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8.7 Spending Choices and Use of Government Revenues

Resource revenues, like any others, can be put to various uses, such as spending through a public investment program, benefiting the population through public expenditure on infrastructure investments, through social benefit expenditures such as health and education. They can also benefit the population by means of direct distribution to the general population through the tax system and or ‘citizen dividends.’¹ Irrespective of their origin however, they will usually become part of total government revenues. When that happens, once they enter the Single Treasury Account, they are no longer distinguishable and cannot be identified separately.

8.7.1 Domestic Investment

Growth and Long-Term Poverty Reduction. Growth is usually seen as the main way in which incomes and consumption can be increased. It creates employment, bids up wages, and broadens the tax base for future public spending and service provision. Investment in domestic assets, particularly infrastructure, is key to that growth. Several Middle Eastern resource-rich countries (such as Saudi Arabia, Kuwait, and Qatar) engaged in large public investment during the oil boom years between 2003 and 2008. This was aimed at diversifying the domestic economy and improving the quality of infrastructure. However, in many resource-rich countries the limited state capacity makes appropriate and effective investment difficult to achieve. Private sector investment, in the long run, may prove more important to growth than public sector spending, but it may also be ‘crowded-in’ by public spending in some countries.

Against this background, the traditional argument is that in the context of a resource-rich country a disproportionate allocation of public sector resource revenues should be made to domestic investment, with special attention to investments that will stimulate private sector investment. Subsidies to the poor and debt reduction should also be high priority areas. However, this statement cannot apply to countries where the stock of public capital is ample and of relatively good quality. In those countries, the marginal public dollar is likely to be better used in other ways. The key question is: what kind of ‘investment’? Governments also need to distinguish between different projects as targets for investment: how? If there is a capacity

¹ Alba, supra note 157, at pp. 14-17.

deficit this does not only mean that there is a lack of capacity to identify, implement and monitor key investment projects but also that public sector corruption will lead those with influence to allocate high-value construction contracts, in ways that are vulnerable to mismanagement. Finally, governments need to decide what processes (such as procurement, project appraisal, costing and monitoring) they need to put in place to promote effective spending.

On one view, it may be a “serious mistake” for some countries to put all their revenues in a sovereign wealth fund (investing only in financial assets outside the country) when domestic investment needs are very high². The resource revenues from EI production can alleviate capital scarcity and so create opportunities for public investment. Indeed, for some countries it may be far better to use the windfall “to steadily ramp up public investment, tolerate a temporary fall in the efficiency of public investment, and gradually boost the efficiency-adjusted stock of public capital and non-oil output”³. For certain countries then, this will influence their choice of placing their revenues into a fund⁴. In the event, it may be sensible to park a portion of the windfall temporarily in a fund in the face of absorption constraints when investing in public infrastructure and human capital.

Arguments in favour of direct public spending include: retention of central control over both the macroeconomic trend and microeconomic detail of spending; the chronic undersupply of physical and social infrastructure supported by public expenditure and the high rates of economic and social return on such investments; the potentially significant catalytic impact of public expenditure on private sector investment; and job creation and employment. With respect to private sector investments, direct public spending could be complementary: for example, public investment that included strategic investment in key infrastructure, education and training, and human capital could facilitate private investment in both the EI sector and in complementary sectors.

The main argument against direct public spending of resource revenues has to do with its ability to handle any rapid increase in expenditure in an effective manner (see **Section 6.4** above). In addition to the problem of absorptive capacity discussed above (including bureaucratic capacity and capital expenditure processes), there is the risk of waste and, without adequate transparency and oversight, the *probability* of corruption. A rapid escalation in spending can also be expected to put upward pressure on domestic prices. This can result in a

² Van der Ploeg, R (2012). Managing Oil Windfalls in the CEMAC, in Oil Wealth in Central Africa: Policies for Inclusive Growth, (Akitoby, B and Coorey, S, eds.) IMF, Washington DC, 89-109, at 98.

³ Ibid, 107.

⁴ If the fund were to be used to invest domestically, it would not be offsetting the risks associated with Dutch Disease and would be vulnerable to special interests and rent-seeking.

real appreciation of the exchange rate, loss of competitiveness of non-resource exports, and, as a consequence, loss of economic diversity as well as a large negative impact on overall economic performance. This describes the problem known as Dutch Disease, which is discussed earlier (see **Chapter 2**).

If the intention is to engage in domestic investment, a clear benefit to a government would be to establish a public investment program for the medium and long-term. This could include priorities for strategic investments. With an appraisal process that is not capricious, this would set out a clear plan as to what projects will and will not receive funding, as well as having planning and implementation capacity at the line ministries. *Institutional factors will be central to its success, including the capacity to select, implement and evaluate projects.* In turn, this requires the creation of robust public financial management systems.

