Social fund for oil revenues: Valid option, but not a panacea

The discovery of giant pre-salt offshore oil reserves brings to Brazil the traditional dilemma of countries that are major oil producers: On the one hand, an abundance of oil is good news; on the other, it requires an institutional framework that minimizes the significant fiscal and exchange rate risks that characterize the "resource curse." One major component of the institutional framework to manage oil revenues in Brazil is the Social Fund of the Pre-salt Oil Revenues that draft law 5,940 of 2009 would set up. The fund would be a stabilization sovereign wealth fund like those established by several countries that enjoy significant revenues from oil or other natural resources.

Fiscal policy must take into account the fact that oil prices — and therefore revenues — can vary widely, but public expenditure tends to be stable, with a high degree of inertia. Since the end of the 20th century Brazil's public spending has been increasing. A government heavily dependent on oil revenues is subject to periods of alternating financial abundance, with the associated risks of waste, and penury, which presents fiscal problems. At all three levels — federal, state, and local authorities — Brazilian government revenues from oil are projected to reach 1.6% of GDP in 2024 and 2.7% when production peaks in 2034. Such large and potentially volatile oil revenues raise considerable fiscal risks that should be addressed beforehand.

Insurance — Sovereign funds are used to stabilize oil revenues and offset their inherent volatility. In other words, they are instruments of self-insurance. The fund ensures that revenues do not fall when oil prices decline, preventing drastic cuts in government spending. Also, the funds promote intergenerational redistribution of oil resources. Since oil and other minerals are nonrenewable resources, the fund makes it possible to accumulate savings for future generations.

Sovereign funds help to manage Dutch disease — the loss of international industrial competitiveness that results from exchange rate appreciation caused by large oil-related inflows of US dollars. The funds often use part of the oil revenues to buy foreign assets to help relieve exchange rate appreciation.

Political cycle — Political competition tends to lead the government to pursue a looser fiscal policy. When oil revenues are exceptionally large, the administration of the day may seek to spend at a faster pace than is ideal. The opposition, with the prospect of coming to power, will seek to suppress use of those resources to a level below the ideal. Thus because of the policy cycle, intertemporal competition for resources will lead to suboptimal public spending. This problem becomes worse the less political stability a country has and the less mature its institutional development, the fiercer the competition between political groups, and the less social control and transparency there is in the collection and use of resources.

Sovereign wealth funds aim to minimize such problems, segregating oil revenues in an account where they are subject to rules on investment and spending that seek to balance

conflicting political and group interests. They can be structured in a variety of ways. Some may have rigid rules for both investment and end use of funds resulting from oil revenues; others are more flexible.

Flexible quantitative rules make it easier to adjust to unexpected shocks. If a natural disaster or social upheaval occurs, the system can respond much more quickly. In such situations very rigid rules for investing the funds could prevent their socially optimal use. Also, rigid rules cannot stand up to governments (especially those with great popular support) that are willing to bend the rules. The risk then is that the institutional environment and the protection of agreements will become even more unstable. It is also clear, however, that quantitative rules that are too flexible would destroy the main function of the fund, which is to balance the spending of oil revenues over time.

Qualitative rules define the destination of resources, limiting the power of the government to allocate resources according to its own political priorities. The intention would be to ensure a continued flow of revenue to previously agreed priorities based on social and political consensus.

With regard to fund management, the inclusion of other partners in the decision process makes it more difficult to favor certain groups over others. Some possible schemes for power-sharing on sovereign wealth funds are to abide by rules and guidelines approved by a parliamentary majority, ensure opposition participation in or endorsement of some types of decisions, and adopt quantitative and qualitative rules that disperse decision-making among different spheres of government.

A critical point is the independence of the stabilization fund. There are several ways to address the issue. The fund may, for instance, have legal and institutional independence, as it does in the US state of Alaska. Another possibility is appointing staff that is already part of the state bureaucracy — as in Norway and Chile — to manage the fund's resources and set the spending ceiling. In some cases — like Chad and São Tomé and Príncipe — civil society has a decision-making and supervisory role.

Social fund draft law — The goals of Brazil's Pre-Salt Oil Social Fund draft law are to stabilize revenues, increase public savings, and finance social development through programs in education, culture, public health, science, and technology, in addition to fighting poverty and climate change. Funding will come from both government oil revenues (signing bonus, royalties, and the marketing of oil and gas) and the income earned from investing those revenues. The fund would be directly subordinate to the Presidency of the Republic.

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Fund activities will be carried out by two separate bodies. The Financial Management Committee of the Social Fund (CGFFS) and the Advisory Board of the Social Fund (CDFS). The CGFFS must define the annual amount to be drawn from the fund and assess the risks and the distribution of the fund's investment portfolio. The CDFS will define priorities and allocate the resources drawn annually from the Social Fund.

The main quantitative rule of the draft law at first seems rigid: only the income earned on

fund assets can be spent. However, the law creates a loophole by making it possible to draw on the fund's principal when it is being formed. Although Congress is involved in defining for how long and how much could be drawn from the fund beyond earned income, clearly that loophole could considerably undermine the quantitative rule. It is crucial that the government act in good faith when proposing to Congress the final rule of the Social Fund, so that there is a balanced distribution of oil revenues over time.

Another critical point is the management model, which seems to concentrate too much power in the executive branch — more specifically, in the party and political group that controls the government. This is clear from the fact that the composition of both management bodies, the CDFS and CGFFS, will be defined by presidential executive orders, without any mandated involvement of Congress or civil society. The management of large oil revenues raises delicate dilemmas of political economy. One way of ensuring that these issues are addressed satisfactorily is to disperse the decision-making process among government, Congress, and supervising agencies as well as society and political forces, including opposition parties.

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Experience suggests that sovereign funds are not a fiscal panacea. There is no guarantee that they will actually stabilize income despite variations in commodity prices. In fact, indications are that there is no substitute for a commitment of government and society to general economic stability, including control of public spending and inflation. A government that opts for populist spending policies when oil prices are soaring probably will find ways to circumvent or even repeal the limits set by the sovereign fund law.

Sovereign funds may in fact not really be necessary. The countries that are best able to implement sound institutional frameworks for sovereign funds are those that are already committed to economic stability — in other words, countries that do not need an institutional framework to tie the government's hands. Moreover, it is perfectly feasible that for a country highly dependent on oil revenues, the government increases public debt when commodity prices fall and buys it back when prices recover, thus smoothing out public spending.

Yet in practice even countries that are mature in terms of institutions and governance and that could address fluctuations in commodity prices with proper public debt management have opted to establish sovereign funds even though such funds are not essential for sound fiscal policy. Norway and Chile are notable examples. A possible explanation is that by segregating oil revenues in an account and creating rules for their use, a country draws attention to the fiscal problem of fluctuating oil revenues and educates society about the fiscal risks. Moreover, sovereign funds make it easier to manage the exchange rate in the face of strong oil-related inflows.

Brazil does well to establish a sovereign fund in connection with the exploitation of pre-salt oil reserves. But we should bear in mind that no funds and no rule on the use of funds can replace the commitment of society and the government to macroeconomic and fiscal stability and economic rationality.