

The difficult task of managing oil revenues

Solange Monteiro, *Rio de Janeiro*

SINCE 2007, WHEN THE DEEP SEA OIL reserves were discovered, a whirl of figures has invaded the minds of policy makers and corporate executives. After six years, the numbers are settling, with daily production estimated at about 311,000 barrels, and the first round of bidding for oil blocks is scheduled for October. Maria das Graças Foster, CEO of state-owned Petrobras, estimates that by 2020 deep sea oil will be responsible for half of Brazilian oil production, which is currently about 800 million barrels a year. Some people venture to predict that the reserves are as much as 100 billion barrels, compared to 15.7 billion of proven reserves today. That would make Brazil on of the top five global producers.

Even if the best estimates are confirmed, the country is far from becoming a petroleum economy like Venezuela or Middle East. Currently, the share of oil in GDP is only about 1%. Still, the fact is that oil revenue will grow significantly, and waiting until the oil is actually flowing to start the debate on how to manage the revenues is not the best choice, according to participants in a roundtable on Brazil's Tax Risks in the Medium and Long Term.

The discussions on distribution of royalties to states and municipalities are focused on spending oil revenues, with little concern about whether they will be used efficiently or saved. Samuel Pessôa, IBRE consultant, points out that so far there are no measures to mitigate Dutch disease—the economic distortion caused by an excess of

exports, which generates serious exchange rate appreciation and causes a country's industry to lose international competitiveness.

Choosing a model

The main factors leading natural resources–rich economies to establish specific management systems for these revenues are that such resources are limited and their prices are therefore volatile. "In such cases, the budget framework has to be associated with appropriate management of public spending to ensure long-term solvency. If the country greatly increases its current spending in accordance with revenues [resulting from exploration of natural resources], then it might not be able to pay for increased spending in the future," IMF economist Alex Segura-Ubiergo said. Country experiences vary considerably. "To reduce volatility, Russia, for example, does not use the current price of oil in calculating revenues for its public budget but takes an average of the last five years," Segura-Ubiergo said. Another example, Chile, has been dependent on its earnings from copper exports; since 2001 it has replaced the concept of a budget surplus with a structural budget balance based on potential GDP growth and trends in tax revenues.

To these measures it can be added, for example, a rule that limits the growth of public spending so that it does not generate demand that is incompatible with economic stability, which would push up inflation. As an example of a sustainable fiscal strategy, Segura-Ubiergo cites the Norwegian model, in which all revenues and financial resources are saved in a separate fund, and the government spends only the return on investment of the fund, generating a permanent income. "This model is less flexible, but good for developed countries," Segura-Ubiergo said. He pointed out, however, that in countries like Brazil, investing oil revenues in infrastructure could bring a higher rate of return than investing it in financial assets as the Norwegian model does. In any case, he said, "What is especially important is to make sure that these natural resources funds are not able to spend autonomously."

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According to Sergio Gobetti, an economist with the Secretary of Economic Policy of the Ministry of Finance, besides saving oil revenues for future generations or investing them, the country could also use oil revenues to pay down public debt. "In theory, the idea of the permanent income model [for managing natural resources] is the most appropriate, because it allows for more balanced treatment of [the distribution of benefits to] intertemporal generations. But the profitability of accumulating any assets in Brazil is lower than the opportunity cost of rolling our public debt," he added.

Gobetti thinks that using oil revenues to narrow the public deficit could increase fiscal space, which could be used both to raise public investment and reduce the tax burden.

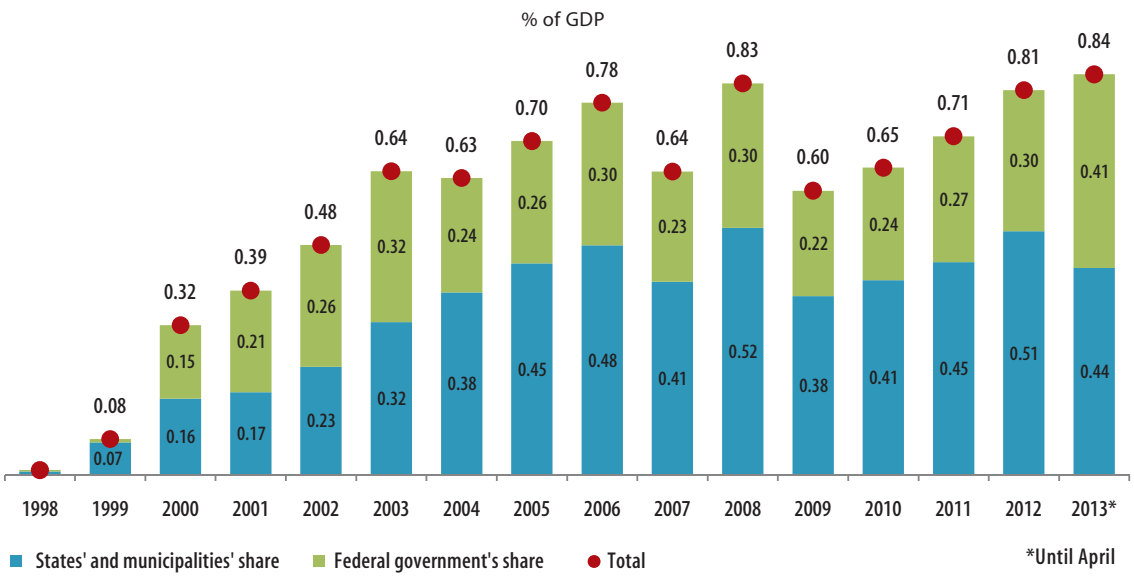
IBRE's Pessôa encourages the idea of accumulating part of oil revenues in a fund. "We could invest part of the return on the fund in education," he said. "But I think the ideal would be spending part of this oil revenue on imports to renew Brazil's infrastructure." Lia Valls Pereira, coordinator of IBRE's International Economics Studies, believes that greater openness would avoid negative economic effects. "A good result will depend on the efficiency of public administration, investments that are long lasting and open the economy to import inputs," she said.

