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8.4 Alternative Means of Addressing Fiscal Sustainability

An assessment of long-term fiscal sustainability is particularly challenging in resource-rich economies due to the exhaustibility of the resource, and therefore the revenue from its production. Although this affects all countries with resources, it is much more of a concern for countries with limited resources and therefore shorter resource horizons, like Uganda, Yemen and Cameroon. In such cases, there is a need to focus on how government expenditures can be sustained once resource revenues come to an end. If there is no framework in place for fiscal sustainability, there will be considerable uncertainty about how long a government can sustain its current spending, tax and other promised expenditures. For countries with longer resource horizons, the main objective of fiscal policy will be how to manage revenue volatility as the price of the resource fluctuates. Whether or not government spending can be sustained is a less immediate question for them.

There have been various studies in recent years including several by the IMF on the fiscal response of petroleum-rich developing states to oil booms.[1] They have demonstrated the following: while the prospect of long-term fiscal sustainability was improving in many states, that prospect is being seriously jeopardized by short-term policies and behaviour that sharply increased non-oil fiscal deficits through tax cuts or dramatic escalation of expenditures. This results in significantly increased vulnerability to future revenue shocks from price collapses or resource exhaustion. Two macroeconomic management tools which can act as complementary mechanisms to funds or fiscal frameworks (rather than alternatives) in avoiding these risks are: (1) medium-term frameworks (MTFs) and (2) revenue forecasting.

Medium-Term Frameworks A medium-term expenditure framework (MTEF or MTF[2]) can help frame fiscal policy in a longer-term context, providing structure to decision-making and

[1] For example, G Shabsigh and N Ilahi, 'Looking Beyond the Fiscal: Do Oil Funds Bring Macroeconomic Stability?' (2007), IMF Working Paper WP/07/96; M Villafuerte, P Lopez-Murphy, R Ossowski, 'Riding the Roller Coaster: Fiscal Policies of Non-renewable Resource Exporters in Latin America and the Caribbean (2010), IMF Working Paper WP/10/251; for earlier work on this theme, see generally Davis, J., Ossowski, R., and Fedilino, A. (eds.)(2003). *Fiscal Policy Formulation and Implementation in Oil Producing Countries*. Washington, D.C.: IMF Media Services Division.

[2] The generic acronym for a medium term framework for fiscal policy is MTF, connecting the annual budget to longer-term policies and sustainability objectives, and enhancing risk analysis. A simple form of MTF is the medium-term fiscal framework (MTFF). More advanced in terms of their implications for how budgets are put together are medium-term budget frameworks (MTBFs) and medium-term expenditure frameworks (MTEFs). The former incorporates realistic projections of spending by individual agencies that allocate resources in line with strategic priorities and consistent with overall fiscal objectives of the MTFF. The latter takes the analysis further and provides more detailed costing within sectors and performance measures. Their implementation, especially in the more advanced forms, has to be consistent with administrative capacity.

fostering transparency and accountability. MTFs for fiscal and expenditure policy are planning tools that help connect the annual budget to longer term objectives such as poverty reduction and sustainability, and the policies to achieve them. They also enhance analysis of risks of revenue volatility, a positive feature given the need for EI producing countries to be in a strong position to deal with exogenous shocks and to facilitate orderly adjustment processes when needed. *Importantly, the publication of medium-term projections, which incorporate the policy and economic assumptions used in the framework, will assist the public in understanding the future implications of current fiscal policies*[3].

The budgets of many governments in resource-rich states continue to be too dependent on volatile and exhaustible resource revenues in the short-term and suffer from excessively short-term budget planning horizons. They would benefit considerably from introducing a medium-term to longer-term perspective to budget planning. MTFs for these states would typically incorporate estimates of future resource revenue earnings, giving important weight to uncertainty through evaluation of a range of possible future external scenarios and their impact on revenues. Additional relevant considerations would include macroeconomic stabilization, medium-term expenditure priorities, and absorptive capacity. They would also usually be formally linked to the annual budget cycle in order to be implemented properly. This can be challenging for some resource-rich countries since ministries and government agencies do not always have adequate technical capabilities to develop and implement a multi-year budget approach. It can nonetheless help to manage fiscal risks and foster expenditure smoothing. However, an MTF can be designed in a way that takes into account the stage of development of the country and also the level of administrative capacity.

An example of an MTF is the system mandated by the Fiscal Responsibility Law introduced by Mexico in 2006. The law requires the annual budget to be presented to congress with quantitative projections of the next five years and explicit costing for new fiscal measures. Other measures were included to smooth expenditures, strengthen management, promote transparency and encourage performance-based budgeting[4].

