Sovereign Wealth Fund requires legal standing, binding rules and transparency

By Alexandra Gillies

Nigeria's Excess Crude Account (ECA) seeks to protect the country's economy from the volatility of its revenue base. Due to its permissive governance structures, the account will soon be empty of the sizeable windfall profits collected during the recent period of high oil prices. In response, policymakers including the National Economic Council and the Ministry of Finance are considering reforms or replacements, including the creation of a Sovereign Wealth Fund (SWF).

For a Sovereign Wealth Fund to function more effectively than the ECA, it must enjoy the following:

- ✓ **A solid legal standing**
- ✓ **Binding rules regarding inflows and outflows**
- ✓ **Transparency**

The urgent need for stabilization

Around 80% of Nigeria's public revenues come from oil, leaving the government dependent on a highly volatile income stream. Public expenditures have tended to follow the boom and bust cycles of the oil market. This contributes to damaging "resource curse" effects including indebtedness, currency instability, inflation, weak growth rates and limited economic diversification.

Special savings or investment funds help to protect against volatility by de-linking government spending from the fluctuating price of oil. Such funds pursue different purposes, and their design and structure vary accordingly. For instance, depending on the fund's objectives, the savings can be invested in domestic or foreign assets, and managed by a government entity or an autonomous parastatal. The savings also can be used for different purposes, including: compensating for revenue shortfalls; saving for future generations; or investing in the physical and human capital needed for economic growth. There is no single model that works in all countries. Rather, successful funds reflect each country's development needs, and serve as one element of a sound economic policy environment.[1]

This policy brief does *not* address whether an SWF is the ideal type of fund, nor how one should be structured. These are crucial questions which deserve careful consideration.[2] Instead, we make three basic governance recommendations—legal standing, binding rules and transparency—that will bolster the effectiveness and sustainability of any new Fund, regardless of its specific nature.

Sub-par performance of the ECA

Former President Olusegun Obasanjo's economic team introduced the **oil benchmark price** and the **Excess Crude Account** in 2003. By setting a conservative oil benchmark price and saving the revenues received over that price, they sought to discontinue the destructive pattern of volatile spending.

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[1] Heuty, Antoine and Juan Aristi. 2010. *Fool's Gold: Assessing the Performance of Alternative Fiscal Instruments…*. New York, The Revenue Watch Institute (http://www.revenuewatch.org/files/RWI_Fools_Gold_Heuty_Aristi_FINAL.pdf).
[2] See Katz, Menachem and Cijeyu Ojong. 2009. *Should Nigeria Establish a SWF?* (www.cseaafrica.org/).

After an encouraging start (including the repayment of Nigeria's external debt), the ECA has failed to serve its intended purpose. Even with heavy outflows, the ECA balance reached $20 billion in late 2008 following a historic oil price boom. But policymakers have exhausted these savings, and the current balance of $3.2 billion leaves no safeguard against future price shocks nor any resources for strategic long-term investment. Moreover, the withdrawals during recent years have not increased the quality or quantity of infrastructure, even though most outflows were designated for this purpose. National power supply, for example, remains below 4000MW despite an excess of $14 billion in ECA spending on the sector by the last two administrations. Nigerians are familiar with the wastage of windfalls; for instance, similar problems occurred in 1992, when the Middle East conflict caused prices to spike.

For a Fund to be successful, its balance must be protected from the short-term political pressures to spend. The rules establishing the fund must bind the hands of the current leader, and be seen to be binding on the successors as well. In Nigeria, where political power changes frequently, a leader will be more inclined to save if assured that the next leader will also be bound by prudence. The primary shortcoming of the ECA is the failure to provide these kinds of protections and guarantees.

President Obasanjo's withdrawals from the ECA appear ad hoc and discretionary, rather than components of a long-term development plan. His withdrawals included at least $8 billion for independent power plants, and $10 billion to compensate for overly optimistic budget revenue projections. These withdrawals, and the flimsiness of their justification, accelerated as the 2007 elections approached and the former president faced political battles and shorter horizons.

The late President Umaru Yar'Adua withdrew funds to appease state governors demanding access to the ECA balance. Federal and state authorities reached a so-called gentlemen's agreement that permitted 80% of the inflows to be distributed across the three levels of government. Since then, the balance has quickly been depleted, and the governors enjoy regular transfers from the country's "savings." President Goodluck Jonathan has continued this practice—authorizing a $2 billion outlay was one of his first actions as Acting President. These withdrawals contribute to damaging instability in state-level incomes. For instance, Bayelsa State's average monthly allocation fell from N9.8 billion in 2008 to N5.1 billion in 2009,[3] a fluctuation that illustrates how budget levels still follow price volatility.

