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Threatening to Increase Productivity

Arilton Teixeira (FUCAPE Business School)

Benjamin Bridgman

Victor Gomes

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Benjamin Bridgman† Victor Gomes‡ Arilton Teixeira§

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Abstract

The wave of privatization in the 1980s and 1990s increased productivity of many previously state owned enterprises (SOEs). However, governments often do not have sufficient support to privatize SOEs. We provide evidence that threatening privatization and market competition (entry of new firms) can increase the productivity of SOEs, even though privatization and entry of new firms does not occur. We study productivity at Brazil's state-owned oil company Petrobras. After it lost its legal monopoly, Petrobras's total factor productivity increased sharply. These large gains occurred despite the fact that Petrobras faced no immediate *de facto* competition. The *threat* of competition and privatization was sufficient to generate large productivity gains. These findings suggest that changing the competitive environment can be a powerful force for improving productivity at state-owned firms.

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†Bureau of Economic Analysis, Benjamin.Bridgman@bea.gov.

‡Universidade de Brasilia, victorgomes@unb.br.

§Capixaba Research Foundation, arilton@fucape.br.

1 Introduction

There is a great deal of evidence that private firms perform better than public ones. The wave of privatization of the 1980s and 1990s led to higher productivity at a number of previously state-owned enterprises (SOEs). (See Megginson and Netter [28] for a survey.)

However, governments are often politically constrained from privatizing. While some governments would like to privatize these firms, they cannot. Privatization often does not have public support and those who benefit from state ownership may able to block it. Some high profile privatizations, such as those in Russia, were done in a way that many people perceived as only benefiting politically connected elites. People in countries with a colonial history are often leery of privatization since it risks placing public assets in the hands of foreigners, thought of by many as neocolonialism. Clear majorities of the population in many Latin American countries do not think privatization is beneficial and its popularity has been falling over time (McKenzie and Mookherjee [27]).

Are SOEs doomed to poor performance in cases where privatization is not politically feasible? In this paper, we show that governments can improve the performance of SOEs even without privatization. We study a case where the threat of market competition and privatization increased productivity and improved the performance of a SOE, even though privatization and entry of new firms did not occur during the period we examine.

In 1995, Brazil ended the legal monopoly rights of its state-owned oil company, Petrobras, over production, refining, import and export of oil. We evaluate the productivity performance of the company's oil extraction division before and after this change in the economic environment.

The main finding is the reform led to a significant increase in Petrobras's productivity growth. Between 1976 and 1994 labor productivity grew at an annual average of 4.7 percent whereas between 1995 and 2001 it grew at an annual average of 14.6 percent. Not only did growth triple, the sources of the growth changed. Labor productivity growth prior to 1995 was due to capital accumulation and materials use with little TFP growth. Beginning in 1995 TFP grew rapidly, accounting for almost

all the increase in the labor productivity growth rate.

To accomplish these results, Petrobras slashed its use of inputs while maintaining output growth. It also began to shift its portfolio of oil wells to more productive regions and changed its corporate structure. The speed with which the changes were implemented indicate that they were feasible prior to reform (physically, if not politically).

What makes this case particularly compelling is that labor productivity growth immediately doubled despite the fact that the reform resulted in no immediate changes in Petrobras's market or ownership. In the period we examine, no other firms entered the market and no competing imports were allowed. The firm was not been privatized and has not been in the 15 years since the reform. Petrobras maintains a dominant position, still extracting 97 percent of Brazil's oil. Its advantages as a large incumbent made it difficult for competitors to enter the market. The changes brought about by the reform were sufficient to generate significant productivity gains.

The intuition for these changes in the performance of Petrobras is the following. Petrobras was a monopolist and competing imports were prohibited (only Petrobras could import oil). Shielded from competitors, Petrobras was not forced to minimize costs. Many of the non-economic goals that it pursued, such as increasing employment, directly reduced productivity. Petrobras's production cost was higher even when it used the best technology available.

After the reform, Petrobras knew that it would lose its monopoly over the Brazilian market. Facing the prospect of competing against lower cost producers, Petrobras's managers had an incentive to get rid of non-economic goals, reducing costs even before the changes were implemented[1]. Had Petrobras continued to pursue non-economic goals, it faced losing significant market share. Petrobras needed to reduce its costs to avoid losing its dominant position in the market.

The prospect of foreign firms in the market also constrained the government. Knowing that lower cost firms would be entering, it could not ask Petrobras to pursue non-economic goals without inducing losses that the government would have

[1]There is a literature suggesting that competition over a field (that is, more than one company exploring the same field at the same time) can generate inefficient allocation (Libecap and Wiggins [26]). As shown below, this did not happen in the Brazilian oil industry. By competition we mean here more than one company exploring different oil fields in Brazil at the same time.

to cover. It also helped commit future governments to maintain the open markets by making a return to a monopoly more costly. Reclosing the market would require expropriating Petrobras's foreign competitors, risking international retaliation, or buying them out.

The reform also increased the threat of privatization. The constitutional change lowered the institutional barriers to privatization. The legal requirement was reduced from a Congressional supermajority to a simple majority. It was also a clear sign that the government had changed his objectives. Since its creation, Petrobras's monopoly rights had only been expanded. (We will discuss the history of Petrobras below). The reform was the first time that Petrobras's legal monopoly had been raised in Congress. Therefore, the constitutional change pursued by the government and accepted by Congress was a clear sign that the government's attitude had changed. In addition, new producers in the Brazilian market would provide a performance benchmark. If other companies operating in Brazil's oil market were successful while Petrobras was not, it would provide the government with a rationale for privatizing Petrobras.

These results have some policy implications. When privatization is not politically viable, increasing competition in the markets of state-owned firms can provide an avenue for improving performance. Also, indicators of market outcomes can be poor proxies of market competitiveness. The prospect of competition resulted in major changes in Petrobras's management strategy and productivity. However, commonly used market outcome proxies such as concentration indices changed very little with the reform. As a proxy for competition, they would have missed a important shift in the competitive environment.

Our findings are in line with that of Goolsbee and Syverson [19] and Bartel and Harrison [3]. The first shows that the threat of entry in the U.S. airline industry led to price cuts by incumbents before the entry occurred. The second provides evidence from Indonesia that the competitive environment is an important determinant of productivity, regardless of ownership. Our findings are also consistent with contestable markets theory, which argues that a monopolist's behavior is affected by the threat of new entrants, not just actual entrants (Tirole [37]). Similar to Bresnahan and Reiss [5], adding an entrant to a market with few incumbents has a large effect.

Though only one company entered the oil extraction market in the first ten years of the reform, the productivity growth rate more than doubled.

Our paper is part of a growing literature examining the productivity effects of discrete changes in competitive pressure. Galdon-Sanchez and Schmitz [15] and Schmitz [21] find that productivity increased sharply in response to increased competitive pressure in the 1980s. Schmitz and Teixeira [22] find that private firms' productivity increased when public firms in the Brazilian iron ore industry were privatized. Cole, et al. [11] examine a number of these studies for Latin America. The closest work to ours is Garcia, Knight and Tilton's [16, 17] study of Chilean copper mining. Industry labor productivity increased after other firms were allowed to compete with the state-owned monopoly Codelco. In contrast to our findings, most of the increase came from high productivity entrants rather than improved productivity at Codelco.

It is closely related to the "barriers to riches" literature. Parente and Prescott [31] build a model where a monopolist sets price above marginal cost and does not use the most productive technology. Our empirical results match their theoretical predictions. After the end of monopoly rights of Petrobras, output and technological progress (as measured by TFP growth) increased sharply.

The causes of the post-reform productivity gains are similar to those found in Olley and Pakes [29]. They study the effects of deregulation and entry on productivity at the plant level in the U.S. telecommunication industry. They find that productivity increased mainly due to reallocation of inputs (capital) toward more productive plants. Productivity growth increased in a similar way at Petrobras, as it shifted production to more productive wells after the loss of its monopoly.