It may be asked what 'teeth' an MTF typically has. The short answer is that an MTF forces the government to think about the medium-term and about fiscal risks; it forces spending ministries to think multi-year in their budgeting and incorporate the recurrent implications of current policies; and it fosters transparency and accountability. Even so, medium-term fiscal

[3] IMF, Guide on Resource Revenue Transparency (2007), p. 36.
[4] For a discussion of MTFs in general and further examples see: Ossowski, R, Villafuerte, M, Medas, PA and Thomas, T (2008). Managing the Oil Revenue Boom: The Role of Fiscal Institutions, IMF, Washington DC, 20-23. See also more recent WB material on MTEFs: ADD

planning will retain a measure of flexibility. An MTEF is not a multi-year budget, which would entrench rigidity and hamper flexible and efficient responses to changing circumstances.

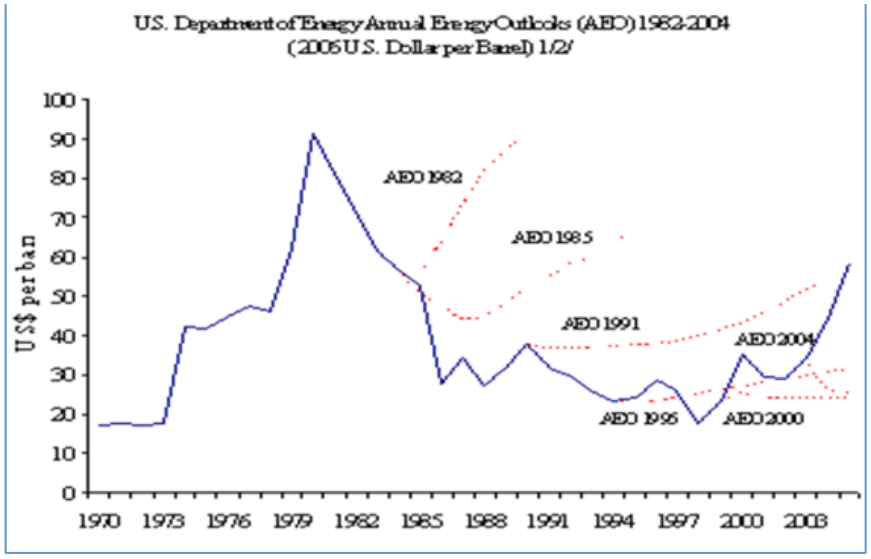
In a practical sense, there are issues that rise over the level of flexibility of expenditure. Capital spending is typically one of the most discretionary forms of public spending and is, therefore, vulnerable to periodic fiscal adjustments. If most of the recurrent expenditure is largely non-discretionary in a country and cannot be cut quickly, then, by necessity, when faced with volatility, governments could look to cut capital expenditure in a non-optimal way to spread the pain equally. The investment budget needs to have commitment control mechanisms and an ability to implement investment spending to be credible.[5]

Revenue Forecasting. Realistic resource revenue forecasting is the starting point for good practice in revenue and budgetary management. Ideally, good practice suggests that forecasts should be prepared on a (resource exploitation) project-by-project basis, applying simple fiscal models and aggregating them to the economy-wide level. Data required from EI sector investors should include expected volumes and expenditures. Price projections should be consistent with EI sector-wide forecasts, but at the same time they need to recognize the volatility of prices and the notorious inaccuracy of price forecasts (see **Figure 8.1** below). There should be a realistic resource price forecast in the budget for the next year (one price, possibly adjusted for quality in some cases) and all resource revenues should be projected on that basis, regardless of how individual companies projected their revenues on the basis of other price projections. The budget can only be set on the basis of one resource price projection; the same way that the budgets of other countries are set on the basis of a single macroeconomic projection. Then, the budget is subjected to stress tests (lower resource prices than the price in the budget, or other shocks) to assess the budget's vulnerability to potentially adverse developments, and what would be done if such circumstances arose.

Finally, price and production assumptions should be codified and not made subject to year-on-year or month-on-month manipulation in order to generate more fiscal space. However, the limits of revenue forecasting are there: a government can have good revenue forecasting and still run a reckless fiscal policy.

[5] Barma, N, Kaiser, K et al (2012) 185.

Figure 8.1: Resource Price Forecasting Experience



Source: US Department of Energy. *Annual Energy Outlook* (1982, 1985, 1991, 1995, 2000, and 2004).