

GOOD-FIT PRACTICE ACTIVITIES IN THE INTERNATIONAL OIL, GAS & MINING INDUSTRIES

8.1 Fiscal Rules for Saving vs. Spending

Transparency and Accountability
Policy, Legal and Contractual Framework
Sector Organization and Institutions
Fiscal Design and Administration
Revenue Management and Distribution
Sustainable Development

For a country facing the prospect of significant resource revenues the question arises as to how it should plan the time path of spending and saving from this revenue flow. What fiscal rules will apply to the revenues? Such fiscal rules are typically defined as “institutional mechanisms that are intended to permanently shape fiscal policy design and implementation.”^[1] They vary widely across countries and can comprise numerical rules designed to guide and benchmark performance against quantitative indicators (such as the fiscal balance of debt), and procedural rules intended to establish transparency, coverage and accountability requirements.^[1]

The need for fiscal rules is readily apparent: if a country decides to allocate the resources to current consumption, this would be a waste and probably generate unfair outcomes; if the benefits of consumption were to be postponed into the distant future, the result would be similar. So what should be done? A number of factors and policy choices have to be taken into account in making such fiscal rules, including the factor of absorptive capacity, and choices such as tax reduction, increases in expenditure, debt reduction or savings of ‘windfall’ revenues.

It is crucial to understand that making fiscal rules for this situation will be complicated by the volatility and uncertainty of resource revenue flow: there can be sudden slumps in demand following euphoric booms. These fluctuations are a stimulus to the discussion of rules designed to smooth revenue flows and for the use of stabilization funds. Nor is this a matter of economics alone. Referring to the work of Collier and Goderis, the above authorities note: “Some societies have succeeded in harnessing commodity booms for sustained increases in production, while others have not, with the quality of governance playing an important role. Resource-exporting countries with good governance grow more rapidly in the long run as well as in the short run, Botswana being an African example.”^[1]

8.1.1 Fiscal Rules

Fiscal rules attempt to constrain the overall fiscal policy, and are less common than the fund instrument (discussed in 8.2 and 8.4 below), at least in the oil sector. The volatility of revenues in the EI sector plays a large part in this. Some fiscal rules target overall

or primary balances or particular debt ratios to Gross Domestic Product, but they can transmit oil fluctuations to expenditure and the non-oil balance. Experience has shown the difficulties of implementing effective and durable rules. Essentially, the rules, often based upon short term considerations, can be found too rigid to adapt to economic fluctuations and lack reliable support among political elites. During a boom, liquidity pressures can ease and governments may find it very difficult to contain spending pressures. There are examples of fiscal rules being weakened over time or ignored. Equatorial Guinea has an expenditure rule, which requires current spending not to exceed non-oil revenue; it has been repeatedly breached and even interpreted as a medium-term goal. Expenditure in this case has even grown substantially faster than EI revenue, rendering the fiscal rule largely irrelevant as an instrument to benchmark fiscal policy.

Among the various fiscal rules found in practice are: the balanced budget rule (sometimes called ‘hand to mouth’), meaning that all annual oil receipts are spent while the government’s overall financial position is kept in balance (the disadvantages are that it can privilege current over future generations in terms of their share of consumption of oil wealth and it subjects governments to ‘boom-bust’ cycles in the international markets); the ‘bird-in-hand’ rule, where spending decisions are predicated only on the assets already in hand; only the interest income that accrues from accumulated revenues is spent consistently over time (this ‘precautionary saving’ avoids the above shortcomings but may create social tensions since public expenditure may be low while revenues are accumulated during production, and lost opportunity in terms of social and infrastructure spending in the early years at the expense of future spending); and others that are less extreme such as constant expenditure rules; rules that target a price of oil and save any revenues generated by prices above that threshold; and rules that save a fixed percentage of revenues.

The modest successes of Botswana and Chile with fiscal rules are explained in **Box 8.1**. Other, contrasting examples include:^[1]

Azerbaijan: A long-term revenue management strategy established by Presidential Decree in 2004 was designed to address a temporary increase in oil production. Its basic elements were the maintenance of constant consumption out of oil wealth in real terms, limiting annual fluctuations in the non-oil deficit to ensure economic stability and use of a public investment plan to provide a foundation for investment spending. When revenues from oil proved to be larger than expected, there were growing expenditure pressures and, two years later, the budget envisages a near-doubling of expenditure and an increase of more than 20% in the non-oil deficit ratio.

