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Oil Royalties In Brazil: Between Financial Compensation And Taxation – A Legal And Economic Analysis

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Abstract:
This article examines the use and distribution of oil royalties in Brazil, which shifted from being treated as financial compensation to taxation following the enactment of laws by the National Congress. This change in the treatment of royalties can be explained by public choice theory, which suggests that the actions of parliamentarians reflect the interests of pressure groups. Consequently, the compensation intended for entities where oil and gas exploration takes place began to be treated as a tax, benefiting all entities within the federation. Thus, it is reasonable to admit that the law's approval overlooked some essential characteristics of the nature of royalties by modifying their distribution to subnational entities that do not have oil exploration activities. Through a critical approach, the article suggests the need for a conceptual and normative review to ensure that royalties fulfil their role as a financial compensation mechanism without harming economic growth or fiscal transparency.
***Keyword**: Public Choice Theory; Oil Royalties; Revenue Distribution; Financial Compensation; Parafiscal Taxation.*

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I. Introduction

Legal, economic, and political controversies mark Brazil's discussion around oil royalties. Originally conceived as a form of financial compensation to the federative entities affected by the exploitation of natural resources, royalties have become the subject of disputes that highlight the multiplicity of interests at play. Law No. 12734/2012 significantly changed Brazil's oil royalties distribution. These changes sparked legal debates and objections, particularly from oil-producing states, who claimed that the new rules undermined their rights and financial interests (Brasil, 2018b)

This dispute is not limited to financial issues; it also involves interpreting the concept of royalties in Brazilian legislation. According to paragraph 1 of Article 20 of the Federal Constitution, royalties are defined as compensation for extracting finite natural resources. However, over the years, new rules and interpretations have been added to the legal framework, creating a situation of confusion and competition for revenues, as will be detailed throughout this study. Serra, Terra, and Pontes (2006) discuss these threats to the current distribution rules, highlighting the disputes over how oil royalties should be allocated. Furthermore, royalties have been expanded to finance various public expenditures, raising questions about their original function and effectiveness as a compensation mechanism. According to the Manual de Contabilidade Aplicada ao Setor Público (Brasil, 2018a), the accounting records of these resources must be accurately maintained to ensure fiscal efficiency and accountability.

In this context, a need arises to distinguish royalties from other revenue mechanisms, such as taxes. In the legal sphere, a tax is any compulsory pecuniary payment required by the State or other public entities to raise funds for financing public activities and expenditures. The imposition of a tax is established by law and is obligatory, regardless of whether the taxpayer receives any direct or immediate compensation from the State.

According to the National Tax Code (CTN), taxes are classified into five categories, which do not include oil royalties:

- Taxes: These are levies triggered by a manifestation of the taxpayer's wealth, not linked to any specific state service or activity. Examples include Income Tax (IR), Urban Property Tax (IPTU), and Tax on the Circulation of Goods and Services (ICMS). The payment of taxes does not guarantee direct compensation from the State to the taxpayer.

- Fees: These are charged due to the exercise of police power (such as inspection fees) or for providing a specific and divisible public service to the taxpayer—for example, a waste collection fee or the fee for issuing public documents.
- Improvement Contributions: These apply to property owners who benefit from public works. The aim is to charge the beneficiaries a portion of the cost of the works, resulting in an appreciation of their properties, as in the paving of streets or the construction of new public roads.
- Compulsory Loans: These taxes are instituted by the Union in exceptional situations, such as wars, public calamities, or to finance urgent and relevant public investments. Unlike other taxes, compulsory loans must be repaid to taxpayers.
- Special Contributions: These are allocated to the funding of specific activities or groups, such as social contributions (like the Contribution to Social Security Financing - COFINS and the contribution to the National Social Security Institute - INSS), economic intervention (CIDE), and parafiscal contributions, such as those charged by professional councils (OAB, CREA).

These categories of government revenue, including taxes, serve various purposes, such as funding the State and its public services, redistributing income, regulating the economy, or encouraging specific behaviours among taxpayers.