The political pressures which drove this underperformance will always be present, especially given the very fluid and competitive nature of Nigerian politics. Savings will remain vulnerable and require careful protection. The ECA has lacked such protections. While other factors have contributed to poor performance, such as consistently unrealistic oil revenue projections, weak and malleable governance structures have played the decisive role.

New options on the table

In response to the depleted ECA and the 2008 fiscal crisis, the National Economic Council announced in June 2010 that it would consider reforming the ECA, possibly through the creation of a Fund. The primary explanation given was that Nigeria is the only OPEC member without such a fund. This is hardly adequate. A SWF should be adopted only if it best serves a coherent long-term economic strategy, and its design should reflect the specifics of the Nigerian context.

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[3] Bayelsa Expenditure and Income Transparency Initiative, 2010 (www.beiti.bayelsa.gov.ng/).

Should Nigeria choose to create a new Fund, we advance **three recommendations for how such a Fund can avoid the problems of the past.** These recommendations reflect international best practices, such as the Santiago Principles[4] and the Natural Resource Charter.[5]

✓ A solid legal standing

A fund with a contested legal standing will continue to generate controversy and competing claims.

Article 162 of the 1999 Constitution requires that "all revenues collected by the Government of the Federation" enter the Federation Account, from which they are then allocated to the three levels of government according to the formula established by the National Assembly. The *Allocation of Revenue Act* contains the current formula. Allocations of revenue outside the established formula therefore face objections. Courts ruling on this issue have tended to side with the states, calling for a strict interpretation of the sharing of revenue across all the federal units rather than their retention by the federal government. As a result, centralized saving—the saving of revenues prior to their deposit in the Federation Account—has become a source of legal debate, and this controversy undermined the sustainability of the Excess Crude Account.

The 2007 *Fiscal Responsibility Act* sought to create a legal framework for centralized savings that respected the above constitutional requirements. Article 35 states:

> Where the reference commodity price rises above the predetermined level, the resulting excess proceeds shall be saved. … The savings of each Government in the Federation shall be deposited in a separate account which shall form part of the respective Governments Consolidated Revenue Fund to be maintained at the Central Bank of Nigeria by each Government.

Therefore, the *Fiscal Responsibility Act* establishes the ECA as a collection of savings accounts, one for each constituent government, held on their behalf by the CBN. The Act goes on to empower the CBN to invest all the savings, though it must consult with federal, state and local finance authorities and identify the shares of each government and the income due to them. It then requires that the savings be accessed only if the oil price falls below benchmark price for three consecutive months, or for capital spending in the following year's budget. The Act does not specify which budget (federal or state) nor how the type, level and distribution of such capital spending should be decided.

This legal framework has failed in practice. As evidenced by their 2007 lawsuit and consistent claims on ECA funds, the states reject the idea that the Central Bank of Nigeria (CBN) manage their savings. Therefore, citing the constitutional requirement for revenue-sharing, state authorities successfully lobbied for independent control over their share of the savings, which they have subsequently spent. The Act's failure to clarify the relationship of the centralized savings with the constitutional revenue-sharing system enabled these events. Moreover, some elements of the *Fiscal Responsibility Act* are not observed: there is little evidence to suggest that the CBN engaged in the required consultations with states regarding its investment decisions, or regularly communicated information on states' respective balances. A number of the Act's other provisions also go unheeded, such as its extensive fiscal reporting requirements.

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[4] The Santiago Principles are good governance standards adopted by 23 sovereign wealth funds (www.iwg-swf.org).

[5] The Natural Resource Charter identifies best practices for natural resource management (www.naturalresourcecharter.org).

The rapid depletion of the ECA—in spite of the *Fiscal Responsibility Act*—illustrates the importance of a robust and binding legal foundation for any new Fund. A negotiated consensus is not enough: Priorities and personnel shift easily, and individual governments will inevitably seek to maximize available resources rather than support long-term saving. The resources and operations of the Fund must enjoy robust legal protection from the inevitable negotiations between the governments of the federation.

While the Constitution requires sharing of all revenues, this provision does not eliminate the possibility of centralized savings. The key step is to identify and establish the best possible legal framework for the Fund. One option is a constitutional amendment that recognizes the principle of centralized saving. Rather than addressing the specifics of the Fund and its mechanics, an amendment would legitimize the practice of centralized saving so as to permit the long-term accumulation of assets and the stabilization of the entire Nigerian economy. However, this measure may not be necessary. The Constitution empowers the National Assembly to determine the revenue allocation formula, as currently contained in the *Allocation of Revenue Act*. Future versions of this formula could accommodate savings objectives.