Laitner [24] separates the costs of imperfect competition in two parts: a static and dynamic effect. The static effect is the well-known deadweight loss caused by setting price above marginal cost (Harberger Triangles). The dynamic effect is due to underinvestment, reducing the capital stock and production. While Petrobras's production grew rapidly after the reform, to the point that Brazil is a zero net importer of oil, investment did not. Production was increased by using capital and other inputs more efficiently. In fact, it was during the monopoly period that Petrobras invested heavily, due in part to a national policy designed to encourage investment

(Bugarin et al [9]).

Our work is largely consistent with the literature on the effects of competition. However, in contrast to much of this work, we study a public company. We find that public companies react to competition in the same ways as private ones. However, the nature of the inefficiency of monopoly may be different, since public firms may pursue political goals that privately held companies do not.

2 Petrobras and the Brazilian Oil Industry

Petrobras is an integrated state-owned oil company that extracts, imports and exports, and refines crude oil and distributes gasoline[2]. It is a major player in the world oil industry and was ranked 125th in the 2005 Global Fortune 500. It is also very important in Brazil. Its sales are 6 percent of Brazil's GDP.

While its sheer size makes it economically important in Brazil, Petrobras is also politically important. It is one of the "Crown Jewels," a set of politically sensitive state-owned companies that figure prominently in the nationalist movement. Taxes on oil extraction are an important source of revenue for Federal, state, and city governments. There are also indirect benefits. It employs skilled, high-wage workers and is a source of local supply contracts.

Petrobras was created in 1954 and given a monopoly over oil exploration, extraction and refining. (Existing private refining companies were allowed to continue operating but could not expand.) This policy was part of a larger import substitution policy to develop the industrial sector (Kingstone [23]).

From its creation until the 1990s, Petrobras's control of the Brazilian oil market steadily increased.[3] The monopoly power of Petrobras was extended to the import and export of oil in the 1963. Between the creation of Petrobras and 1970s, domestic prices were essentially equal to the international price plus a Federal tax. In an attempt to shield the domestic economy from the oil shocks, domestic prices became disconnected from international prices in 1977 and based on a measure of domestic

[2]The government holds a majority of the voting stock. Non-voting shares and a minority of voting shares have been held by the public since the creation of Petrobras.

[3]See Campos [10] and Barreto [2].

production cost. In 1988, Petrobras's monopoly rights were guaranteed in the new Brazilian constitution.

The policy to remove the monopoly originated with President Fernando Henrique Cardoso. The first time that he publicly mentioned his intention of ending Petrobras's monopoly rights was in December of 1993 while he was still the Finance Minister (Prado [33, page 178]). He was elected with a majority in the first round of presidential voting in October 1994 and took office in January 1995. The election also provided him with strong legislative support, which his reformist predecessors did not have. Having strong legislative support was important for the reform since changing the constitution requires a supermajority vote in the Congress. In February 1995, he sent the amendment to the Congress eliminating Petrobras's monopoly.

Congressional resistance to the reform was strong. Members from both the left and right opposed it on ideological grounds; the left was opposed to private involvement and the right opposed weakening a nationalist symbol. The reform also threatened patronage opportunities. The reform likely would have failed without a strike by Petrobras's employees that generated a shortage of natural gas, which is used widely for cooking. Public opinion turned sharply against the strikers, which coupled with his personal popularity as the architect of currency stabilizing *Real* Plan, allowed Cardoso to push the reform through the Congress. Cardoso's congressional allies extracted a concession in the form of a clause prohibiting privatization in the law regulating the oil sector[4]. (This Petroleum Law was approved in 1997, as seen below).

The amendment was approved in November 1995. The Federal government retained the ownership of hydrocarbon reserves but opened the sector to private firms, ending 40 years of monopoly.

Market opening was phased in. The amendment called for new legislation regulating the oil market. This law, called the Petroleum Law, was approved by the Congress in August 1997. It created the National Petroleum Agency (ANP henceforth), which took over regulation of the oil market from Petrobras. The Petroleum Law set out the process of liberalization for all sectors related to production of oil products. In this paper, we focus on the extraction sector. (For a description of the

[4]The law requires that at least 51 percent of the voting shares be held by the Federal government.

deregulation of other sectors, see Serour [36]).

The Petroleum Law allowed Petrobras to keep its rights of extraction of oil in areas where it could prove that it had done investment. In August 1998, Petrobras signed 397 contracts with ANP, 282 of which covered areas already under development. These contracts, called "Round Zero," gave the rights for 450 thousand square kilometers to Petrobras without payment. After that, new areas for exploration were offered in auctions where any company from any country could participate. By 2003, 41 companies, besides Petrobras, had bought some areas. In that year, Shell was the first private company to produce oil in Brazil, though Petrobras's share of Brazilian production is still almost 100 percent.

In 2001, exports and imports of oil and its derivatives were opened to companies besides Petrobras (through its subsidiary Transpetro).

In what follows, we date the beginning of the reform in the oil industry as 1995. Even though the change in Petrobras's monopoly status occurred at the end of 1995, as noted above, discussion of the policy change began earlier. When dating the beginning of a reform, the date of the legal change may not be the most relevant date. Managers in the reformed industry may have anticipated the reform and introduced changes prior to the reform becoming official[5]. For example, in a study of the impact of privatization in the Brazilian iron ore sector, Schmitz and Teixeira [22] argue that the reform began in 1990, when a new President was elected promising to privatize and deregulate the economy, rather than the official announcement in 1995.

3 Production Process in the Oil Industry

This paper examines oil and gas extraction productivity. This section discusses the techniques employed to extract oil and gas from the soil and preparing it for refining, with particular attention to the attributes of wells that affect extraction

[5]We would date the beginning of the reform as the election of Cardoso and his congressional allies in October 1994 if we had monthly data. We designate 1994 as a non-reform year since we only have annual data. The election occurred late in the year and any changes Petrobras's management made would take time to take effect. We test the robustness of our results to including 1994 as a reform year below.

productivity.[6]

Once a field with oil and gas is discovered, the first step is to install the wells: holes where pipes are inserted to extract oil and gas from the rock. Recent advances in satellite seismic imaging have improved exploration and the siting of wells. In the 1990s, seismic imaging shifted from two to three dimensional geological images. These techniques are available in the international market and any company in the sector can use it.

Every well produces both oil and natural gas simultaneously.[7] Extraction may or may not use energy. Some wells have natural pressure that forces oil out without additional inputs. Other wells do not have enough natural pressure, so it must be built up artificially. This can be done by either pumping water into the reservoir or compressing gas into the well.[8] Adding pressure requires energy which comes from the gas produced by the wells themselves, reducing net output. The consumption of gas can reach 30 percent of the total produced by a well.

Natural pressure is related to the age of the well since removing oil from a field reduces its pressure. It is possible to reduce the amount of energy spent to produce oil and gas by shifting production to new wells, even when the new wells are much bigger than the old ones. As discussed below, this happened in the Brazil when Petrobras abandoned older, smaller wells in the states of Alagoas, Sergipe, and Bahia and concentrated its production in the state of Rio de Janeiro.

The oil and gas extracted from wells comes mixed with water which must be separated out. The oil and gas are separated from water using chemicals. The amount of chemicals required may not increase in the same proportion to the liquid extracted from the well. Chemical use depends on the temperature of the liquid once it has reached the platform, with colder liquid using more chemicals.

Larger and newer wells may use fewer chemical inputs. First, the amount of water coming out of a well together with oil depends on the age of the well. The older the

[6]This section draws heavily on discussions with Petrobras engineers Sergio Barros da Cunha, Demetrius Casteloes, and Marcelo Duque.

[7]Generally the separation of oil from gas is automatically done through the change of pressure. That is, inside the field there is high pressure. Once the oil and gas comes to the surface, the reduced pressure allows an automatic separation. See Worley and Laurence [38] and Rondeon [35].

[8]See Bennion et al [4] and Patton [32].

well, the more water it produces. Second, equipment specialized in the separation of oil from water can be attached to a platform. It uses gas to produce energy that is use to separate oil from water through a electrostatic treater[9]. This reduces transportation costs, since less water is transported to the refinery. This technology is only economical for wells that produce a high daily volume. This technology is used in Rio, where wells are large, but is rare in the states where wells were closed.