In this context, this article aims to analyse the use and distribution of oil royalties in Brazil, investigating whether they effectively function as financial compensation or have become a parafiscal tax[1]. This situation arises because oil royalties have been used to finance expenditures in states and municipalities that are not directly linked to compensation, including sectors such as health and education.

The analysis explores the legal basis and economic rationale of royalties, highlighting the conflicts between federative entities and the many regulations affecting the sector's governance and transparency. Furthermore, based on public choice theory, this study examines how the interests of pressure groups can influence legislative decisions related to royalties, diverting them from their original role as financial compensation. In sum, it suggests the need for a conceptual and normative review to ensure that royalties fulfil their purpose reasonably without undermining budgetary efficiency. Similar dynamics are discussed by McLeay, Ordelheide, and Young (2004), who analyse how constituent lobbying impacts the development of financial reporting regulations in Germany.

II. The Dispute Over Oil Royalties: Legal Actions And The Concept Of Financial Compensation

The Dispute over Oil Royalties: Legal Actions and the Concept of Financial Compensation

The State of Rio de Janeiro, feeling disadvantaged by the new distribution of oil royalties established by Law No. 12,734/2012, filed a Direct Action of Unconstitutionality (ADI) with the Federal Supreme Court (STF), arguing that the new legislation violated the rights of producing states and would significantly compromise their revenues. Under the new criteria, producing states and municipalities would lose revenues to the other federation entities, as observed in the following chart. In other words, the authors of the ADIs above claim that the federative units affected by oil and natural gas exploitation would receive fewer royalties and special participations, in line with paragraph 1 of Article 20 of the Federal Constitution. However, the change occurred more due to the parliamentary strength of the unaffected states during the legislative process than to technical rigour related to the compensation owed, thus initiating the distortion of financial compensation. The STF provisionally granted the request.

Royalties Sea	2013	2014	2015	2016	2017	2018	2019
Producing/Concession States	20%	20%	20%	20%	20%	20%	20%
Producing/Concession Municipalities	15%	13%	11%	9%	7%	5%	4%
Affected Municipalities	3%	3%	3%	3%	3%	2%	2%
Special Fund E	21%	22%	23%	24%	25.50%	26.50%	27%
Special Fund M	21%	22%	23%	24%	25.50%	26.50%	27%
Union	20%	20%	20%	20%	20%	20%	20%
Special Participation (SP)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Producing/Concession States	32%	29%	26%	24%	22%	20%	20%
Producing/Concession Municipalities	5%	5%	5%	5%	5%	5%	4%
Affected Municipalities	-	-	-	-	-	-	-
Special Fund E	10%	11%	12%	12.50%	13.50%	14.50%	15%
Special Fund M	10%	11%	12%	12.50%	13.50%	14.50%	15%
Union	43%	44%	45%	45%	46%	46%	46%

[1] Royalties in Brazil, initially conceived as financial compensation for the exploitation of natural resources, have been broadened to include allocation to the general budget of federative entities. While some funds are still directed towards specific purposes, such as health and education, their use for the general budget dilutes the traditional parafiscal nature, bringing them closer to fiscal taxes, though they retain a compensatory element.

The basis of this dispute lies in the concept of royalties, which the State of Rio de Janeiro understands as compensation to the owner, as established in paragraph 1 of Article 20 of the Federal Constitution. This understanding aligns with the legal perspective discussed by Manoel (2003). This concept defines royalties as compensation applicable only to activities involving the extraction of finite natural resources. The extraction of this type of natural resource, rather than its possible environmental or economic impacts, generates the right to royalties. Oil royalties can be divided into actual royalties and special participations, representing a form of differentiated compensation proportional to the production and profitability of each oil field. Special participation is an extraordinary financial compensation owed by oil or natural gas exploration and production concessionaires for fields with a high production volume.

