A HUMAN RIGHTS CENTERED ANALYSIS OF EAST TIMOR'S PROPOSED PETROLEUM FUND[1]

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Summary

In a Public Consultation Discussion Paper, East Timor has recently proposed a Petroleum Fund (hereinafter "the Fund") to manage the revenues it receives from petroleum development.[3] Though it follows a Norwegian model,[4] the East Timor Fund is unlikely to be nearly as effective. The Fund, as currently envisioned, could easily be subject to abuse because there are no serious checks on parliament to prevent it from accessing and potentially depleting the Fund. In addition, the law raises several human rights concerns. First, the Fund's structure and maintenance of assets abroad[5] raises potential issues of distribution of benefits to Timorese populations. Similarly, Fund investments should be made in socially conscious investments that uphold principles of human rights. Furthermore, the Fund's transparency provisions are not strong enough; they neither mandate that records be clearly and widely publicized, nor that they be in languages accessible to minority population groups. Finally, the Discussion Paper does not

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[1] These comments primarily focus on human rights issues, though many of the comments could be applied to other arenas like energy independence (*see supra* discussions on guidelines that include human rights protection).
[2] Thanks also to James Cavallaro and Amy Lehr for their review and comments on the memo.
[3] *Establishing a Petroleum Fund for Timor-Leste*, Public Consultation Discussion Paper, Ministry of Planning and Finance, October 2004.
[4] *Id*. at 4.
[5] *Id*. at 13.

explicitly include any guidelines and/or rules that might incorporate human rights or environmental protection measures into the way the Fund is managed or utilized.

A Description of the Fund

The Fund would segregate all of the government's petroleum revenues into a Petroleum Fund, which would be invested in low-risk foreign assets and investments. As fashioned in the Discussion Paper, the revenues of the Fund would routinely be used to offset any budget shortfalls,[6] and the remainder would stay under investment. Through sound financial management by East Timor, the idea is to turn the revenues from petroleum into a long-term savings fund; this would be done by avoiding unsustainable short-term expenditures.[7] The Ministry of Planning and Finance and the equivalent of the central bank (the Banking and Payments Authority) will manage the Fund.[8] Fund spending is a function of the nation's budgetary policy, and more specifically the size of the deficits the parliament runs up; although there is discussion of the sustainability goals in the Discussion Paper,[9] the Fund contains no constraints in this area.

An Essential Weakness of the Fund

The Discussion Paper asserts that the East Timor Fund is modeled after the Norwegian model.[10] In most respects, this is true. However, there is a fundamental difference between the

[6] *Id.* at 11 ("The outflow from the Fund will be the amount necessary to finance the government budget deficit (excluding petroleum revenues). This design creates a direct link from the budget deficit (excluding petroleum) and the use of the Fund's capital. Increased government expenditure or lower tax incomes (from domestic activities) result in smaller net allocations to the Fund."). The Discussion Paper does acknowledge some possibilities for borrowing, but devotes more attention to the routine off-setting for budget deficits by the Fund. *Id.* at 13.
[7] *Id.* at 8, "Petroleum Wealth, a Blessing or a Curse?"
[8] *Id.* at 13.
[9] *Id.* at 16-24.
[10] *Id.* at 4.

funds that makes the East Timor model unlikely to be nearly as effective as the Norwegian model. The East Timor Fund provides for easy funding of budget shortfalls with the Fund capital.[11] In contrast, the Norwegian fund, the only comparable program,[12] requires that the parliament pass a specific resolution each time it seeks to access its fund capital, thus making it far more difficult to spend the money.[13] This is a crucial difference; the Timorese parliament will be able to treat the fund money as simply part of the budget, and will be free to spend it at will. The proposed East Timor process also makes the process of accessing the money less public; while Norway requires a congressional resolution (with the accompanying parliamentary procedures and safeguards), the automatic transfer in the Timorese fund would be relatively quiet.

Norway effectively puts petroleum revenues in a "lockbox." East Timor has the box part, with segregated funds, but does not lock it with anything resembling a procedural barrier. Without this lock, the Fund may not justify its costs.