We conclude that a shift to newer and larger wells used in production likely reduced materials usage per well. Newer wells tend to have higher pressure, so they consume less energy than older wells, and produce less water, so they use fewer chemicals inputs. The move to larger and newer wells also allowed the use of separating technology based in gas that reduces chemical use and reduce transportation cost.

4 Productivity at Petrobras

In this section, we analyze Petrobras's domestic oil extraction unit's labor productivity and TFP performance in response to the loss of its legal monopoly. We argue that the end of Petrobras's monopoly and the threat of new competitors had an impact on its productivity performance. We compute Petrobras's TFP using a Cobb-Douglas production function given by

$$Y_t = A_t K_t^{\theta} M_t^{\alpha} N_t^{(1-\theta-\alpha)} \tag{1}$$

where K_t is the aggregate capital stock, M_t is materials use, N_t is the number of employees, θ is the capital share, α is the labor share and A_t is TFP. We first discuss the construction of the data series, followed by the choice of factor share values.

The data are drawn from the ANP and the balance sheets of Petrobras. Output Y_t is the total physical quantity of oil produced. Natural gas produced, a joint product of oil, is converted into oil equivalents as described in the Appendix. Labor input N_t is the number of exploration and production employees for each year, adjusted for contracting out as described in the Appendix. These data begin in 1976.

[9]See Cummings and Engelman [12] and Bromley, Gaffney and Jackson [6].

The capital stock is calculated using perpetual inventory on capital expenditures.[10] Data extends back to the establishment of Petrobras, so we directly observe the initial stock. (Further details are available in the Appendix). Capital expenditure measured in the Brazilian currency was converted into U.S. Dollars using the December monthly exchange rate and deflated by the U.S. oil and gas equipment price index.

We did not have data for Petrobras's material use so we use wells in production as a proxy. This assumes average material use per well is constant over the period considered. The robustness of the results to this assumption and those used to construct the capital series are discussed below.

We now turn to the choice of factor share values. Petrobras's average labor share in the period 1976 and 2001 is 0.2. Since we do not have data on Petrobras's materials expenditures, we cannot calculate the capital and materials shares directly. Instead, we use U.S. data. Labor share in Brazil is same as that of the United States, which is an indicator that factor shares are similar in the two countries. We use a capital share of 0.45 and material share of 0.35 [11].

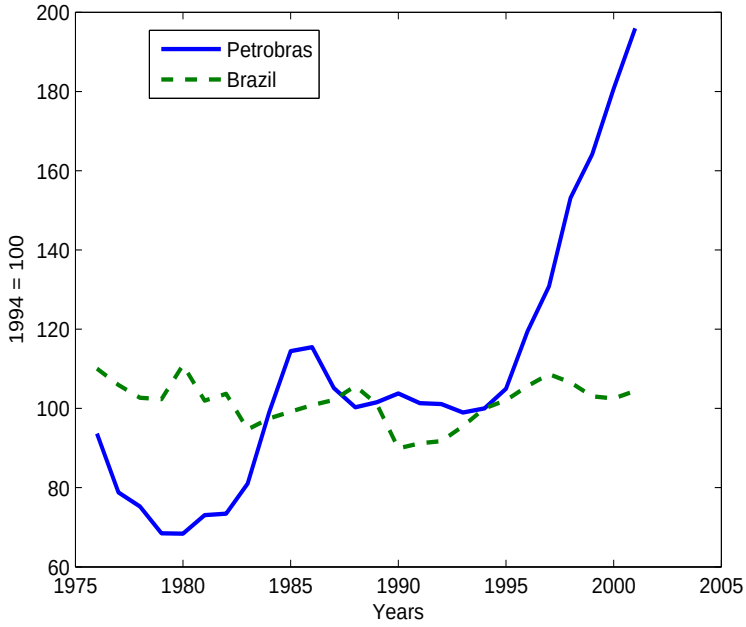
Using equation 1 and the Brazilian data we computed Petrobras TFP shown in Figure 1. (Figure 1 also shows aggregate Brazilian TFP, which will be discussed below.) During the time that Petrobras was a legal monopolist, there is very little sustained growth in TFP. There is a deep and abrupt fall in TFP in the second half of the 1970s with a recovery in the early 1980s. From 1984 until 1994, TFP shows no sustained gains. On the other hand, during the reform era from 1995 until 2001 TFP almost doubled, growing 95 percent.

This calculation allows us to decompose the sources of growth of labor productivity (henceforth productivity). Dividing Equation 1 by N_t, then taking logs yields:

[10] Our measure of capital includes capital formation in two sectors - well exploration and development - but we do not include development as part of our output. Well development is fairly constant aside from a spike in the years 1979 to 1983. This should not affect our main results although our estimate of TFP may be biased downward during the early 1980s. The data cannot be extended beyond 2001 since the Exploration and Production unit was consolidated with other units in 2002, making the data non-comparable.

[11] We use the KLEM data set for Oil and Gas Extraction (Industry Group 4) described in Jorgenson and Stiroh [20]. See the Appendix for details on the data.

Figure 1: Total Factor Productivity of Petrobras and Brazil, 1976-2001



$$\left[\log\left(\frac{Y_{t+s}}{N_{t+s}}\right) - \log\left(\frac{Y_t}{N_t}\right)\right]/s = \left[\log A_{t+s} - \log A_t\right]/s + \tag{2}$$
$$\theta\left[\log\left(\frac{K_{t+s}}{N_{t+s}}\right) - \log\left(\frac{K_t}{N_t}\right)\right]/s + \alpha\left[\log\left(\frac{M_{t+s}}{N_{t+s}}\right) - \log\left(\frac{M_t}{N_t}\right)\right]/s$$

Table 1 reports a growth accounting for the pre- and post-reform periods. The growth rate of productivity more than tripled after the end of monopoly. The sources of growth in the two subperiods also changed. In the first subperiod, productivity grew almost completely due to an increases in K/N and M/N while TFP was nearly constant. In the second, TFP became the major source of growth.

Table 1 - Growth Accounting of Petrobras's Labor Productivity (%)

Period	change in Y/N	due to TFP	due to K/N	due to M/N
1977-1994	4.7	0.3	2.1	2.2
1995-2001	14.6	9.6	2.7	2.3

This result is similar to the the findings of Bugarin, et al. [8] for the aggregate Brazilian economy. They find that the government encouraged capital accumulation to keep the economy growing after the oil shocks of the 1970s, despite the lack of technological progress. The government subsidized private companies and had SOEs, like Petrobras, increase investment.

We now examine the assumptions used in the construction of the capital and materials series. We find that they do not significantly impact our results.

There are a number of difficulties that could lead to the mismeasurement of capital. First, Brazil's history of very high inflation rates complicates the measurement of capital. Since the data reported on an annual basis, the same nominal expenditure will buy much less real capital if it occurs in December rather than January. Brazilian accounting rules required indexation of financial reports during the high inflation years, which mitigates this problem.

High inflation also led to rapid depreciation of the Brazilian currency, which affects the conversion to dollars. Using the December exchange rate will tend to underestimate the real capital stock when inflation is high. The Brazilian currency was pegged to the dollar. The peg was periodically adjusted (daily during hyperinflation), depreciating the Brazilian currency. Therefore, the currency would be at its most depreciated level at the end of the year. Capital expenditures are converted using the exchange rate when the Brazilian currency buys the fewest dollars during the year, which will tend to understate investment. In turn, TFP will tend to be biased upward. This systematic bias is not present in low inflation years. This factor will lead us to understate the impact of the reform on TFP growth. Since the oil sector reform occurred after high inflation ended in Brazil (the *Real* Plan that ending high inflation was implemented in July 1994), the upward bias will only be present before the reform.