8.7.2 Consumption

Urgent Poverty Concerns Once revenues from resource production begin to flow, a case can be made for immediate allocation of part of those revenues to recurrent expenditure on consumption in the form of subsidies based on the urgent poverty reduction needs of large segments of the population in some resource-rich developing states. Even setting aside the humanitarian motives for such spending, it is sometimes considered essential on political stability grounds.

Once the existence of large-scale resource revenues becomes known, allocating at least a proportion to consumption of this kind may become a political imperative. At the same time, it will have to compete with other ‘political imperatives’ such as that of increasing investment in infrastructure such as roads, ports and so on, which may be as strong as that of providing or increasing subsidies for poverty alleviation.

Against this prioritization of immediate action on poverty reduction, it can be argued that a holistic approach should be taken to setting expenditure in the budget. All needs and potential expenditures should – on this view – compete in an open budget process. In this way, the marginal dollar would be allocated to the area where the marginal benefit is highest, given efficiency and equity considerations that have to be balanced in the political process. It is also a priority that is vulnerable to circumstances: for example, if the fiscal position is unsustainable, or if inflation is high and the economy overheated, or the external position precarious, or if there is rampant corruption to the extent that only a fraction of the resources would reach the poor. In such circumstances, it would make little sense as a priority. Further, such policies can

generate benefit-dependence if not properly designed, targeted and conditioned, and may give rise to entitlements which are very difficult to reverse at a later stage.

8.7.3 Cash Transfer Schemes

An alternative to public consumption or investment is the direct transfer of resource revenues to citizens. The payment of dividends from resource revenues directly to the population has been the subject of much research in recent years⁵. Sometimes known as ‘oil-to-cash’ and invoking the Alaskan experience⁶, the idea is to place some revenues from extractives production into a fund and through that to pay cash directly to citizens, who would be taxed on the income. It establishes a close link between the citizen, the government and the natural resources being produced.

This is *not* a replacement for an established revenue sharing mechanism with or without a formula; if that is absent, local government activities and expenditures could not be financed. It also differs from reduced taxation, which is only applicable in countries where there is a large income tax base, a condition that does not apply to most resource-rich countries⁷.

In favour The two main arguments advanced in support of direct distribution are either based on a governance proposition or on distribution and efficiency. The first argues that direct transfers can always be taxed back by the government, with the taxing relationship forming the basis for long-term improvements in governance and accountability. The second argues that direct transfers will be more equitable and efficient than many mechanisms now used to provide either public goods or subsidies, and that they reflect better the proposition that resources belong to ‘the nation’. Fuel subsidies, for example, are very regressive as well as being distorting. An example of a country that has moved at least partly from fuel subsidies to transfers is Iran. A key difference between these two arguments is that the former requires a

⁵ For example: Todd Moss (2011) *Oil to Cash: Fighting the Resource Curse through Cash Transfers*, CGD Working Paper 237, Washington DC: Center for Global Development; A Gelb and C Decker (2012), *Cash at your Fingertips: Biometric Technology for Transfers in Developing Countries*, Review of Policy Research, vol 29, No 1, pp. 91-117.

⁶ Fifty per cent of the state’s oil revenues are pooled in a sovereign wealth fund with five-year average earnings divided among the population. By contrast, in Bolivia a conditional cash transfer program was developed with hydrocarbon revenue: Bono Juancito Pinto was used to incentivize primary school enrolment and completion and Bono Juana Azurduy was designed to incentivize uninsured new mothers to seek medical care during and after pregnancy.

⁷ In developing countries VAT and sales taxes are more important proportionately than in advanced countries, since direct taxes are weak. It is possible to distribute resource revenues in the form of low VAT rates. There are very low or no sales taxes or VATs in the Gulf states, for example. That is one way in which rents are distributed to the population there. Another example is the low taxes adopted in Alberta, Canada.

large share of the rents to be transferred (to make the government dependent on taxes), while the latter does not.

Counter-arguments The strongest of these is that such schemes create entitlements (and an entitlement mentality) that soon become entrenched budgetary rigidities. Once direct payments to the population are granted, it will be very difficult to abolish them or change them at a later date if circumstances or policy priorities change. This is borne out by the experience in Alaska. Another strong counter-argument is that government can pool resources in order to make large investments, such as education systems, health care, and roads and electricity projects. Individuals cannot coordinate these activities and hence there is a role for government to invest resource revenues. In economic terms, there are externalities which the private sector would not address if left to its own, leading to sub-optimal efficiency and social outcomes.