Human Rights: Foreign Investment

The Fund's assets will be invested in "low risk financial assets abroad", which raises several concerns, especially given the major weakness in the Fund discussed above.[14] First, by definition, this means that funds coming into Timor will be held abroad, which will potentially prevent them from being used for improvements or management within Timor. Due to concern

[11] *Id.* at 11.
[12] Chad has a more limited fund that involves some oversight of petroleum spending, and setting aside 10% of revenues in a limited fund. Charles McPherson, "Petroleum Revenue Management in Developing Countries," *World Bank*, at 13-14.
[13] Norway Act no. 36 of 22 June 1990, §3 ("The Fund's capital may only be used for transfers to the central government budget pursuant to a resolution by the Storting (Norwegian parliament). The Fund's capital may not be used in any other way, nor may it be used to provide credit to the central government or to private sector entities.").
[14] *Id.* at 13.

over the possibility of corruption and fears of upsetting local economies,[15] very little of the Fund may end up being used for long-term investments within East Timor (e.g. roads, housing, etc.) if the budgetary process over-emphasizes long-term savings instead of short or medium-term "physical asset" development.[16] If such political decisions are made to defer use of the Fund, the downside of this policy could implicate economic and social rights of the current population (noting that these needs should be balanced against inter-generational equity and other policy considerations). Although there may be very good reasons for this policy (corruption, economic distortion, and risk avoidance), the interests of Timorese in local investment must be raised.

The second concern raised by the maintenance of the Fund abroad is that the benefit of these funds could end up in a tiny handful of Timorese managers and bankers in international financial centers. This concern is especially strong when one considers there are no safeguards to prevent overspending of the Fund (as there are in Norway); this is the opposite scenario from the first concern raised immediately above. If, for example, the money in the Fund is spent each year, then in practice, money will flow offshore each year to the Fund and then return to East Timor through its national budget. In its most extreme, the Fund could be little more than a means of siphoning several million dollars of petroleum money to investment bankers as they manage the transfer of the Fund's assets in and out of the country.[17]

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[15] *Id.* at 13 ("The Petroleum Fund's savings are to be invested securely in low risk financial assets abroad, so that they are available when there is a need to draw on them. By investing a large part of the petroleum revenues securely in international financial markets, one reduces the risk of the Fund's savings ('not all eggs in one basket'). This strategy also has the benefit of putting less pressure on the domestic economy and contributes to a balanced economic development. (Had the Fund invested large savings in assets in Timor-Leste, these activities could contribute to a rapid increase in prices and accelerate the structural changes in the economy frequently associated with the use of petroleum revenues.) There is also a concern that investing domestically may increase the risk of corruption and bad governance.").

[16] *Id*. at 16. The Discussion Paper points out that the Fund can be spent in two ways, on "'physical assets' (e.g. infrastructure like roads, education to improve the human capital) or in financial assets (e.g. bank deposits, bonds and equities – channeled through the Petroleum Fund)." *Id*.

[17] International bankers and the Fund's managers will incur fees under any scenario if the Fund is maintained abroad, and as mentioned this may be worth the cost of preventing corruption and local economic distortions and

Finally, no matter where the Fund's assets are maintained—locally or abroad—there should be specific requirements to maintain "socially conscious" investments. In addition to mandatory requirements, these could be added explicitly to the Fund's Key Principles (Box 3: #6): "The investment of fund resources to be exercised according to written and approved guidelines which emphasize a conservative, low risk, ***socially conscious*** approach to the placement and management of funds."[18]

Human Rights: Guidelines and/or Rules

The Discussion Paper mentions that "many countries have introduced fiscal rules", but then it dismisses adopting such rules because "they do not allow future governments to react to unforeseen circumstances, such as wars, epidemics, demographic changes etc."[19] It goes further to state that the main considerations for assessing fiscal policy should be: 1) inter-generational equity, 2) the economy's absorptive capacity, and 3) macroeconomic stabilization objectives.[20] While the Discussion Paper professes to not address "how" the Fund will be spent,[21] this cursory discussion of guidelines leaves human rights and other social protections absent from the Fund's framework.

Given that the Discussion Paper specifically recognizes that "many petroleum producing countries are associated with negative developments like: poverty and lower economic growth; prone to conflict, war and civil strife; corruption; and unrepresentative government," structuring

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inflation. The scenario in the text highlights that if the Fund is not accumulating long-term savings, then the primary beneficiaries of the Fund will be international bankers.