We use the U.S. oil equipment price index to deflate investment, which raises

the concern that it may not reflect price changes in Brazil. Overall capital price movements are similar in the two countries. The aggregate price of equipment relative to the GDP deflator have similar declines in the United States and Brazil from 1976 to 2001. However, U.S. oil equipment prices do not have the same behavior as U.S. aggregate capital prices, so the aggregate price index may not be appropriate. We use the U.S. oil equipment index because it is specific to the oil industry and there is no corresponding Brazilian index. In any case, the results are not sensitive to the selection of deflator. The results are not significantly altered if the Brazilian aggregate equipment price index is used as a deflator.

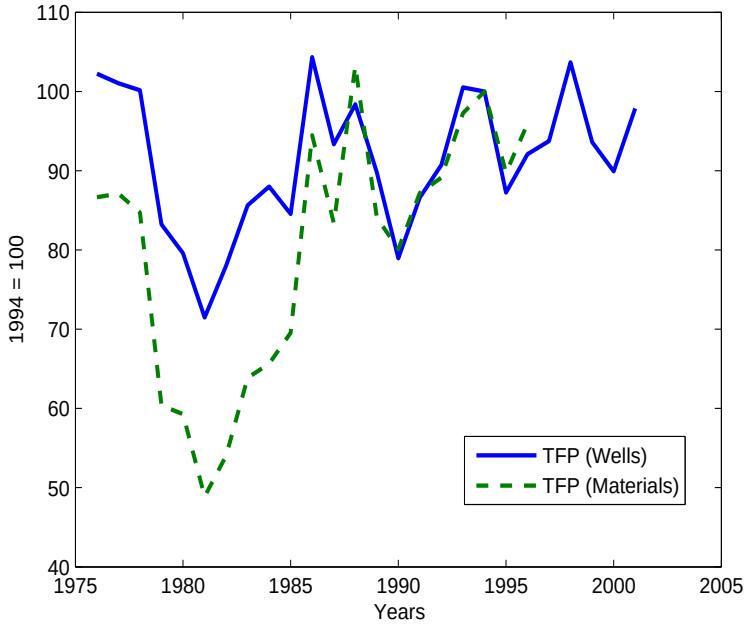
Another issue is that the relative price of structures in Brazil nearly doubled in the mid-1980s (Bugarin, et al. [7]). This mismeasurement would also tend to overstate TFP growth since real investment in structures would be understated after the mid-1980s. However, the quantitative impact is likely to be tiny. Structures make up very little of Petrobras's capital, less than 2 percent of the value of net property, plant and equipment in 2005.

Turning to the materials series, the constant materials use per producing well appears to be a reasonable assumption. Examining U.S. data, we compare TFP using real materials (from Jorgenson and Stiroh [20]) with TFP using the producing wells proxy. As can be seen from Figure 2, the two estimates are very similar after 1984. The divergence prior to the mid-1980s can be explained by an increase in well development during the oil crisis years. This industry does not just produce oil and gas products, but is also engaged in exploration, drilling and equipping oil and gas wells. A substantial share of materials use is for well development[12]. U.S. materials per producing well are relatively stable except for a spike from 1978 to 1984, which coincides with a spike of the same magnitude in well development.

Brazilian material use per producing well may have fallen during the 1990s. As discussed above, material usage is largely driven by well attributes and Petrobras shifted production to newer and larger wells that tend to use fewer material inputs. If this is the case, our measure of TFP is biased downward since we overestimate material input.

[12]The largest categories of expenditures in the U.S. Census of Mineral Industries are "Purchased machinery installed" and "Steel mill shapes and forms."

Figure 2: Alternative U.S. TFP Measures, 1976-2001

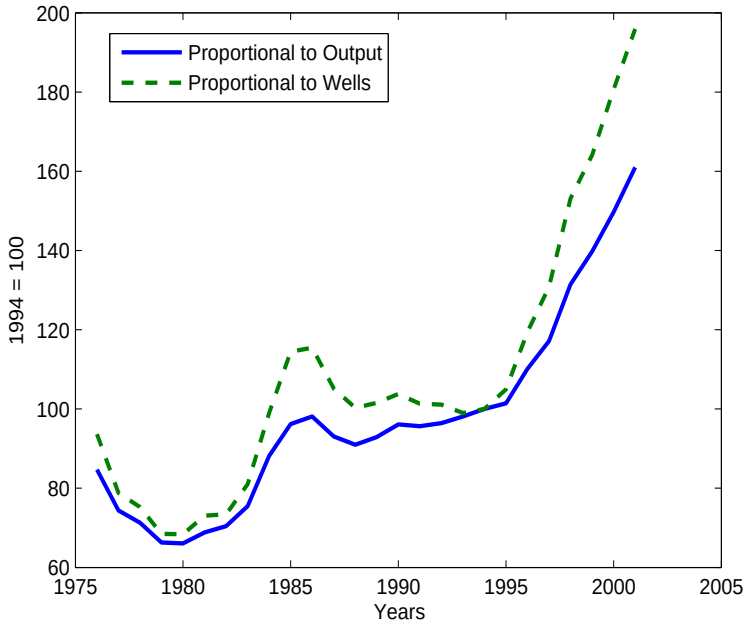


On the other hand, if material used per well increased, we overestimate TFP growth. However, it is unlikely that our results would be overturned. Material usage per well would have to have increased by a factor of nearly 7 to account for the post-reform increase in productivity. TFP (A in Equation 1) grew by a factor of 1.95. Given an input share of 0.35, material usage per well would need to increase by a factor of 6.74 ($1.95 = (6.74)^{0.35}$). Petrobras engineers we spoke with did not believe that such an enormous increase in materials use occurred.

As an additional robustness check, we calculated TFP assuming that growth rate of material use was the same as that of output[13]. This assumption implies that material use per well increased after the reform since output per well increased. As can be seen from Figure 3, the path of TFP is largely unchanged and continues to

[13]We set $M_t = \zeta Y_t$, for some $\zeta > 0$, which gives $A_t = \frac{Y_t^{(1-\alpha)}}{\zeta^{\alpha} K_t^{\theta} N_t^{(1-\theta-\alpha)}}$. Note that ζ^{α} cancels out when TFP is normalized to an index, so the calculation is not affected by the value of ζ.

Figure 3: Petrobras TFP with Materials Proportional to Output and Wells, 1976-2001



show an enormous increase after the reform.

5 Sources of Productivity Growth

Since TFP growth increased so dramatically, it is natural to ask what the sources of that growth were. In this section, we argue that TFP accelerated due to the reform that brought the threat of competition and privatization after 1995. Though the increase in TFP coincides with the policy change (Figure 1), it could have resulted from some other unrelated sources. We first show that the increase did not result from a number of plausible candidates: improvements in the aggregate Brazilian economy, technological progress in oil extraction and maturation of previous investments. We then show that inputs were used inefficiently prior to the policy change. With the

loss of its monopoly, Petrobras quickly reduced its use of inputs while continuing to expand output. (Output grew at similar rates before and after the policy change). The company reorganized its structure in an effort to appeal to outside investors. The evidence is consistent with non-economic goals becoming less important relative to the economic goal of improving efficiency.

5.1 Ruling Out Potential Candidates

One potential source of the improvement in productivity is the expansion of the Brazilian economy in the 1990s. It began recovering from its depression of the 1980s when many reforms such trade liberalization, currency stabilization, deregulation, and privatization took place. After these reforms, Brazilian labor productivity and TFP began growing (Bugarin, et al. [9]). This raises the possibility that it was the aggregate environment that caused the increase in productivity at Petrobras.

The evidence is not consistent with this explanation. We computed the TFP of Brazil using the methodology used in Bugarin et al [9]. Returning to Figure 1, TFP for Brazil and Petrobras have very different patterns[14]. Brazilian TFP started increasing earlier than Petrobras's. While Petrobras's TFP shows sustained growth after 1995, Brazil's begins to decline after 1998. We conclude that Petrobras's experience is not due to the movements of the aggregate Brazilian economy.

It is also possible the increase was the result of significant improvements in oil extraction technology after 1995. The evidence does not support this explanation. We compare the Brazilian industry to those of the United States, United Kingdom and Norway. If technology advanced faster after 1995 the relative productivity should not change. We would expect the oil industries in other countries to implement the new technology and experience similar growth in the labor productivity.