Therefore, it is relevant to understand the different natures of royalties and special participations, which act as financial compensation mechanisms for federative entities. Actual royalties are regularly paid for exploiting natural resources, while special participations represent extraordinary compensation in high production and profitability fields. Thus, the dispute over the distribution of these revenues does not merely involve the issue of compensation for the use of resources but also the proportionality between production volumes and the benefits received by the producing entities.

Paragraph 1 of Article 20 of the Federal Constitution:

§ 1 It is ensured, under the law, to the Union, the States, the Federal District, and the Municipalities participation in the result of the exploitation of petroleum or natural gas, water resources for hydroelectric power generation, and other mineral resources in the respective territory, continental shelf, territorial sea, or exclusive economic zone, or financial compensation for such exploitation.

In general terms, a royalty consists of the payment for the right to use a product to the owner, as established in Article 22 of Law No. 4,506/64. Royalties are paid to rights holders in music, use of franchises by franchisees to franchisors, etc. According to the usual concept of royalties, it would be expected that the destination of oil royalties would only be the Union, the owner of the assets present in the subsoil. However, the distribution of oil royalties is governed by specific criteria in the Constitution, generating debates about how and to whom these financial compensations should be directed. Nunes and Nunes (2000) explore this issue, highlighting revenue sharing as a fundamental federalism problem in Brazil. Furthermore, Decree No. 9,810/2019 establishes complementary regulations that affect how royalties are treated, see Brasil (2019), reinforcing the need for a conceptual and normative review to ensure that these mechanisms fulfil their original role as financial compensation.

Royalties are levied on the gross revenue of producing fields and are calculated as a rate applied to the result of multiplying the monthly production by the reference price of oil. In this way, the government appropriation's income should be directly related to the costs, damages, and risks to which the producing or affected states and municipalities are exposed, making them the legitimate beneficiaries. Otherwise, society would bear the costs of a project that would be unfeasible from the socio-economic impact perspective. It is important to emphasise that the financial compensation should be sufficient to compensate the affected entities but not exceed that amount not to jeopardise sector investments.

Despite the constitutional concept of royalties as compensation, rules have been enacted that provide for the allocation of royalties to finance various public expenditures in all federative units of the country. The approval of these rules for the expansion of revenues is expected when there is an alignment of interests in the National Congress, as observed by McLeay, Ordelheide, and Young (2004). Such laws motivated the Direct Actions of Unconstitutionality (ADIs) Nos. 4,916, 4,917, 4,918, 4,920, and 5,038 against Law No. 12,734/2012, filed with the Federal Supreme Court (STF). The ADIs contest the constitutionality of the new distribution of royalties to subnational entities, regardless of whether these entities are in oil extraction areas. In this context, oil royalties should be linked to sufficient financial compensation to cover the costs and risks the affected entities face but not exceed this value so as not to harm investments in the sector.

New foundations for understanding their true legal nature must be established to correct this conceptual inaccuracy that distorted the Institute of Royalties. Based on this review, it would be possible to accurately define the scope and applicability of royalties, ensuring that financial compensation fulfils its role of fairly and proportionately indemnifying the affected federative entities.

The competition for revenue resulting from conceptual inaccuracies of royalties generates conflicts between the federal government and subnational governments and between the federative entities. This dispute is evidenced by bills such as Bill No. 4,000/2019, which allocates part of the royalties to civil defence, and Bill No. 10,898/2018, which establishes their application in disaster prevention. Complementary Bill No. 216/2019, in turn, links the royalties to education. Bill No. 5,478/2019, approved, determines allocating resources from surplus production sharing to subnational entities and the Union. The revenues from royalties can also be allocated to the payment of social security expenses and investments made by the Union, States, Federal Districts, and Municipalities. The use of oil royalties to finance population health is defended by Daniel et al. (2013). Clause I of Article 15 of Law No. 9,424/96 is another provision that establishes the application of onethird of federal resources to finance programmes aimed at universalising primary education and reducing regional inequalities.