[18] Discussion Paper at 15 (bolded and italicized language added to original text).

[19] *Id*. at 18-19.

[20] *Id*. at 19.

[21] *Id*. at 5.

the Petroleum Fund to prevent such ills would seem appropriate.[22] The Fund, for example, could be established to include explicit reference to human rights principles, norms and protections.

Several alternatives exist for including human rights protections in the Fund's framework. For example, the Fund's Key Principles (Box 3) could include reference to human rights and environmental protection or sustainable development or even the goal of reaching energy independence. Similarly, in addition to inter-generational equity and economic considerations for how the Fund will be spent, the Fund could explicitly seek to improve human rights protection and sustainable development and to prevent negative outcomes associated with petroleum producing countries in the past.[23] Another approach would be to create specific rules or percentages of the Fund to be devoted to promoting human rights or increasing energy independence or some other specific social issue of importance.

A "watchdog" mechanism could be used to verify compliance with the guidelines and/or rules that are eventually adopted. To alleviate concerns that guidelines and/or rules might overly constrict the Fund and discretion of future governments in times or war or crisis, specific procedural rules (e.g. supermajorities or declarations of national emergencies) could be created to allow for deviations from the normal provisions.

Human Rights: Transparency

The Discussion Paper states that transparency is a clear goal of the Fund, and provides for Fund reports and spending to be made public.[24] However, transparency in this case is limited to

[22] *Id*. at 8.
[23] This would explicitly add a fourth consideration to the Discussion Paper's Fiscal Policy Guidelines: 1) Inter-generational equity, 2) The economy's absorptive capacity, 3) Macroeconomic stabilization objectives, ***and 4) human rights protection and sustainable development and the prevention of negative outcomes associated with petroleum producing countries in the past***. *Id*. at 19 (bolded and italicized language added to original list).
[24] *Id*. at 14.

reporting in the regular budget reports and in a single annual report.[25] As stated above, there need not be debates about the spending, so the Fund's activity will not necessarily appear in government policy discussions. There are also no requirements that the single annual report be published in all languages spoken in the country. This makes it unlikely that spending of the Fund's assets will be easily accessible to most of the population. Without aggressive supervision and publicity by civil society organizations, spending and management of the fund, while theoretically public, will likely be relatively obscure. The goal of transparency is a good one, and the 'watchdog' provision would be a good step,[26] but more specifics are needed. This limited transparency raises human rights concerns, and could be remedied with relative ease by employing very specific reporting requirements.

Conclusions and Recommendations

The Timorese government should follow the Norwegian model and require parliamentary approval for every transfer from the Fund to the budget. If there are no spending constraints accompanying it, the Petroleum Fund may be ineffective, and will raise human rights concerns.

The Timorese government should also ensure that the Fund is managed through "socially conscious investments." Furthermore, at a minimum, the government should include specific reference to human rights and sustainable development in the Fund's key principles. The

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[25] *Id.* at 14-15 ("The Ministry of Planning and Finance will report on the Petroleum Fund through the regular budget documents and a separate annual report. . .
· The Banking and Payments Authority will report regularly (probably every quarter) on the operational management of the Fund, both to the Ministry of Planning and Finance and to the public.
· There will be independent external, independent audits to bolster confidence that money going to, from or remaining in the Petroleum Fund are not misappropriated.
· One can also consider establishing an independent Council of Eminent Persons to monitor and inform Parliament on all aspects of the operations of the Fund. This council could act as a "watchdog", where the aim is to contribute to an informed public debate and a sound management of the petroleum wealth. The council could comprise a few eminent persons in whom there is a wide degree of trust and respect within the Timorese community. One could also contemplate including someone widely respected internationally, with integrity and knowledge about the management of petroleum wealth, who could contribute with an international perspective.")

[26] *See id., supra note* 25.

government should also more thoroughly consider other guidelines and rules that seek to ensure human rights protection and sustainable development through the management and use of the Fund. The Timorese government should adopt clear and specific disclosure standards to ensure that the public has easy and easily understandable access to the uses of the Fund. Finally, the government should create some specific ‘watchdog’ mechanism to verify the Fund is managed and used appropriately and in line with its key principles.