Most of Brazil's oil comes from offshore wells, accounting for over 85 percent of production in 2004. Norway's and UK's oil industries resemble Brazil's since they extract oil (exclusively) from deep water wells and began offshore production the mid-1970s. The United States also extracts some oil from deep water but much

[14]Brazil's TFP is calculated using a value added measure while Petrobras's uses a gross output measure. Data constraints prevent us from calculating a value added measure of Petrobras's TFP. We use a capital share of 0.37 for Brazil.

comes from land-based sources. Therefore, the comparison should control for both general technological change in extraction that would affect all countries and specific change that would only affect offshore extraction.

We do not have enough data to compute TFP for the Norwegian and UK oil industries or the U.S. industry beyond 1996, so we examine labor productivity.

Figure 4: Oil Extraction Labor Productivity - Brazil, Norway, UK and the United States (Index 1994=100), 1976-2001

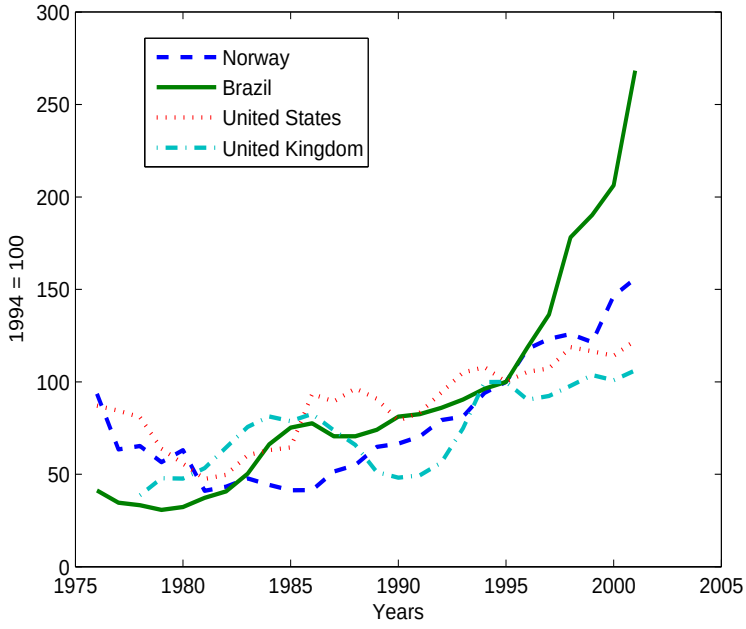


Figure 4 plots labor productivity, as measured by oil production per worker (indices set to 100 in 1994), for the four countries. While there are clearly differences in the year to year movements of productivity, the overall pattern is similar prior to 1995. Productivity falls in the late 1970s and begins to grow in the 1980s. The magnitude to the growth from the 1980s to 1994 is similar for all four countries. After 1995, Brazil begins to strongly outperform the other three.

Another possible candidate to explain Petrobras's rapid productivity growth since

1995 could be the maturation of previous investments. There is a lag between exploration and production. In our case, Petrobras could have increased its investment in exploration for new and more productive fields during the 1980s and the increase in productivity could be due to the start of production in these fields.

Figure 5: Brazil Wells Exploration and Real Crude Oil Price, 1976-2001

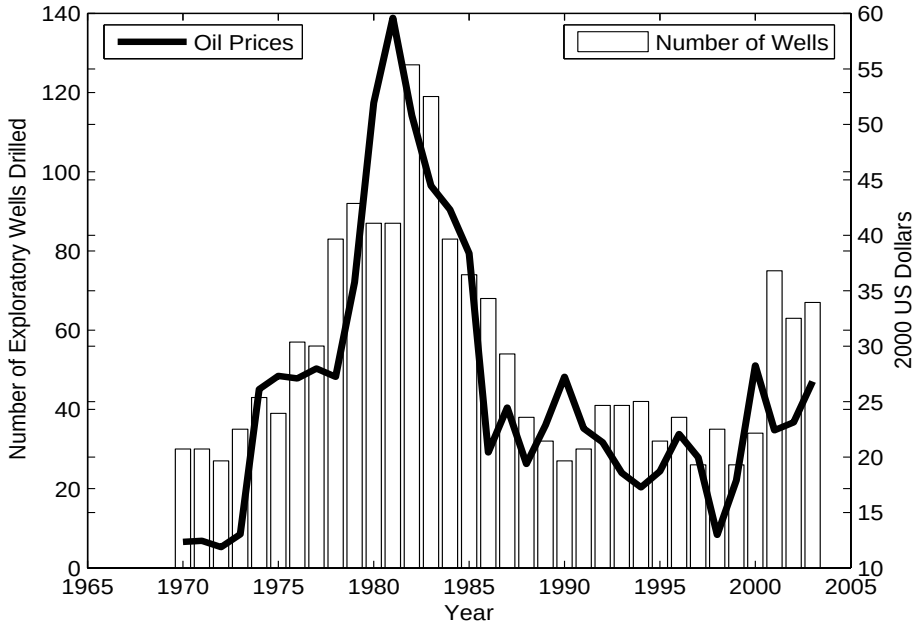


Figure 5 plots the number of exploratory wells drilled and real crude oil prices from 1970 until 2001. Until 1999, the number for the whole industry corresponds to those drilled by Petrobras. From the late 1980s through the 1990s, there relatively little exploration activity. The number of wells drilled is strongly correlated with the oil prices, which were low during this period. Therefore, there is little evidence of the increase in TFP being caused by previous exploration coming online.

While the 1980s were not a period of heavy exploration, one might be concerned that fields that were coming online were particularly high quality. The Campos Basin contains a number of high quality fields and production has shifted to this area. It

does not appear that the quality of these fields is responsible for the increase in productivity after 1994. The dominance of Campos precedes the increase in productivity by a decade. By 1985, Campos accounted for over 60 percent of Petrobras's oil production and has been slowly increasing its share since then.

Finally, the increase in productivity might have been due to one particularly good field within Campos. We found one potential candidate for such a field in Marlim, a large field discovered in 1985 that began commercial production in 1994. To measure the impact of this field, we compared two measures of labor productivity. The first uses Petrobras's total oil production as the measure of output. Output in the second is total oil production excluding Marlim's production. Both use the same labor measure, the total employment series used in the TFP calculation since we do not know how many workers were employed in Marlim. Labor productivity still nearly doubles, growing 76 percent, between 1995 and 2001 when Marlim's production is excluded. (It grows 174 percent with Marlim.) All the difference comes at the end of the period when Marlim's production reaches its peak. The two measures grow by nearly the same rate until after 1998. In fact, productivity growth is higher in 1998 without Marlim (54 percent) than with (49 percent). Therefore, the rapid increase in productivity right after 1994 can not be accounted for by the beginning of Marlim's production. Oil production grows even when Marlim is excluded while employment falls sharply. This calculation is a very conservative lower bound, since we are including labor input used in Marlim but excluding its output. Marlim is a very large field that Petrobras has expended substantial resources developing. At minimum, labor productivity nearly doubled in less than a decade, so we conclude that this field is not the reason for increasing productivity.

5.2 Our Explanation: The Reform of 1995

We now turn to our explanation of the increase in productivity. We argue that the threat of competition and privatization led to a change in management's priorities. We show that inputs were used more efficiently with the reform. Overstaffing was reduced and production was shifted to more productive wells. The inefficient use of inputs likely reflected non-economic goals such as maximizing employment that

became less important after the reform.

We begin by showing that the increase in Petrobras's productivity growth rate during the reform era is statistically significant. We run a difference in differences regressions using Norway, the United Kingdom and the United States as controls. We estimate a pooled panel regression on labor productivity growth of the four countries. The treatment "Reform" is a dummy variable that takes the value 1 for Brazil in the years 1995 to 2001. We correct for country specific autocorrelation and heteroskedastic errors by using Newey-West standard errors[15]. The sample period is 1977 to 2001 (the UK data begins in 1979). The dependent variable is the annual log difference of labor productivity.

The results are shown in Table 1. Column (1) reports our baseline, the regression with time dummies. The coefficient of the reform is positive and significant at 1 percent level, a strong result especially considering the relatively short treatment period.

