zone (PZ)	21,8%	10%		
PZ Neighbourhood	4,5%			
Afected by desembarkation of oil	8,8%			
Of bordering states (through VAT)	3,8%			
All municipalities (entitlement fund)	7,0%		23,5%	

HISTORICAL CONTEXT

- The current model of oil revenue sharing reflects a broader process of fiscal decentralization that marked the transition from military dictatorship to democracy in the 1980s.
- In the 1960s, when the first discoveries off-shore occurred, those royalties belonged to the Union only.
- In 1985, royalties off-shore were extended to states and municipalities after years of political bargaining, but at that moment oil revenues were much smaller than today.
- The main changes in tax structure and sharing rules were established by Petroleum Law (1997), the same that has abolished the state monopoly and created the concession regime.

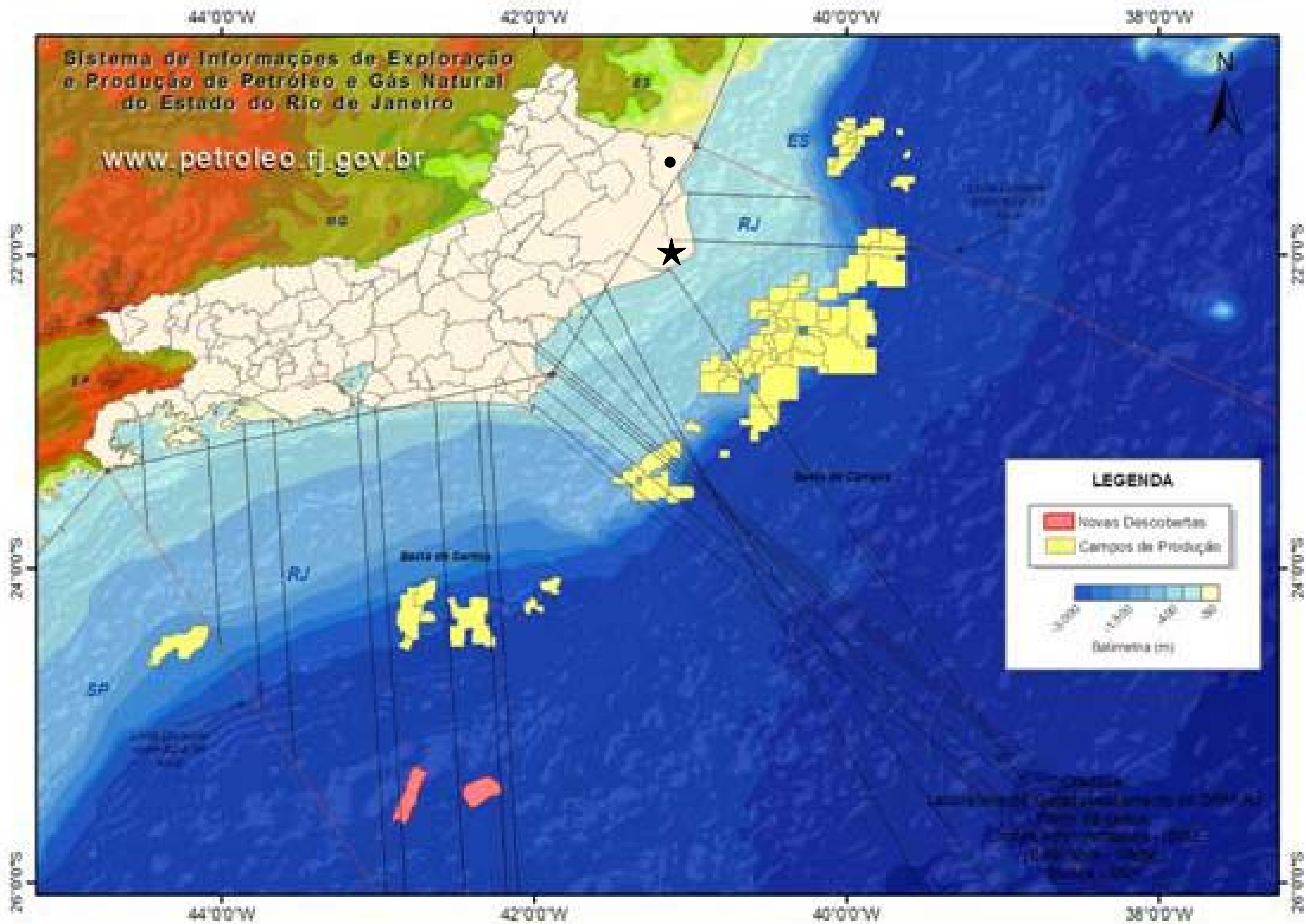
INEQUALITY DISTRIBUTION

- The changes in legislation deepened the tendency to unequal sharing among states and municipalities.
- Rio de Janeiro concentrates 80% of oil production and 75% of royalties and special participation.
- Only 10 municipalities concentrate more than 50% of municipal royalties.
- One single municipality (Campos) receives 20% – about US$ 650 million of royalties, while its tax revenue is US$ 70 million and its payroll expenditure is US$ 300 million.

WHAT EXPLAINS THIS?

- What explains such model if 95% of oil production is off-shore?
- The rules of oil revenue sharing were built on a key concept of “bordering”, based on orthogonal and parallel projections on continental platform.
- There are other criteria of distribution, but the “bordering area” is the main one, which explains the huge share of Rio de Janeiro and of a small group of municipalities.

WHAT EXPLAINS THIS?



FIRST CONCLUSIONS

- Royalties do not work as a compensation for future generations or for social and economics impacts, but rather as a gift for geographical luck!
- If one changes the geographical criterion, luck may change of hands, but doesn't solve the problem: the lack of economical rationality and of equity between generations and federal entities.
- Moreover, states and municipalities are not prepared to deal with oil price volatility and the paradox of abundance: empirical evidences of "royalties disease".

NEW CHALLENGES

- Pre-salt discoveries pose tremendous macroeconomic and federal challenges:

$\Rightarrow$ Appreciation of exchange rate and Dutch disease

$\Rightarrow$ Macroeconomic vulnerability due to oil prices volatility

$\Rightarrow$ Risks of unsustainable fiscal trajectories

$\Rightarrow$ Increasing of regional disparities, since the new oil frontier is also concentrated in the “bordering area” of Rio, São Paulo and Espírito Santo, which make up Brazil’s most developed region

LAST CONCLUSIONS

- The model of oil revenue sharing must be changed and adapted to new challenges posed by pre-salt.
  - The bordering states may enjoy special access to oil revenues but not on the basis of current rules, for oil wealth belongs to all Brazilian people.
  - The institutional and fiscal arrangement must induce states and municipalities to invest their oil rent in benefit of present and future generations.

THANK YOU!

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