Comments on Timor-Leste Ministry of Planning and Finance Discussion Paper "Establishing a Petroleum Fund for Timor-Leste"

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This memorandum contains a few short remarks on the Discussion Paper laying out the East-Timorese government's proposed policy for a petroleum fund.

1. Fiscal policy considerations surrounding the establishment of a fund

The Discussion Paper gives a clear and fairly comprehensive analysis of the fiscal challenge posed by the special nature of petroleum revenues. The uncertainty, volatility, and non-permanence of oil revenues means that sound fiscal management involves high rates of savings; a petroleum fund is a useful way of facilitating such savings.

An important preliminary question is how exactly petroleum revenues are defined. The Discussion Paper addresses this question and chooses the wise policy of including all revenue flows to the government from petroleum activities, whether they be in the form of tax oil, profit oil, or royalty oil/First Tranche Petroleum. The relevant section (p. 11) is, however, unclear on signature bonuses, production bonuses, and other payments—it should be made unambiguous that all such payments are counted as oil revenues and should be treated equally with respect to the eventual petroleum fund.

The tradeoffs involved in the choice of various savings policies are very well explained and should be taken to heart by all partners in the East-Timorese policy debates. The choice of maintaining constant the real value of the expected oil wealth seems like a prudent savings policy. Note however a mistake in the graph in Box 4: Line (b), showing the level of spending under a savings policy of maintaining the real *per capita* value of petroleum wealth, should be upward-sloping in the top graph. Under this policy, total spending would be lower in early years, but higher in later years, keeping real spending per capita at a constant level. Conversely, the policy advocated by the Ministry involves a *falling* level of per capita spending so long as population growth is positive.

This savings policy, however, is not incorporated in the rules of the fund. The Discussion paper makes it clear that the fund is a mere accounting device, and that the savings policy is to be implemented through the regular budget process, which is to be guided by a "longer-term fiscal policy guideline." In the absence of such a guideline, or in a situation in which the political economy of Timor-Leste makes such a guideline ineffective in the ordinary budget process, the proposed institutional set-up of the fund would do nothing to secure the desired savings policy. The Discussion Paper could be clearer on this. A new, poor nation like East Timor differs fundamentally from the stated model of Norway, precisely in that one cannot simply assume that future annual budgetary processes will respect a fiscal policy guideline if it has no legal force. Nor, indeed, can one assume that future governments will even try to

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commit to such guidelines. This means that the role of a petroleum fund must be discussed also with a view to how it can *promote* good fiscal policy, not just presuppose it. This is further discussed below.

A similar point can be made about stabilization. The Discussion Paper makes it clear that the level of expenditures must be divorced from short-term revenues, but the proposed structure for the fund does not do this. The stabilization function that a fund could have is again relegated to the budget process, without any reason to believe that such policies will in fact be followed once the oil revenue is flowing in. This is also further discussed below.

2. Institutional considerations surrounding the establishment of a fund

a. Institutional independence of the fund

The Discussion Paper states that the "fund should be coherently integrated into the budget process." This is an important principle, as such an integration is crucial to facilitate good economic management. Multiple budgets can only serve to confuse the optimal allocation of government spending, and undermine the coherence of the budgetary procedure in the executive and the legislative branches. More importantly, however, a unified budget maximizes transparency and thereby minimizes the opportunity for corruption and mismanagement.

It does *not*, however, follow that the fund must therefore operate "only as a government account rather than a separate institution," as the Ministry suggests in the Discussion Paper. While it is not exactly clear what is meant by a "separate institution," there are many intermediate solutions in between the Norwegian model of a fund that is a merely virtual government account, and the "trust fund approach" described in the Discussion Paper's footnote 4. It is entirely possible to set up a fund that enjoys institutional distance from the executive—thereby providing additional checks and balances on any sitting governments' ability to overuse oil revenues or draw down the oil wealth for its own political benefit—without having any spending authority on its own.

The Oil Revenue Management Law currently under parliamentary debate in São Tomé e Príncipe is a case in point. Under the proposed Bill of Law, all oil revenues have to be paid into a 'National Oil Account' which is managed by an Investment Committee and supervised by an independent Petroleum Oversight Committee. There are strict limits on how much can be spent in every year, so the allowed transfer in part determines the budget process rather than *vice-versa*. This will not lead to multiple budgets, however, since the only transfers allowed are transfers to the national government budget (within the limits). The limits are secured by requiring the joint signature of several branches of government before the holding bank is authorize to execute a transfer.