In either case, the new Fund absolutely requires a comprehensive and tightly drafted establishing law. The law would explicitly state the Fund's relationship to the Constitution, detail governing structures, including rules for inflows and outflows, and identify the role of each federal unit with respect to the management of the fund and their access to its assets. Article 4(5) of the Constitution contains a supremacy cause, establishing that National Assembly legislation (if constitutional) can bind the actions of state and local governments. However, the federal politics of Nigeria may necessitate special measures to establish state support for the Fund's operation, possibly including state-level legislation. At the bare minimum, in the absence of a legal solution that binds all members of the federation, the federal government could establish a Fund for saving a portion of its own revenues. This would be better than nothing, but the stabilization of *all* revenues would more fully serve the totality of the Nigerian economy.

✓ **Binding rules regarding inflows and outflows**

Which revenues will enter the account? Who can access the funds and for what purpose? All stakeholders including the public must know the answers to these questions. Rules about inflows and outflows should reflect the specific purpose and objectives of the Fund. Regardless of their exact content, these rules must bind current and future leaders. They can permit flexibility, but not discretion. Above all, the rules must protect the Fund from the day-to-day battles over resources between the various government units, and constrain access to its balance for any purpose other than the established long-term priorities.

The Fund should receive a clearly defined portion of oil revenues. The benchmark oil price is a viable approach, though currently its application to the principal oil revenue streams (PPT, royalties, crude sales) suffers from a few weaknesses. Unrealistic revenue projections lead to lower levels of savings, ECA inflows are not transparent, and some degree of confusion mars their calculation. The rules governing inflows to a future Fund could address these problems.

As for outflows, the creation of binding rules is paramount. The *Fiscal Responsibility Act* contains remarkably vague outflow rules. The steady stream of discretionary withdrawals from the ECA has occurred as a result of this failure to institutionalize and protect the saved resources. **The establishing law for a new Fund must define in detail when withdrawals can occur, for what**

purpose, and through what process. Moreover, even if the Fund is independent from the treasury, its expenditures should still be subject to the established budget appropriation process so as to facilitate coordination and oversight.

Outflow rules should ensure that all withdrawals advance the long-term economic objective of the Fund. As mentioned above, saved funds should be used to augment the budget during low price periods, to fund domestic capital investments or to save for future generations—each option has advances different macroeconomic goals. In developing countries, domestic spending to expand human and physical capital may bring greater economic benefits than holding resources in foreign assets, assuming expenditures follow broadly-accepted and pragmatic long-term development strategies. However, such spending could increase inflation or defeat stabilization objectives. Policymakers will need to consider such debates and design a Fund that reflects specific economic priorities.

✓ **Transparency**

Transparency will help to enforce the rules that govern the Fund and its financial flows. Transparency protects against abuse and reduces misunderstanding regarding the Fund's purpose and operations. If everyone knows the rules, breaking them becomes more difficult. Transparency also sends encouraging signals to external stakeholders like investors, lenders and credit ranking agencies.

Currently, information on the ECA emerges only through sporadic statements by finance officials. As an example, efforts to acquire inflow and outflow data for this publication were unsuccessful. Such opacity abets discretionary spending, and contributes to the confusion and mistrust surrounding the ECA. Widely-held knowledge of the Fund, its purpose and its operations would bolster cooperation and support from the governments of the federation, the legislature and the public. Such a well-informed consensus would help to further safeguard the Fund's sustainability.

The following information should be disclosed in an accessible and comprehensible manner:

- Objectives and strategies
- Legal standing and governing structures, including information identifying fund managers
- Rules of operation, including those covering inflows and outflows
- Guidelines in reference to ethical standards, investment policies and guideline enforcement
- Fund investment strategy, portfolio market value, benchmark returns and actual returns
- Balance, inflows and outflows, including the purpose and justification of outflows
- Independently audited annual reports that detail and evaluate the Fund's activities

The way forward

In closing, we support the efforts by Nigeria's leaders to reform the underperforming Excess Crude Account. Stabilizing the economy and protecting it from the volatility of oil prices are crucial imperatives. Moreover, carefully managed savings can be deployed in ways that stimulate the non-oil economy, and a successful Fund will help to create the economic conditions that attract investment and stimulate growth. We urge policymakers to recognize these imperatives, and equip any new Fund with the kind of governance structures capable of protecting its vital mission.