Sao Tome e Principe: Fiscal strategy was based on an estimated permanent income approach.^[2] Rules were adopted that determined how much could be transferred from the oil fund to the budget. This implied that the size of the primary non-oil balance should be determined by looking also at the expectation of government wealth. Such a framework did not effectively constrain the non-oil balance since the government was still able to borrow but it could have implications for the management of assets and liabilities. The guidelines on fiscal matters were flexible with the emphasis upon transparency procedures and sound management of the anticipated oil wealth (these procedures were put in place well before oil production). They underlined the non-oil deficit that is consistent with the estimated permanent income from oil wealth net of government debt, but the government is still free to propose a budget with a higher non-oil deficit, providing there is a rationale and an impact analysis on oil wealth in future years.

Nigeria: An oil price-based rule was adopted from 2004, which require oil revenue above a reference price to be deposited in extra-budgetary accounts. The idea is that this would allow the resources to finance projects agreed by all levels of federal and sub-national government. Its transparency is not perfect however and the effect could be to limit the scope of the budget as an instrument for setting priorities. Its success appears to have been limited.

Box 8.1. Botswana and Chile: Experiences with Fiscal Rules

Botswana and Chile have managed relatively successfully their dependence on natural resources. They have achieved stable macroeconomic environments and high growth rates. Given the importance of their natural resource sectors (mainly diamonds in **Botswana** and copper in Chile) and their use of fiscal rules, they present useful lessons for OPCs.

Botswana has implemented medium-term national development plans (NDP) closely linked to the budget process for decades. The six-year NDP sets broad fiscal objectives and associated policy actions. It has contributed to the implementation of a longer-term strategy that has helped contain spending during periods of revenue buoyancy and led to

overall surpluses for most of the last two decades. The framework has incorporated goals for the overall balance and a type of “golden rule,” where non-mineral revenue should at least cover noninvestment recurrent spending. This rule has been adhered in most years, except for a few years in the early 2000s, when fiscal deficits emerged. While the fiscal position has been under some strain, continued commitment to prudent fiscal policies and medium-term planning put Botswana in a strong position to face important medium-term challenges.

Chile introduced an informal fiscal rule in 2001. The rule calls for maintaining a structural central government surplus over the economic and copper price cycles. It is seen as a useful signal to financial markets, indicating a sensitivity to the risks of procyclical spending. The successful implementation of the rule is seen in large measure as due to low debt and high policy credibility, themselves the result of past prudent policies and good institutions. While fiscal rules have been operationally useful to the conduct of sound fiscal policies in Botswana and Chile, the evidence suggests that they were not critical elements—the key has been political commitment and good institutions. Both countries’ economic success mostly points to strong overall institutional quality, willingness to adopt key structural reforms, and political commitment to ensure fiscal discipline (Iimi, 2006). According to World Bank and Transparency International governance indicators, both countries have significantly higher levels of governance and institutional quality than most OPCs.

8.1.2 Absorptive Capacity

While a significant allocation of EI sector revenues to spending and especially to domestic investment is desirable, the effectiveness of that spending will depend to a large degree on the absorptive capacity of the resource-rich economy. A rapid buildup of spending in response to a revenue windfall could be inefficient if countries do not have adequate absorptive capacity, as the economy will face absorption problems. The spending path needs to be set at a rate that is efficient for the economy.

Absorption difficulties often arise at the institutional level in many developing states as a result of limited capacity, which can limit government in its ability to identify and implement policies and projects that are a cost-effective use of resources. If investments are badly chosen or badly executed, the state will have wasted a unique opportunity for transformative development. White elephant projects and half-completed investments are all too common. However, absorption is not only a capacity issue. It is also a function of poor budget and capital expenditure processes: for example, development planning, medium term expenditure frameworks, project appraisal and costing, procurement, financing, project execution monitoring and operations and maintenance. Moreover, the flow of revenues tends to undermine the incentives to build the institutions designed to manage investments in the first place: if you are able to obtain ‘cheap’ money, then you may not have to think very hard about the efficiency with which you are spending it.

Good practice in response to absorptive capacity issues involves credible commitments to improvements in public expenditure management and a gradual buildup in expenditure.

Experience of both expenditure smoothing to address volatility concerns and a gradual expenditure buildup in the face of absorptive capacity constraints suggests that part of any resource revenue windfall should be allocated to saving.^[4] However, this depends on a number of factors including the size of the windfall relative to budget expenditure and potential to increase absorptive capacity. Saving of resource revenues may also be justified on other grounds (such as a precaution against unforeseen negative events or to generate wealth for future generations in anticipation of the eventual depletion of resources). The next two sections discuss one of the better known savings options.

Additional Reading:

- [Collier, P., et al., Managing Resource Revenues in Developing Economies, OxCarre Research Paper 15, Revised May 2009](#); link to summary document.

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