The Timor-Leste proposal instead leaves the flow of funds completely to the discretion of the yearly budget process. This means that all the political economy challenges that the Discussion Paper (rightly) raises simply remain where they would have been without a fund: In the yearly budgetary process. The people of Timor-Leste should seriously evaluate whether their governing institutions and public officials are sufficiently experienced that they will be able to implement a sound long-term fiscal policy on the basis of the discretionary budgetary decisions of governments that depends on regular electoral success. While

Norway's fiscal policy institutions may have succeeded in this, it is doubtful that the same framework can be successfully transplanted into Timor-Leste's situation.

b. Legal status of the fund

The Discussion Paper envisages a fund that is essentially an accounting device. Other options are possible, as discussed above. Whichever option is chosen, the decision has to be made as to the legal status of the fund. At one extreme, the fund could be treated as no more than a separate government account, without even being enshrined in law. At the opposite extreme, the fund could be established by constitutional amendment. The appropriate legal status should be chosen with a view to the possible incentives for future governments to attempt to overturn the restrictions imposed by the fund structure (which in the current proposal are admittedly very weak, therefore arguably not requiring a strong legal protection). While this is a decision to be weighed by the appropriate Timorese stakeholders, it is an issue that has not been sufficiently considered in the Ministry's Discussion Paper.

c. Transparency

As the Discussion Paper stresses, transparency is absolutely necessary in the management of oil revenues. The Paper makes important commitments, such as signing up to the recommendations of the Extractive Industries Transparency Initiative, external audits, and accessible reporting of petroleum fund balances and transactions.

There are several additional steps that could be taken to reinforce the transparency of revenue management:

- Not only payments by oil companies (and subcontractors) to the government, but also all their contracts should be published. Confidentiality clauses should be limited to information legitimately considered intellectual property, such as seismic survey data, but all financial agreements should be in the public domain. This allows all concerned observers to verify that the payments made correspond to what is owed, as well as to evaluate whether the government is performing the best it can in negotiations with oil companies.
- One should attempt to make the petroleum fund balance accessible in real time over the internet.
- There should be concrete requirements of how the information is to be made realistically accessible to all citizens of Timor-Leste. This might involve a requirement of translating all relevant documents into local languages, or the establishment of a library or public registry where people can physically access the information.
- There should be an independent watchdog body that would oversee all the government agencies charged with parts of the oil revenue management process. In particular, such an independent group should have the power to enforce the transparency requirements that the oil revenue legislation should include. The Discussion Paper mentions the possibility of a "Council of Eminent Persons," but the non-committal language ("one can consider establishing…", p. 15) leaves it unclear what the Ministry's position on this possibility is.

Again, the Oil Revenue Management legislation of São Tomé e Príncipe provides examples of all of these suggestions.

3. Institutional prerequisites for sound fiscal policy-making

As mentioned above, the proposed design of the fund leaves the whole burden of choosing appropriate savings and stabilization policies within the regular annual budget process. As is well understood, this runs the risk of holding fiscal policy hostage to short-term political pressures and encourages a political economy of populism. A large part of the Discussion Paper (p. 6-9) is devoted to explaining the particular challenges of natural resource-dependent economies; yet no remedial policies are proposed, short of the exhortation to follow a long-term fiscal policy guideline.

Essentially, the Ministry proposes a fund structure that serves as an instrument for whatever fiscal policy is produced through the budget process, but begs the question of how to ensure that fiscal policy is sound. Given that one important rationale for an oil fund is to facilitate good stewardship of oil revenues, this is a serious omission.

An alternative view is to see the fund not as a complement to (assumed to be already existing) sound fiscal management, but as an institutional lever to promote it. If the fund was set up to automatically take care of the chosen savings and stabilization policy, the budgetary process would be put in a situation of a country without natural resource revenue. Suppose that the fund was set up not to finance the budget deficit, whatever it might be, but instead followed the São Tomé model of paying out a fixed annual amount in real terms (the permanent income).[2] The annual budget would then have to balance internally generated revenues against expenditures in the ordinary way, without having to take account of the question of saving and stabilizing oil revenues. It would have a predictable, stable, and permanent source of revenue which would allow it to finance permanent primary deficits of a certain size, much as if the country had a positive foreign asset position that paid interest in perpetuity. In such a set-up, countercyclical fiscal policy to stabilize the domestic economy could be handled through short-term borrowing like in other countries.

[2] Essentially this would involve legally enshrining the Ministry's proposed savings policy as the limit on payouts from the fund.