Government Debt, Spending and the Role of Sovereign Wealth Funds

Curtin Corner

Dr Kylie Coulson
Adjunct Professor

5 May 2017
Sovereign Wealth Funds

- Reasons to establish SWFs
- International examples
- Australian examples
- Redistribution options
- Policy considerations
**Sovereign Wealth Funds**

- Government controlled investment vehicles, often associated with natural resource revenue

- Three main reasons to establish resource SWFs
  - Intergenerational equity
    - Finite natural resources
  - Foreign exchange stabilisation
    - Offset exchange rate appreciation associated with increased exports
  - Reducing impact of ‘resource curse / Dutch disease’
    - Adding discipline to government expenditure
NORWAY’S GOVERNMENT PENSION GLOBAL FUND
Norway’s Government Pension Fund Global

- Established in 1990 as the Petroleum Fund, and sets aside net cash flow from the extraction of petroleum
- Managed by Norges Bank Investment Management
- Despite the change of name in 2006, it is a general savings instrument, and is not earmarked for pensions or other specific purposes
- “Spending rule” established in 2001:
  - No more than 4% of the fund can be spent on the annual national budget
  - Considering lowering to 3%
- 2016 first net withdrawal – lower commodity prices
- Expenditure increasingly focussed on education, research, infrastructure and tax cuts
Norway’s Government Pension Fund Global

- **Total value at end of 2016** was 7.51 trillion kroner (A$1.16 trillion)
  - Double the size of GDP
- **Invests in**: **Shares 62.5%**, fixed income 34.3%, real estate 3.2%

- **Total return**: 6.9% or 447 billion kroner in 2016 (A$69b)
  - Shares returned 8.7%, real estate 0.8%

- **Annual average return**: 5.8% from 1998 to end Q1 2017
- **After inflation and management costs**: 3.9%

- Management costs of 0.04% of assets under management
• Share investment has increased as a % of portfolio, with a target of 60%
  • Potentially increasing this target to 70-75%

• Explicit decisions taken to sell companies considered ‘unethical’
  • Gradual sales due to size of holdings

• Does not invest in some industries, including nuclear weapons and tobacco
TIMOR-LESTE PETROLEUM FUND
Timor-Leste Petroleum Fund

- Following independence in 2002, petroleum and gas exports began in 2004
- IMF recommended establishing a petroleum fund based on the Norway model to manage revenues
- Petroleum Fund Law passed in 2005
  - Fund established with US$370 million
- Operational responsibility lies with the Central Bank
- Until 2009, invested in US government bonds only
- Now, revenues are received in central bank account, then invested offshore by external investment managers as well as the Central Bank
Timor-Leste Petroleum Fund

• **Balance** of the fund at December 2015 = US$16.2 billion
  • GDP 2015 = US$1.4 billion

• As at December 2015, **assets were invested in**:
  • US government bonds 50%
  • Other government bonds 10%
  • Developed market equities 40%

• **Annual investment return** 2005-15 = 3.8% (**target** 3%)

• Management fees in 2015 = US$15.7 million (0.1% of fund)
Timor-Leste Petroleum Fund

- **Transfers** from the fund to government budgets are intended to be limited by the **Estimated Sustainable Income (ESI) – 3% of balance of fund**
- Transfers can be higher than ESI if approved by parliament
  - e.g. 2015 ESI = US$639 million, actual US$1.28 billion

- In 2017, 78% of government budget using $1.1 billion from the fund
- **Declining production and finite resources;** sustainability unlikely

- **Issues** with ESI of 3%
  - **Based on Norway’s model** – established nation with lower short-term infrastructure needs (T-L prioritising infrastructure)
  - Conversely, **capacity of the economy** to absorb additional spending is limited, potentially leading to inflation or ineffective / inefficient spending
AUSTRALIAN FUTURE FUND
Australian Future Fund

- Established in May 2006 to fund the cost of **unfunded defined benefit pension liabilities** for military and Commonwealth public servants
  - Reduces burden on future generations
  - Defined benefits scheme closed in 2006 – by 2040, requirement estimated at $140 billion

- **Future Fund Management Agency** (FFMA) established to oversee investment
  - Commercial funds managers used
  - Total management costs in 2015-16 $246 million
    - Approx 0.2% of funds under management
Australian Future Fund

Asset allocation as at June 2016

**Australian equities** 6.3%
Global market equities 15.2%
Emerging market equities 7.3%
Private equity 10.4%
Property 7.0%
Infrastructure and timberland 6.7%
Debt securities 11.6%
Alternative assets 13.7%
Cash 21.7%
Australian Future Fund