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>
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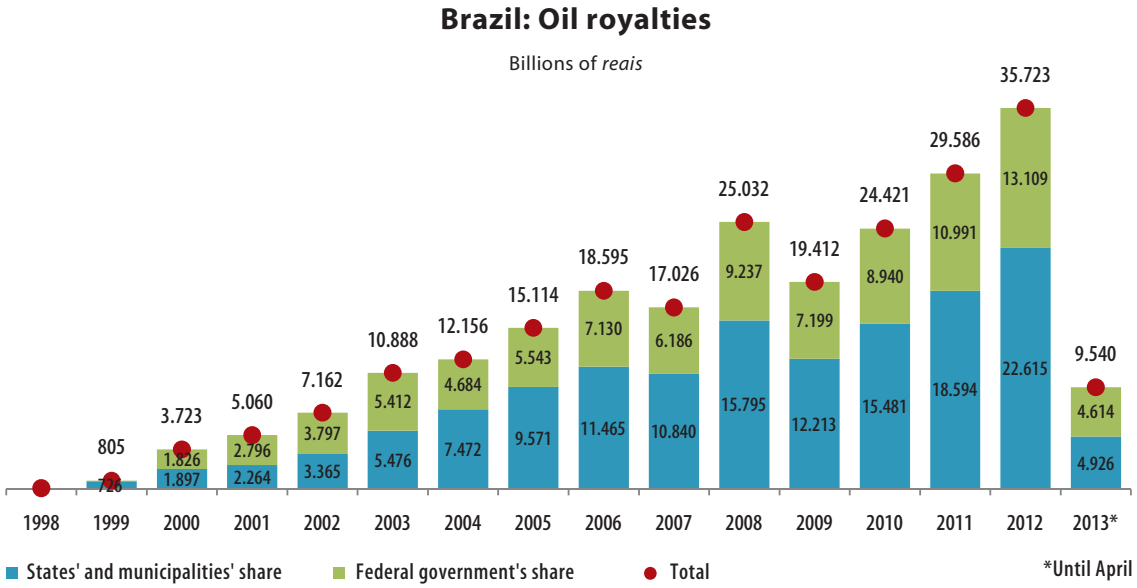
Avoiding repeating mistakes

Roundtable participants agreed on the need to intensify the debate to ensure that the oil revenues resulting from deep sea oil exploration provide tangible benefits to society. It is best to avoid the temptation to increase spending without planning, and also to limit discretionary spending. "The Brazilian Sovereign Fund [created in 2008], for example, is not a sovereign wealth fund. It is simply an instrument for managing fiscal policy,"

Brazil: Oil royalties



Source: IBRE/FGV.



Fonte: FGV/IBRE.

Pessôa said, and so it should not serve as an example for managing oil revenues. "Sovereign wealth funds … allow for better management of public revenue when a substantial part comes from highly volatile sources," Pessôa explained. In the case of Brazil, the government saves little and has accumulated considerable international reserves. Instead of saving more, however, the government has used the fund's resources to purchase shares of state-owned companies and in 2012 to meet the budget surplus target.



Without planning and a focus on management, roundtable participants pointed out, revenues from deep sea oil exploration will hardly become the ticket to development, as they are being sold today. "Just look at the history of municipalities that have benefitted from oil royalties," says IBRE researcher Joana Monteiro, Between 1997 and 2010 royalty revenues of municipalities in Rio de Janeiro state grew 34-fold, reaching R$3.3 billion—but, she says, "there is no evidence that royalty revenues have brought improvements in the provision of education, health, and infrastructure compared to cities which did not benefit from such royalties." For every royalty dollar received, the municipalities spent 67 cents on current expenditure and only 24 cents on investment.