Table 1 - Labor Productivity Panel Regressions
Dependent Variable: growth rate of labor productivity

Equation	(1)	(2)	(3)
Reform	0.1137	0.0843	0.0879
	(0.000)*	(0.047)*	(0.008)*
Controls	Time,	Time,	Time,
	1995 Treat	1995 Treat	1994 Treat
		Country	
Obs.	98	98	98

∗ p-value

We did a number of robustness checks. In equation (2), we repeat the estima-

[15]We implement these regressions using the "newey2" command in Stata 9. We set the maximum autocorrelation to 3 years, following the rule of thumb of using the cube root of the number of time periods T: $T^{\frac{1}{3}} = 25^{\frac{1}{3}} \approx 3$.

tion of equation (1) but we add country controls. The reform indicator is reduced somewhat, but is still significant at the 5 percent level.

The results are not sensitive to our dating of the reform's beginning. Since the event we mark the beginning of the reform (Cardoso's election) occurred in late 1994, we set the beginning of the reform in annual data as 1995. However, a small part of 1994 comes after the reform. In column (3), we add 1994 to the treatment period. ("Reform" takes the value 1 for Brazil in the years 1994 to 2001.) The reform indicator remains positive and significant at the 1 percent level. The reform is associated with an increase in growth labor productivity around 8 percent a year. Again, we obtain this strong finding despite having a relatively short treatment period.

As a check that the three countries are reasonable controls, we estimate another pooled regression (not reported here) for the years prior to the reform (1978-1994) with a dummy for Brazil. The Brazil dummy is not significant, which suggests that Brazil's oil extraction labor productivity growth process was similar to the other countries prior to the reform.

Given the small sample size, we were concerned that we could not be rely on inference based on asymptotic results. We tested the residuals for normality using the Skewness-Kurtosis test. It does not reject the null of normality at the 5 percent level.

To check that the results are not driven by changes in the overall economy, we rerun the regressions after removing average productivity growth in each country. Since Brazil has a history of macroeconomic instability and significant changes in economic policy, the results could be driven aggregate changes in Brazil's economy. Table 2 reports the results using the growth rate of the labor productivity in the oil sector minus the growth rate of GDP per capita (from the Penn World Tables) as the dependent variable. This approach has the advantage of controlling for the country specific effects without losing degrees of freedom to country dummies.

Table 2 - Labor Productivity Panel Regressions
Dependent Variable: Difference of growth rate of labor productivity in the oil sector

and aggregate economy

Equation	(1)	(2)
Reform	0.1447	0.1160
	(0.000)*	(0.001)*
Controls	Time,	Time,
	1995 Treat	1994 Treat
Obs.	98	98

∗ p-value

The results are robust to the new measure of productivity growth. Column (1) reports the results of the baseline specification. The reform indicator remains positive and significant at the 1 percent level. The reform coefficient is robust to changes in the year which the reform starts. As reported in column (2), adding 1994 to the reform period generates similar results. These results indicate that the reform increased the annual growth rate of labor productivity 10% above the growth rate of labor productivity of the aggregate Brazilian economy.

How was Petrobras able to increase its productivity so significantly? After the reform, the company made a number of changes in an effort to become more internationally competitive. Company managers explicitly state that prior to the reform, Petrobras pursued a number of non-economic goals such as encouraging Brazilian economic development by building infrastructure in remote areas and purchasing domestically produced inputs (2003 Annual Report). During the 1970s, the company restricted its foreign purchases to conserve the government's foreign currency reserves (1977 Annual Report).

Anticipating a loss of market share in Brazil with the loss of monopoly, it changed its corporate and financial structure so the the company would be able to expand overseas. A major goal was to be able to raise capital "at a cost that was at least compatible with that of its competitors" (2003 Annual Report). It issued a minority of its voting stock as American Depository Receipts on the New York Stock Exchange in 2000, which requires the company maintain U.S. accounting, disclosure

and corporate governance standards.[16]

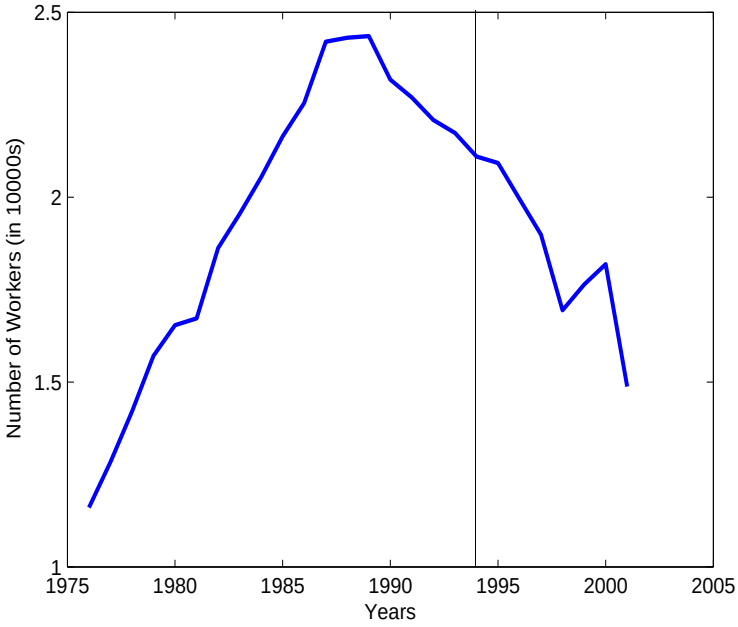
The data are consistent with this change in priorities. Employment fell rapidly after the reform, suggesting there was overstaffing before. Figure 6 shows the number of employees. Employment began declining prior to the loss of monopoly status, though its rate of decline increased sharply after 1994. This decline was due to the reforms implemented by the Collor government that took office in 1990, part of which was an across the board reduction in public employment. These changes reduced the number of employees at Petrobras. However, despite this earlier reduction of employment productivity does not start increasing until after 1994. This suggests that the earlier reduction of employment was not enough to change Petrobras's managers' behavior. Only once the end of monopoly was approved by Congress signalling that competition and privatization were a real threat did Petrobras implement other changes that increased productivity.

The data are consistent with Petrobras employing more workers than required to produce its output, either for specific patronage reasons or to increase employment generally. A number of authors have argued that political considerations led to overstaffing. Some overstaffing was due to patronage. Geddes [18] argues that Petrobras began to be used for political purposes in the 1960s, while it had been relatively unpoliticized before. Management power was given to the oil workers' union to garner political support of the employees. Randall [34] estimates that that the company was overstaffed by 20 percent. Up to 10 percent of the workforce were political patrons, hired at the behest of the government. Political pressure also forced the rehiring of fired employees, so both the replacement and original employees were on the payroll. Petrobras was also expected to assist in economic development which may have encouraged excess employment in an attempt to build up the Brazilian economy.

Oil wells were also used inefficiently, with low quality wells kept in production prior to the policy change. Figure 7 shows the number of wells in production. Prior to 1995, the number of wells increased steadily. In 1995, wells in production decline (sharply) for the first time in the period covered.

[16]This offering was not part of a privatization program. In this offering, the Federal government reduced its holdings from 82 to 56 percent of voting shares. Recall that it is legally obligated to hold 51 percent of voting shares.