- Total value **as at June 2016**: $123 billion
  - **Initial contribution** from Cth Government of $60.5 billion in 2006
  - **Investment earnings of $62 billion over 10 years**
    - Net return of $5.6 billion in 2015-16 (4.8%)
  - **Three year average** return of **11.4%**
    - **Target** benchmark of **6.3%** (CPI + 4.5%)
  - **Ten year average** return **7.7%** (Target 6.9%)

- **Four other funds** established: medical research, disabilities, education, building Australia
  - Also managed by FFMA
  - Only last two have withdrawn funds
WESTERN AUSTRALIAN FUTURE FUND
Western Australian Future Fund

- Purpose: set aside and accumulate revenue from the State’s finite mineral resources for the benefit of future generations
- Established under the *Western Australian Future Fund Act 2012*, with **seed funding of $1 billion over 2012-13 to 2015-16 from Royalties for Regions fund** and interest receipts

- From 2016-17, **additional contributions of 1% of annual royalties revenue**
  - Royalties estimated at $38 million in 2016-17
  - Interest estimated at $35 million in 2016-17
  - **Earnings reinvested for 20 years**
Western Australian Future Fund

- **No separate entity created** – transactions managed by WATC on behalf of Department of Treasury
  - Management fee of $250,000 to WATC in 2015-16
  - Other costs minimal e.g. $18.50 per WATC bond transaction

- Fund can only be invested in line with the Public Bank Account i.e. **cash and high credit debt instruments**, though the Act also allows for investment in **gold**

- **More than half** the current balance of $1.1 billion is **invested in WATC and other state government bonds** – as at March 2017:
  - WATC bonds $199.3 million
  - Other semi-government bonds $579.2 million
Western Australian Future Fund

- **Average investment return above the cost of funds** in all periods since inception (e.g. 0.4% above cost of funds in 2013-14)
  - Does not allow for impact of inflation
  - Reflects lower risk approach to investments

- Higher yielding investments e.g. **corporate bonds limited to 25%** of portfolio – may be under consideration
Western Australian Future Fund

- Balance as at June 2032 (current est. $3.5 billion) to be maintained – including earnings

- Interest earned on balance of fund from 2032-33 may only be used for **public works and other economic and social infrastructure**

- Any expenditure requires **agreement** between Treasurer and Minister for Regional Development regarding:
  - Split between metro area and regions; and
  - Purpose of expenditure
Western Australia - Royalties for Regions

- Established in 2009 to provide an equivalent of 25% of annual mining and petroleum royalties
- Monies are used *over and above normal / planned expenditure*
- Can be used for *infrastructure or service delivery*

- Investment in line with the Public Bank Account
- Any income earned is credited to the fund; however
- **Balance** of the fund **not to exceed $1 billion**

- WA Regional Development Trust established to provide advice / recommendations to the Minister on how funds are to be spent
- Government approves expenditure as part of the annual Budget process

- Some ongoing expenditure pressures e.g. maintenance and operating costs of capital projects
  - Review flagged as part of 2017 election campaign
OTHER REDISTRIBUTION OPTIONS
Redistribution options

• Substitute for existing taxes
  • Personal or business

• Participatory budgeting
  • Citizen involvement in expenditure decisions

• Direct per capita cash payments to citizens
  • Transparent
  • Equitable
  • Gives expenditure control to the citizens
ALASKA PERMANENT FUND
Alaska Permanent Fund

- Established in 1976 by constitutional amendment
- Receives at least 25% of annual resource royalties
- Managed by Alaska Permanent Fund Corporation

- Balance as at March 2017 = US$57.8 billion
  - US$46.1 billion in principal
  - US$11.7 billion in earnings reserve

- Invests in income producing shares, bonds, cash and real estate
  - 8.96% year to date return
  - 7.7% annual return over five years
Alaska Permanent Fund

• Cash dividend paid to all residents of the state (1 yr+)
• Calculated as 52.5% of the fund’s earnings (less expenses), averaged over 5 years / eligible recipients
• Recently approx $2,000 per person
  • 2014 - $1,884
  • 2015 - $2,072
  • 2016 - $1,022 (was $2,052 – vetoed by Governor)
• Considered income for taxation purposes

• Based on 2015 census data, Alaska had:
  • 4th highest household income; and
  • 5th lowest poverty rate.
POLICY CONSIDERATIONS
Policy considerations

Policy options regarding allocation of resource wealth should consider:

- Governance and transparency structures
- Conditions regarding use of funds
- Retention of capital requirements
- Risk vs return of investments and targets
- Capacity of the economy to absorb additional funds
- Potential inflationary impact
- Effectiveness and efficiency of expenditure
- Potential to involve citizens in decision-making
DISCUSSION