In addition to the bills above, some proposals aim to expand public expenditure by creating federal, state, and municipal councils to oversee receiving and using resources derived from royalties. However, such attributions already fall under the jurisdiction of the courts of accounts, as provided in Article 59, paragraph 1 of the Fiscal Responsibility Law (LRF). Through their committees, parliaments also have broad instruments for fiscal policy oversight. The creation of yet another supervisory body may result in an increase in budgetary expenses and confusion of institutional competencies.

New rules are often proposed to promote improvements in social conditions. Parliamentarians justify the expansion of royalty beneficiaries as a desirable and beneficial measure, arguing that it can create better conditions for developing certain geographical regions and provide social benefits. According to the members of Congress, without implementing these new rules, the payment of oil royalties could result in the misallocation of resources by the entities that receive them.

The reduction of regional inequalities, as provided for in Clause III of Article 3 of the Federal Constitution of 1988, already has several legal instruments. The Constitution provides that the FPE, FPM, and Constitutional Funds (FNO, FNE, and FCO) redistribute resources, prioritising entities with lower per capita income. Furthermore, paragraph 3 of Article 198 establishes that Union resources allocated to health, transferred to States, the Federal District, and Municipalities, aim to gradually reduce regional disparities. Successive Budgetary Guidelines Laws (LDOs) seek to exempt municipalities with lower incomes from the counterpart required for receiving voluntary revenues. However, multiple rules with the same objective may compromise public spending transparency.

The use of royalties to foster economic growth and their legal purpose as financial compensation raises the question of their possible overvaluation, which in some cases may represent a form of economic confiscation. This overvaluation can be assessed by the ratio between the volume of resources not applied as financial compensation and the total collected in a given year. Therefore, the value of royalties must be adjusted to be adequate, aiming to cover only the costs of the affected federative entities without exceeding them.

The excessive collection of royalties increases the costs of oil and gas production for the consumer, hindering the expansion of consumption and, consequently, the collection of direct and indirect tax revenues. Wen (2018) explores how progressive taxation of extractive resources can serve as an optimal policy to address these economic challenges. In their IMF report, this issue is further examined in the context of mining and petroleum taxation by Rota-Graziosi, Luca, Laporte, and Lavoie (2014), highlighting the importance of balanced fiscal policies in resource-rich countries. In countries such as Mali, tax collection from the oil sector exceeds the income obtained from royalties, highlighting the importance of fiscal balance. Revenues from extractive industries are essential for financing infrastructure and social spending investments. Recent discoveries of natural resources in many developing countries, such as Ghana and Sierra Leone, make it urgent to formulate fiscal policies that maximise resource revenue without creating disincentives to production.

Therefore, legal confusion results from enacting numerous rules that do not consider all the laws related to the matter, resulting in duplicate spending and compromising the efficiency of the public budget. From an economic and budgetary perspective, Daniel et al. (2013) assert that this normative fragmentation makes the formulation of expenditures more complex. This legislative dispersion significantly increases sector management costs, both for the government and private investors, generating negative impacts on transparency and good governance and providing conflicting information to investors.

In short, it can be stated that numerous rules that provide for expenditures to reduce inequality and intervene in the economic and social domains result in multiple disbursements. Furthermore, there is a common misconception that certain expenditures belong exclusively to the Union. In contrast, others would fall to the regions when, in fact, all expenditures are made at the regional level, either in the states or municipalities. It is worth noting that promoting balanced development among regions in different economic situations is one of the main functions of the public budget.

III. The Influence Of Interest Groups In The Redefinition Of Oil Royalties: An Analysis From The Perspective Of Public Choice Theory

The approval of Law No. 12,734/2012 is a notable example of the influence of interest groups in the creation of legislation. A parallel example can be found in the United States, with the taxation of the performance fee. This tax increase resulted from a Democratic Party bill that sought to adjust the annual income tax base, extend certain tax credits for families, and increase the tax on the performance fee. The bill, drafted by Rangel, proposed the repeal of the AMT, a reduction in the corporate profit tax rate from 35% to 30.5%, and the compensation for this loss of revenue by taxing the performance fee at 35%, as well as imposing a 4% surtax on individual incomes over $150,000 and $200,000 for couples.