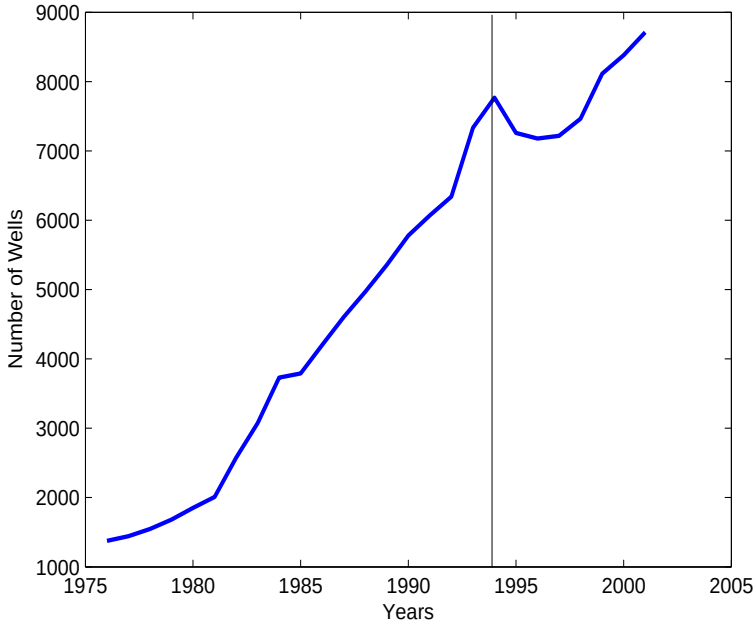
Figure 6: Number of Workers (in 10,000s), 1976-2001



The decline in wells coincides with a large increase in well productivity. As can be seen in Figure 8, output per well declines in the period prior to the reform. The development of the productive Campos field led to an increase in the early 1980s. However, Petrobras added so many wells in less productive areas that total output per well fell below its pre-Campos level. After the reform, Petrobras seems to have removed poor wells from production and concentrated its efforts on the best wells. Marginal wells may have been developed to spread production and the associated employment, tax revenue and other advantages of local production over a wider geographical area.

The geographical distribution of wells does change after the reform, with the number of wells in less productive areas declining. The number of wells in the States of Alagoas, Sergipe, and especially Bahia, states with some of the least productive wells, fell sharply while production has largely shifted to more productive areas. In

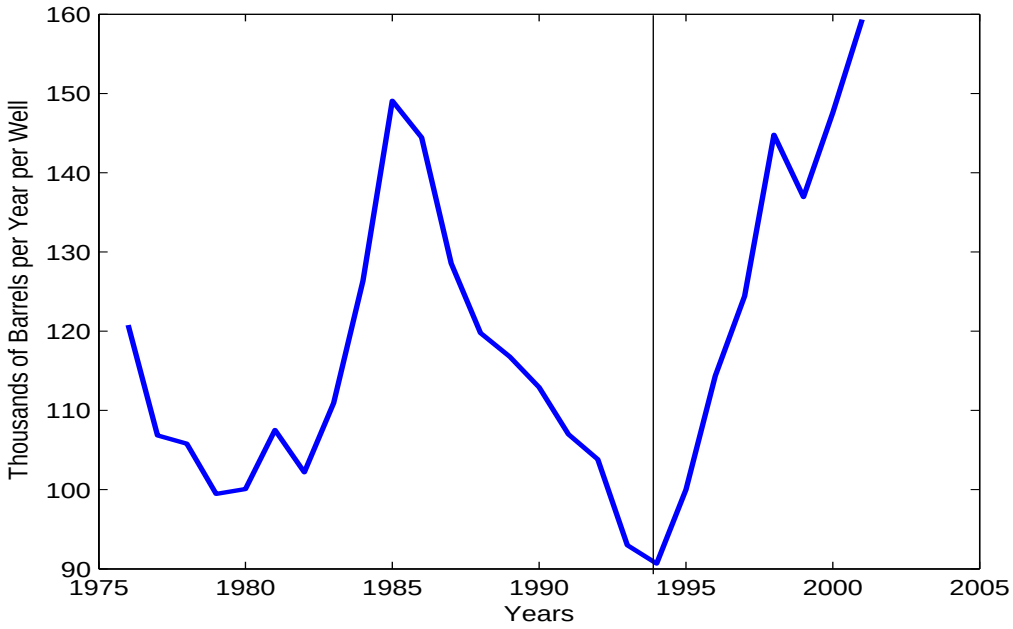
Figure 7: Number of Wells in Production, 1975-2001



1994, wells in Bahia produced an average of 9,300 barrels a year while wells in the State of Rio de Janeiro produced an average of 402,000 barrels a year. The State of Rio de Janeiro is where the high quality Campos reserves are located and is a large source of increased production since the reform. Figure 9 shows the number of wells in Brazil and the state of Bahia. Prior to the reform, the number of wells in both were growing at the same rate. After the reform, the number of wells declined with much of the decline coming in Bahia: In 1995, total wells declined by 509 while Bahia's wells declined by 419. Bahia is a politically important state so maintaining production there may have been politically motivated.

The rapid change in the use of inputs in the absence of major technical change suggests that the goals of Petrobras's managers changed with the loss of monopoly rights. The evidence is consistent with non-economic goals, such as spreading tax revenue across a wider base, becoming less important relative to the economic goals

Figure 8: Output Per Well in Production



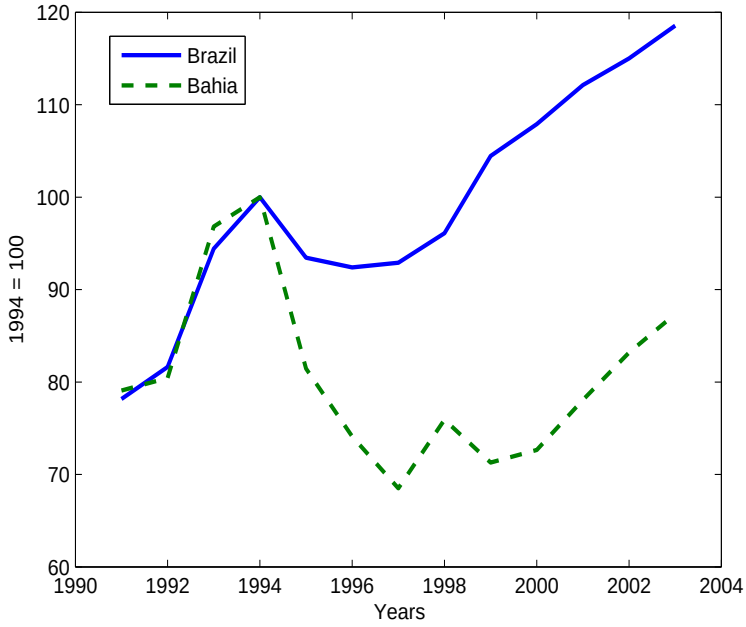
of reducing costs and increasing productivity.

6 Competition and Productivity

The reform brought about a remarkable increase in productivity. What makes it all the more remarkable was how little competition Petrobras faced over the period we study. Even though Petrobras lost its *de jure* monopoly, *de facto* Petrobras is still a monopolist[17] (Palacios [30] and Lewis [25]). The results show that the threat of competition, even absent actual competition, can increase productivity. We discuss

[17]There are still barriers to entry and the sector is quite risky due to government intervention. For example, recently the Brazilian government blocked a price increase in the domestic market in response to the high prices of oil in the international market.

Figure 9: Number of Wells in Production, Brazil and Bahia 1991-2004



the implications of this finding for studying competition and designing reforms.

Petrobras potentially faces two sources of competition in oil extraction: domestic production and imports. There was little competition from either source.

Recall that the reform was slowly phased in. The Petroleum Law was not passed until two years after the constitutional amendment was adopted. The Petroleum Law laid out a process of gradual opening. It took nearly a decade from the proposal to actual market opening.

There was very little entry into the oil extraction market. Table 3 shows the number of fields that Petrobras and other companies bought in each round that took place since 1998. The last column shows that share of all fields purchased over the period. Petrobras has at least an interest in nearly three quarters of new concessions. Even though the number of areas bought by other companies has increased, they have had little success discovering oil. As can be seen in Table 4, it was not until 2003

that a company aside from Petrobras (Shell) extracted oil in Brazil. In the last line of Table 4 we show the Herfindhal-Hirschman Index (HHI) (HHI is the sum of the square of the market share of all companies in a given industry). It takes values between zero and one, with higher numbers indicating more concentration in the industry). The HHI has not changed much since the end of monopoly. According to Kingstone [23], this has been used as evidence that Petrobras kept all the most promising areas in Round Zero.

