

Pre-Salt, Federalism and Risk-Return

Recently, we have seen a number of relevant events related to oil, world's main source of energy. More specifically, we saw a huge economic expansion in China, fueling demand for commodities, which combined with the tight supply of fuel oil and the inherent political instability in producing countries multiplied the price of crude oil 6 times in less than 10 years. Despite the significant fall after the crisis, oil is still trading at prices 3 times higher than the past decade.

Amid a favorable global scenario for commodity producers, Brazil has discovered huge oil reserves off the coast of her southeastern region. This is good news for Brazil and the world. After all, a larger supply of energy means lower world prices of fuel oil and larger availability of foreign currency for Brazil. All very simple so far, the complexity comes out because Brazil is not a single entity, but a federal entity with multiple interests, where public and private sector, federal and sub national actors have different plans for how the newfound wealth should be distributed.

The aim of this essay is to organize ideas of a debate that is taking shape in Brazil, free from passions so that the reader can form his own educated opinion. To do this, we follow the economic literature and use as a starting point the global optimum, or the first best, i.e., the strategy that maximizes wealth production, leaving wealth distribution for later thought. From this point of view, the issue of pre-salt is reduced to: How can we get all those mineral resources out the ground as fast as possible? The answer to this question has to do certainly with involving the largest number of actors possible, including private domestic and foreign capital.

The optimal strategy becomes less simple, when one notices that taking all oil off the ground too fast could lead to flooding the oil market, lowering prices and

reducing the amount of foreign currency Brazil can obtain through time. We are talking about the distribution of wealth between Brazil and the world. Spain led the world to a revolution of prices when the silver of Potosi came about. It was so much silver that prices of goods soared in terms of the precious metal. If the silver had been extracted at a slower pace, the value of mineral extracted would have been maximized over time. Therefore, considering that oil should be the main source of energy in the world for decades to come, it is not obvious to Brazil that it is in her best interest to extract all at once.

If Brazil is not in such a hurry, it means that Brazil does not need to mobilize all resources it can and pour it all into drilling right now. Given that the Federative Republic of Brazil is in a reasonable macroeconomic position and that the central government is capable of raising funds in the international markets through debt issuance, a distributive conflict arises between the public and private sector. That is, there is a business that is probably very profitable that comprises using resources today to produce oil tomorrow. Given that the Federal Constitution clearly states in Article 20 that mineral resources including all underground resources are property of the Union, why shall the Brazilian government divide these potential profits with others?

Several potential answers emerge: (i) Because the government should provide a range of public goods and refrain from taking risks, after all it is the taxpayer who would have to foot the bill 10 years from now if oil prices return to \$ 20 per barrel. The question then becomes: Does the taxpayer want to play that risk-return game? (ii) Another answer would be because the management costs of extraction exceed the costs of outsourcing for a quasi state owned enterprise. Indeed, the first answer suggested is a fact, while the second it is only a conjecture. After all, Petrobras was able to develop a unique technology for deepwater drilling, partially contradicting the managerial challenge of a mixed capital company.

If the Brazilian central government decides it is in her best interest to play the

game of risk and return, rules of the game will change leading to the last distributive conflict that we will point out today: the conflict between the federal government, states and municipalities. This conflict is a complex issue because it involves a web of political, legal and economic questions. Here we present the main points of the issue.

From the economic point of view, one should try to avoid the natural resources curse, where rent extraction becomes so important that all available means of production in the economy are channeled to it at the expense of everything else, with severe losses for the locality after the mineral exhaustion. Simply put: Why promote commerce in a municipality, if the oil income is 100 times what can be earned from this promotion in the short run? In sum, from this point of view, it makes sense to distribute the resources obtained from the exploitation of mineral resources to a great extent within the country.

From the legal point of view, the logic is less straightforward, but it certainly points in the opposite direction. In other words, it is the mission of all federal entities in accordance with Article 23 of the Constitution to record, monitor and supervise concessions of rights to exploit mineral resources. It is therefore important that each federal entity is paid for its regulatory activity, since non-payment would breed incentives for inefficiency and red tape. In addition, the first paragraph of Article 20 of the treaty says that the country requires that all federal entities involved in the exploration be contemplated with payouts.

The political perspective suggests that constitutional rules are at risk, to the extent that current legislation contemplates only the sub national entities that produce oil, which are a minority in Congress. In fact, we are talking about a colossal amount of resources to be distributed through the federation. In my opinion, this is the first real challenge to the Brazilian federal pact since the end of the Estado Novo, which took place after the 1929 crisis.

In summary, the extraction of mineral resources such as oil in the pre-salt layer is characterized by distributive conflicts between Brazil x Rest of the world, private sector public sector, Central government x Sub national entities. The optimal course to be taken depends obviously on which side of the conflict each one is. Mismanaging these conflicts of interests puts the Brazilian Federation at risk. Overcoming the federalism issue is a remarkable footstep to be achieved in the Brazilian development path.

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