During the debate, arguments were raised to protect those benefiting from the lower rates on the performance fee. Ifshin, for example, argued that the bill would be a barrier for those bringing innovation and know-how to investors. Similarly, the U.S. Chamber of Commerce claimed that such an increase would affect millions of Americans and make U.S. companies less competitive.

Although the increase in the performance fee could have raised U.S. tax revenue by $25.7 billion over ten years, the resistance from opposing lobby groups prevailed. This scenario illustrates how specific interests can shape public policies, often in defiance of principles of tax equity. According to Otieku (1992, p. 48), "the effectiveness of the tax system is not just a matter of appropriate tax laws, but more importantly, of the efficiency and integrity of tax administration."

Similarly, in Brazil, even with the constitutional definition of royalties as compensation to the federative entities impacted by the extraction of natural resources, the legislation expanded their distribution to non-producing states and municipalities. From the perspective of public choice theory, this expansion reflects political manoeuvring, in which non-producing states, with greater parliamentary strength, managed to approve a model more advantageous to their interests.

Moreover, this alteration in the destination of royalties blurs the line between compensation and parafiscal public revenue. Using royalties for expenditures in sectors such as health and education in states without extraction activities distorts the original purpose of financial compensation.

The practice of linking revenues to expenditures, rejected by Budgetary Management theory and public managers, leads to the fossilisation of past priorities and restricts budgetary flexibility. Giacomoni (2010) emphasises that this procedure removes the government's ability to set priorities according to current needs. Magalhães (2014, p. 43) highlights the consequences of this budgetary rigidity, pointing to the lack of resources for areas such as mobility and infrastructure.

Thus, it becomes evident that conceptual and normative review is needed to respect the legal nature of royalties and economic efficiency, preventing the legislative process from being exclusively driven by the interests of pressure groups.

IV. Conclusion

The analysis presented in this article highlights that oil royalties in Brazil, originally conceived as a form of financial compensation to the federative entities affected by the exploitation of natural resources, have become the subject of economic and political disputes. The study reveals that, over time, the multiplicity of regulations and legal interpretations surrounding royalties has generated legal confusion that compromises budgetary efficiency and fiscal transparency. The expanded distribution of royalties beyond their original compensatory purpose has led to a debate about their true nature: are they a tax or a legitimate compensation mechanism?

The arguments put forward by different spheres of government and the legislative conflicts indicate the need to review and reform the rules governing royalties. These revenues must be linked to clear financial compensation criteria, covering only the costs and risks to which the federative entities affected by the exploitation of natural resources are exposed. In this way, it would be possible to avoid economic distortions, such as the increase in the prices of petroleum derivatives for consumers, and ensure that royalties are not used as instruments of wealth transfer. This could even result in reducing the funds allocated to royalties, adjusting them according to the actual need for compensation.

This redistribution diluted the compensatory impact of royalties for the states and municipalities directly affected by resource exploitation while offering only marginal benefits to other federative entities. An important issue that warrants investigation is whether this redistribution has led to an overall decline in welfare. Some entities may have suffered substantial revenue losses, while the gains for new beneficiaries were so small that they did not compensate for these losses. In this scenario, the redistribution of royalties may have caused a reduction in the economy's welfare. This fact raises the need to reconsider the distribution criteria, ensuring that royalties more fairly and effectively fulfil their compensatory and public financing roles.

In short, this article suggests that a conceptual and normative discussion about oil royalties should consider their role as a fair financial compensation mechanism. This study should include the precise definition of their legal nature, the limitation of their use to the costs and damages associated with exploiting natural resources, and creating a regulatory framework that promotes fiscal efficiency. Thus, the study of oil royalties can contribute to understanding the influence of pressure groups on the shaping of regulations.

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