Table 3 - Purchase of Rights of Exploitation 1998-2004

Measuring Entry – Number of Fields								
	1998	1999	2000	2001	2002	2003	2004	*Share 98-04 (%)*
Petrobras	96	1	0	7	3	85	57	*54.5*
Petrobras with others	0	6	11	7	5	0	50	*17.3*
Others	19	5	10	19	13	16	47	*28.2*
Total	115	12	21	33	21	101	154	*100*

Source: ANP

There was also very little import penetration. The market was not liberalized until 2001. Petrobras has enormous advantages as the incumbent that cushion it from foreign competition. It owns all oil terminal facilities in Brazilian ports, though competing facilities are currently being built.

Table 4 - Petrobras's Share of Oil Extraction 2001-2004 (%)

Period	2001	2002	2003	2004
Extraction	100.0	100.0	99.2	96.6
HHI	1.00	1.00	0.98	0.93

Source: Anuario Estatistico (ANP) and Petrobras.

Petrobras dominates most aspects of the Brazilian oil market. (Lewis [25] and Ellsworth and Gibbs [14]). It controls nearly all the refining market. Table 5 shows the percentage of Petrobras in the total refining capacity between 1997 and 2003. Petrobras has 98% of the Brazilian installed capacity to refine oil during the entire period. The end of the monopoly did not affect Petrobras's share in the industry[18]. Maintaining control of exploration and refining gives Petrobras control of the gasoline market. There is little international trade in gasoline since it must be formulated to local standards, which prevents taking full advantage of economies of scale in transportation.

Table 5 - Share of the Installed Refining Capacity 1997-2003 (%)

Period	1997	1998	1999	2000	2001	2002	2003
Petrobras	98.7	98.7	98.5	98.6	98.6	98.3	98.4
Other Companies	1.3	1.3	1.5	1.4	1.4	1.7	1.6
HHI	0.97	0.97	0.97	0.97	0.97	0.97	0.97

Source: Anuario Estatistico (ANP).

6.1 Policy Implications

The results have a number of policy implications.

First, economists should be cautious when using market shares as a indicator of competitiveness. Using the HHI, one might conclude that the reform was a failure since Petrobras did not cede its market share. However, it was successful in increasing productivity. Studies using market share data will miss threats of competition, which can have real effects.

[18]Since 1954, four private companies have operated in the refining sector. They were allowed to operate since they were operating prior to the creation of Petrobras (Serour [36])

Another implication is that if privatization is not possible, reducing barriers to competition can increase productivity. There are no plans to privatize Petrobras and it is unlikely to occur in the future (Kingstone [23]). The removal of the monopoly guarantee alone generated significant political conflict.

The results lend support to the view that the competitive environment is an important determinant of productivity, regardless of ownership. In fact, many instances when only ownership was changed have not resulted in an improvement in performance (Bartel and Harrison [3]). When privatization is not politically viable, increasing competition in the markets of state-owned firms can provide an avenue for improving performance.

7 Conclusion

We show that competition can be a strong spur to productivity growth. The threat of competition alone led to a large and swift increase in Petrobras's productivity.

The results provide support for the idea that closing off competition in the 1970s contributed to Brazil's poor economic performance in the 1980s. Petrobras is a microcosm of the aggregate Brazilian economy. As documented in Bugarin, et al. [9, 8], Brazilian TFP began to fall after the government expanded state-owned enterprises (including Petrobras) and raised trade barriers during the 1970s as a strategy to keep the economy growing despite the worldwide recession. While from 1968 to 1974 the economy grew rapidly due to surging TFP growth, after 1974 TFP began to fall. Bugarin, et al. [9, 8] argue that Brazil's falling TFP in the 1970s was due to the closing off of competition. The findings give support to this argument. While the study of a single industry, even a large one like oil, cannot definitely answer whether restricting competition reduced TFP, it suggests that this is a fruitful avenue of inquiry.

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A Data

The main source for Brazilian data is the Oil Report ('Relatório do Petróleo') from Ministry of Mines and Energy.

Oil production – thousands barrels per day:

1. Brazil: Oil Report, several years (1954-1990). Anuário Estatístico Brasileiro do Petróleo e do Gás Natural, Agência Nacional do Petróleo, several years (1990-2003).
2. United States: Energy Information Administration, Annual Energy Review, 2001, p. 129.
3. United Kingdom: BP Statistical Review of World Energy, June 2003.
4. Norway: Statistics Norway, Oil and Gas Activity, 4th Quarter 2002, Tables 23 and 24.
5. World production, includes crude oil, shale oil, oil sands and NGLs (natural gas liquids - the liquid content of natural gas where this is recovered separately): BP Statistical Review of World Energy, June 2002.

Employment – oil and gas extraction, and oil and gas extraction services:

1. Brazil: Oil Report and RAIS. Employment has been adjusted for contracting out. Employment by other firms in the oil extraction industry are added to Petrobras's exploration and production employment. Prior to the reform, all these firms were contractors for Petrobras. Beginning in the late 1990s when other firms could begin oil exploration, employment will include employees of some firms that are not Petrobras contractors. For details about RAIS see De Castro, Gomes and Muendler [13].
2. United States: Production and Service Jobs and Wells Drilled. U.S. Department of Labor, Bureau of Labor Statistics, National Employment, Hours, and Earnings (*www.bls.gov*). Oil and gas production (eeu10131001), and oil and gas services (eeu10138001).

3. United Kingdom: Employees extraction of mineral oil and natural gas: SIC 92 CA 11. Department of Trade and Industry, UK.[19]

4. Norway: Statistics Norway, Oil and Gas Activity, 4th Quarter 2002, Table 45.

Oil Prices – prices for oil: Dubai, oil spot crude price. U.S. dollars per barrel. 1972-1985: Arabian Light; 1986-2001: Dubai. Sources: Brazilian Oil Report and BP Statistical Review of World Energy, June 2002.

Natural Gas Prices – prices for natural gas: U.S. Natural Gas Wellhead Price (Dollars per Thousand Cubic Feet). Source: Energy Information Administration, Historical Natural Gas Annual.

Investment – For investment series, in U.S. dollars, we use the number from the Oil Report (several years). The nominal series is converted to 1994 dollars by deflated by the producer prices *Oil and gas field machinery and equipment manufacturing. U.S. Department of Labor, Bureau of Labor Statistics* (pcu333132333132). This series begins in 1965. For 1954 to 1964, we use the U.S. Consumer Price Index.

Wages – U.S.: Average weekly earnings of production workers, oil and gas extraction. U.S. Department of Labor, Bureau of Labor Statistics (ceu1021100004).

A.1 Capital Stock

We constructed the capital stock of Petrobras using the perpetual inventory method on investment (x). The law of motion for capital stock is:

$$k_{t+1} = (1 - \delta)k_t + x_t \tag{3}$$

where k is the capital stock and δ is a constant depreciation rate. We assume a depreciation rate (δ) of 4% per year. Since we start accumulating investment in

[19]Thanks to Philip Beckett and Mike Earp, Department of Trade and Industry, UK.

1954, the year Petrobras was established, the initial capital stock comes from the data.

A.2 Total Output: Oil and Gas

Typically, petroleum exploration and development yields a joint product: oil and natural gas. The typical way to aggregate oil and gas output has been to convert natural gas to 'oil equivalent' at a fixed ratio based on physical thermal content or on some thermal value content implied by relative wellhead prices at a given point in time. There is a major problem with fixed coefficient. Relative values of oil and gas change over time and this affects the problem of firm (see Aldeman and Watkins [1]).

To adjust our data to this possibility, we transform the amount of gas produced into oil using the price of gas relative to oil in the U.S. spot market. Data constraints prevent us from producing country specific series. Though the relative prices can differ across countries, the variances are very similar. The intuition behind these procedure is that in equilibrium the marginal rate of transformation of gas in oil is equal to the relative price. Therefore the total amount of oil produced is given by:

$$y_t = o_t + \frac{p_{gt}}{p_{ot}} g_t \tag{4}$$

Where o_t is the production of oil in period t (thousand barrels day), g_t is the production of gas in period t (million cubic feet day), p_{ot} is the price of oil (Dubai – barrel price), p_{gt} is the price of natural gas (U.S. natural gas wellhead price – dollars per thousand cubic feet).