



# *Spotlight with NRI*

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### **PNG's Sovereign Wealth Fund: The Critical Elements**

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#### **Introduction**

There are many reasons why the structure and operations of the Sovereign Wealth Fund (SWF) for Papua New Guinea (PNG) must be fully debated. First, revenues from past extraction of PNG's natural resources have failed to impact the lives of the average citizen. In fact, the average citizen has become poorer. This experience is instructive for the present debate. The emphasis must be on ensuring that the LNG income stream and revenues from other similar projects transforms positively the lives of the average citizen, both now and into the future. Second, the magnitude of the projected revenue from the current PNG LNG project is such that its impact on the macroeconomic stability is critical. Prudent strategies aimed at stabilising the plausible macroeconomic consequences from the current and future projects must be packaged into the SWF structure. Finally, protecting the purpose and intent of the SWF through the approved management structure is critical.

The National Research Institute (NRI) places great importance on the establishment of a sound SWF. The NRI engaged in and contributed to the initial consultation discussions in 2010 and at the same time released a Discussion Paper (Johnson, 2010) proposing key areas to be considered in the establishment of a SWF for PNG. In July this year, the NRI engaged another researcher to provide an update on progress made

with regard to the establishment of the PNG SWF and his report is being released as an Issues Paper (Osborne, 2014). His report indicates that various changes are being proposed to the original SWF Bill approved by Parliament in early 2012. This Bill has yet to come into effect due to (it is argued), procedural errors.

It has been speculated that the final structure of the SWF Bill is scheduled to be tabled in the coming (October) Parliament session. Missing from the design of a SWF has been a transparent and wide-ranging debate on its aims and a structure most likely to deliver the intended benefits. As we write this article, we are well aware that the PNG LNG has started exporting. Proceeds from these sales accruing to PNG need to be deposited responsibly.

We therefore continue the series of NRI discussions with the view to ensuring that the SWF is properly structured, established and managed. This article expounds on the three issues raised above and emphasis throughout this article is on the key elements which need to be an integral part of the PNG SWF. We do so to inform the wider public of the issue in order to promote a more informed and robust discussion leading to the formulation of a sound SWF policy mechanism.

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## Brief Overview of the chronology of events for the PNG SWF

We outline the chronology of events to inform of progress to date.

- **March 2010:** The NEC established a joint Department of Treasury-Bank of PNG Working Group to begin consultations. Consultation meetings were organised and discussions were undertaken with input from international and local experts and various interest groups.<sup>1</sup>
- **November 2010:** The 2011 Budget was passed (under the Somare Government) which outlined the first SWF structure. The key elements proposed were: (a) a stabilisation fund; (b) an infrastructure fund; and (c) a savings (futures) fund.
- **November 2011:** The 2012 Budget passed (under the O'Neill Government) made a proposal for the establishment of a SWF under an organic law. The structure was altered to include only two funds: a stabilisation fund and a development fund.
- **November 2011:** SWF Organic Law was published in the National Gazette.
- **December 2011:** The SWF Organic Law was tabled in Parliament.
- **February 2012:** The SWF Organic Law was passed after its second tabling in Parliament.
- **March 2012:** The SWF Organic Law was certified. However, this was later suspected to be defective because of a procedural error. Questions about the validity of the Organic Law were raised and discussed.
- In attempts to rectify the procedural error, it is understood that the Government took the opportunity to propose significant changes to the SWF. There have been some statements and media reports of changes, but there has been an absence of an open consultation process, so it is unclear what changes are being proposed. The Prime Minister had indicated in media statements that a Bill on the SWF would be tabled in the November sitting of Parliament.
- **Current status:** The final structure of the SWF remains to be made public and the legal status is expected to be decided in the October

2014 Parliament sitting (which is at the end of this month).

## Need for Bench Marking the SWF

Given the continuing changes and secrecy surrounding the structure and the legal status of the proposed SWF, there is a need to emphasise a set of benchmark or critical factors (elements) that need to be made part of the SWF. Good governance of a SWF of the nature being envisioned demands transparency in real-time of the health of the fund and its deliverables to date.

We focus our analysis on the following four (4) key elements, that we argue, need to be part of PNG's SWF structure and management:

- a futures fund to look after the needs of the future generation;
- a stabilisation fund to stabilise government revenue (and expenditure) and to mitigate the adverse impacts of external shocks;
- investment in key areas to promote broad-based economic growth; and
- an Organic Law to ensure accountability and good management.

## Need for a Futures Fund

A futures or savings fund is of vital importance for ensuring intergenerational equity. The fact that we are developing or extracting the natural resources now denies the future generation or the unborn child from a say or decision in the development of the resources. Hence, it is critical that a portion of the proceeds is saved and sustainably invested for the benefit of the future generation. If the current generation mismanage their share and do not benefit, at least the future generation will have the opportunity to learn and spend their share of the benefits.