Other counter-arguments include: current beneficiaries of the distribution are likely to give little weight to the future and therefore invest too little; in any case, it is unfair to transfer the benefits of a depleting resource to the current generation only, without saving or investing for future generations; governments are better informed on resource revenue flows, output levels, and price volatility than the general population; and governments are better placed than individuals to absorb revenue fluctuations. The problem of volatile revenues is also a difficult one for transfers. The mechanics of setting up a universal and accountable system have however become more feasible with the advent of new technology for ID and payments. As yet, this appears to hold little interest to governments although some, such as Mongolia, have been moving in this direction. For a few governments, the establishment of a database of its inhabitants will present problems, particularly in contested areas, where ethnicity and population size can be highly sensitive issues (for example, Ethiopia's Ogaden region and Sudan or Abyei in South Sudan).

Further, it is not clear why an increase in direct distribution (involving transfer of small sums of money to the individual household) can stimulate 'private' investment that might lead to a better identification of investment priorities. In many resource-rich countries, the infrastructure gaps are so large that such direct transfers are unlikely to lead to improvements in infrastructure, nor indeed to an offsetting against environmental damage (the Niger Delta being a good example of this). It also carries the risk of capital flight to offshore accounts or to the capital of the country concerned, exacerbating the existing problems in the local area. Inequalities among regions too could end up being exacerbated. Private transfers therefore face a collective action problem in turning the rents into public goods, assuming of course that government manages this well enough to do so.

Implementation Beyond consideration of these arguments – several of which are in direct opposition to each other - the merits of direct distribution will depend on the particular mechanism chosen for affecting the transfer (mechanisms such as tax reduction, subsidy, social protection scheme, or citizen dividend), and its detailed specification. For example, use of petroleum revenues to subsidize petroleum product prices in a petroleum-rich state may have political appeal; but it is distortionary nonetheless, and often seriously so. They can be very poorly targeted, with the rich benefitting much more than the poor from them (except in the specific case of kerosene). Conditional social protection transfers, such as those linked to school attendance, can be very beneficial. In practice, a decision on direct distribution is very likely to depend on state-specific circumstances and available transfer mechanisms. Real technical constraints may arise from difficulties in identifying beneficiaries of such schemes; building a transaction system for cash transfer delivery, electronic payment and transfer systems, all of which need to be in place for a cash transfer to work.⁸ Technological advances, allowing biometric identification through mobile devices, suggest that governments interested in developing such arrangements may have a greater chance of success than in the past.

One further issue that needs to be addressed by proposals of such direct distribution is the need to stabilize transfer programs with respect to actual rent revenues. A degree of predictability is required so that central governments do not alter entitlements on an ad hoc basis, while allowing the government flexibility in its macro-fiscal management.

Examples Experience of direct distribution has produced different and inconsistent lessons. Some might argue that direct distribution can indeed improve social welfare, pointing to examples of this in very low-income countries with large oil revenues or in countries with large per-capita revenues and low government accountability or with adequate capital expenditure. Once that allocation has been made, they could argue, the population's recognition of their entitlement to a share in resource benefits can be expected to increase demands for accountability on the part of the authorities. However, there are also cases where direct distribution can lead to perverse incentives and decrease social welfare. A common assumption is that it will have negative effects on the labour supply, as individuals will have less incentive to

⁸ For an optimistic view of the potential of direct cash transfers see Moss, T (2011). Oil to Cash: Fighting the Resource Curse through Cash Transfers, Centre for Global Development Working Paper, January 2011: http://www.cgdev.org/files/1424714_file_Oil2Cash_primer_FINAL.pdf (last visited 12 April 2016); also, Gelb, A and Decker, C (2011). Cash at your Fingertips: Biometric Technology for Transfers in developing and Resource-Rich Countries. Working Paper 253. Center for Global Development, Washington DC: <http://www.cgdev.org/content/publications/detail/1425165/> (last visited 12 April 2016)

work⁹. It can also have the effect of starving the government of much-needed financing for domestic investment.

The most cited example of direct distribution is the Alaska Permanent Fund, established in 1976 by an amendment to the State Constitution. To date, more than one billion dollars has been distributed annually to 600,000 citizens. One of the reasons for its creation was to provide a safeguard against pressures from politicians to spend the oil revenue. However, the dividends have come to be seen as entitlements and the government has borrowed substantially at times to finance increased spending¹⁰. This is not an approach that has yet found many followers among resource-rich economies¹¹. The nearest comparable initiative is the Human Development Fund in Mongolia, which was set up in 2009 to make contributions to citizens such as cash hand-outs, payments of tuition fees and possibly financing of other social benefits. The initial contribution to the Fund came from a negotiated pre-payment of royalties from a mining project. However, contrasts with Alaska are the decoupling of transfers from the performance of the underlying assets and their front-loading.

In practice, as Barma, Kaiser et al note, “governments endowed with natural resource wealth have provided wealth transfers to citizens in a variety of different ways”¹². Resource rents have been used to finance large transfer programs, even if not expressly linked to resource wealth: Iraq and Mexico being two examples of countries in which this has taken place.

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8.7.4 Debt Reduction

Although not a spending choice and more a use of government revenues, resource-rich states with high debt levels can use some of their resource revenues beneficially to pay off outstanding foreign debt. Many African states, for example, have international debts to pay to other countries and international financial institutions, alongside plans to reduce dependence on external aid in their national budgets. Siphoning off revenues for this purpose dampens the potential for cyclicity in spending, and it raises no domestic absorption issues. Its appeal lies in its positive impact on the state’s credit standing, investor attitudes, and, most importantly, the

⁹ A Isakova, A Plekhanov and J Zettelmeyer, *Managing Mongolia’s Resource Boom* (2012), EBRD Working Paper No 138, pp. 11-12.

¹⁰ Ossowski (2008) 10.

¹¹ Some see it as having applications in such contexts however: see Moss, T (ed) (2012). *The Governor’s Solution: How Alaska’s Oil Dividend could work in Iraq and other Oil-Rich Countries*, Center for Global Development, Washington DC: <http://www.cgdev.org/content/publications/detail/1426542>

¹² Barma et al (2012). *Rents to Riches ?* 170.

cost of capital for the domestic private sector. However, it is only an option if the government is running an overall fiscal surplus. If not, the foreign public debt will simply be replaced by domestic public debt, leading to a rise in domestic interest rates if capital is not fully mobile, and if the central bank does not accommodate the increase in domestic debt with a looser monetary policy.

Between 2002 and 2005, public debt as a proportion of GDP in several countries fell dramatically as a result of this kind of policy: in Saudi Arabia, it fell from 97 percent to 41; in Russia from 35 percent to 14 percent; and in Qatar from 47 percent to 24 percent. Algeria went further in 2006 when it concluded an agreement with France to retire the full outstanding balance of its bilateral debt. Libya too paid off almost all of its external debt. As one former minister of Gabon notes: these countries' experiences "have taught us many lessons, one of which is that paying down debt early brings greater benefits than building up savings that earn a low rate of return"¹³.

Against these, rather positive, instances of debt reduction policies, it should be kept in mind that in many countries the debt may have been accumulated by a previous regime, creating political challenges for the successor government to mount a program of debt reduction. Also, if the country does not have access to financial capital at this stage in its development, how would a program of debt reduction reduce borrowing costs? Domestic borrowing costs are usually driven by short-term liquidity issues so a significant debt reduction is unlikely to have any effect. Finally, there are some countries that will benefit from initiatives such as the Heavily Indebted Poor Countries or the Multilateral Debt Relief or commercial debt buy-back initiatives in place to assist low income countries.¹⁴ This may limit the value of a debt reduction program.

8.7.5 Adjusted Natural Capital

The revenues from extractives represent a transformation of natural capital into other assets. A depletion of this natural capital requires a corresponding increase in other forms of capital such as financial assets or human capital, whether as savings or reinvestment. As we have seen, for some countries a departure from this principle may make sense with clear benefits probable from consumption in the domestic economy. However, if there is a strategy for replacing the natural capital lost from extraction with high quality physical and human capital, some indicator will be required. In some cases, an indicator has been used to measure whether the depletion

¹³ Toungui, Paul (2006). Spend Now or Save? Finance and Development, December 2006, vol 43.

¹⁴ <http://www.imf.org/external/np/exr/facts/hipc.htm> (last visited 12 April 2016)

of natural capital has been compensated for by investment of extractives revenues in other assets such as education and physical infrastructure such as roads and water supply. Natural capital accounting¹⁵ can be a way of measuring growth in the context of long-term sustainability, and can also influence spending choices. Botswana, for example, uses a Sustainable Budget Index (the ratio of non-investment to non-mineral revenues). However, there is no enforcement mechanism to ensure compliance, nor is there any guidance on the composition of public investment expenditure. In practice, mineral revenues “have been entirely devoted to investment in physical and human capital assets, and have not been used to finance recurrent spending”¹⁶.

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¹⁵ World Bank, ‘Growing Number of Countries Factoring Nature’s Value into Economic Decisions’, April 22, 2013.

¹⁶ Africa Natural Resources Center (2016), p. 13.