In terms of the structure of the PNG SWF, a futures fund was part of the initial model (in 2010); however, it was excluded in the version passed in the 2012 budget. It is hoped that the new law to be passed in Parliament this month includes a futures fund component. As stated, this is critical for achieving intergenerational equity.

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<sup>1</sup> The final report of the Working Group is contained in a Discussion Paper published by the Department of Treasury (2010).

### ***Need for a Stabilisation Fund***

The role of a stabilisation fund is two-fold. First, a stabilisation fund can be used to maintain a steady level of government revenue in the event of major fluctuations in global commodity prices. In the context of PNG, it is a primary resource and export dependent economy, which makes it susceptible to commodity price fluctuations. For instance, between 2004 and 2008, PNG enjoyed high revenues due to high commodity prices resulting in the need for several Supplementary Budgets passed by Parliament to deal with the surplus revenues. This resulted in unspent funds put away in Trust Funds with limited information available on how these funds were spent. A soundly structured and administered stabilisation fund will smoothen flows of government revenue (when prices are low). This will ensure that expenditure on vital economic and social development sectors are adequately financed throughout.

The other reason for a stabilisation fund is to cushion the impact of external shocks on the internal structure of the economy.

This is mainly in terms of avoiding inflation and minimising the negative impacts of an exchange rate appreciation on the other export sectors (i.e. Dutch Disease). Besides the resource extraction sector (mining and petroleum), PNG needs to grow its large agriculture sector (coffee, cocoa, palm oil and copra), fisheries and forestry and the tourism sectors. Hence, inflation and appreciation of the exchange rate brought about by big revenue inflows, in the absence of an efficient stabilisation fund would be detrimental to these non-mining export sectors. It is therefore vital that the PNG SWF must have a stabilisation fund component.

### ***Need to invest in areas for broad-based growth***

The ultimate objective of the SWF is to ensure that the proceeds from the PNG LNG project are utilised in the development of the country. Nation building requires investment in strategic areas of the economy. Investments projects should include sectors of the economy that broadens and allows for the greater segment of the population to be sustainably engaged in the national economy. Investments should therefore be in areas that promote broad-based and inclusive growth. That is, more and more of the population must be given opportunities to engage in the production of goods and services,

which will make growth more broad-based and inclusive. The latter entails the creation of jobs for the thousands of youth entering the workforce every year.

The SWF presents an opportunity for investment in critical sectors such as agriculture, tourism and fisheries, where the majority of the citizenry can be meaningfully engaged sustainably. The starting point is to get the basic economic and social infrastructure functioning efficiently. This requires investments in critical sectors such as infrastructure, law and order, and property rights.

This component of the SWF is catered through a process whereby funds are drawn from a development fund, which is used to fund major investments, such as the key economic infrastructure, SMEs and the land and property market, through the annual budget process.

### ***Need for an Organic Law as the legal framework***

The design of the SWF must draw on lessons from both at home and abroad. Many will recall that PNG had set up similar funds in the past such as the Mineral Resources Stabilisation Fund (MRSF) with similar objectives. The MRSF and other funds collapsed largely because of weak guidelines and poor governance. The legal framework or shape that the SWF takes on is vital, as it will determine its usefulness in terms of the sustainable management of the fund and accountability by those who will be managing the fund.

The key point to note is that the fund must be governed by an Organic Law and consistent with provisions of the *Public Finance Management Act*, as opposed to an ordinary law of Parliament. This is to ensure that the legal status of the Fund is not easily manipulated by those who may seek to change it for whatever reason they have, which may be detrimental to the wider good of the population. Easy manipulation can happen under an ordinary law but not under an Organic Law, which requires the Parliament and the different processes (i.e. gazettal, readings and certification).

Although there was an Organic Law on the PNG SWF passed in February 2012, it has been subsequently deemed questionable due to a procedural error. For the reasons articulated above, it would be proper for an Organic Law to be tabled in Parliament and passed only after it has been properly debated.

## Conclusion

The SWF can be a useful tool to manage the risks of external shocks to the PNG economy while advancing the development aspirations of the country. While the action taken by the PNG political leaders to create a SWF is a step in the right direction, the failure of the political leadership in this country to have the SWF established and made operational prior to the commencement of export is of grave concern.

The level of secrecy surrounding the structure of the SWF and the lack of open debate on this important issue is serious. In this paper, we have taken the liberty to make our views known that, the success of the fund in achieving its objectives depends on its structure, legal framework and management. The structure needs to conform to the critical elements highlighted in this article.

More importantly, lessons from the past demonstrate that the SWF needs to have a sound legal framework, built on an Organic Law. Otherwise, the PNG LNG proceeds will disappear into thin air. This has happened in the past and history may repeat itself, unfortunately, to the detriment of us all and especially our future generation. It would be irresponsible of us, the current generation, to allow that to happen.

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