

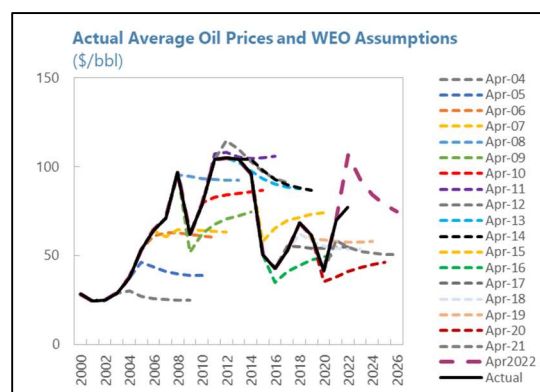
REINFORCING FISCAL SUSTAINABILITY IN OMAN: THE ROLE OF FISCAL FRAMEWORKS¹

Fiscal policy in Oman is undergoing significant changes. The government has adopted the Medium-Term Fiscal Plan, introduced public-sector reforms, and made good progress in improving central government fiscal reporting. These reforms are important, and now there is need to strengthen fiscal frameworks—including clearly defining fiscal policy objectives and the long-term fiscal anchor—before introducing a formal fiscal rule. A fiscal rule is only as good as the institutions that support it.

A. Context

1. Fiscal policy plays a crucial role in Oman as the main vehicle for converting the oil and gas (hydrocarbon) wealth into economic outcomes for its population. Oil and gas are the major sources of export income and fiscal revenues, and this income impacts the rest of the economy through government spending. Over the past several decades, government spending on infrastructure, education, health, and social programs has transformed the Oman's economy and supported some of the highest living standards in the world.

2. Volatility and unpredictability of oil prices have increased in recent years, posing significant challenges to policymakers. Oil price shocks are often large and persistent, with booms and busts involving prices moving up by around 400 percent (2001-2008), increasing by 100 percent (2009-2013), before declining by 40 percent (2014-2019). Sharp drops in oil prices in 2009 and 2020 proved to be only temporary and oil prices rebounded quickly, while oil prices remained low for few years after the 2014 commodity price shock. Hence, forecasting commodity prices has proved exceptionally difficult. Given high uncertainty around commodity prices and dependency of government revenues on oil and gas, policymakers have faced two competing challenges: avoiding procyclical fiscal policy and supporting long-term growth (IMF 2015).



3. These developments highlight the benefits and risks associated with natural resource wealth. Although such wealth creates opportunity to accelerate economic development, it also comes with risks such as susceptibility to fluctuations in commodity prices which can be large and persistent, exhaustibility of natural resource deposits, a tendency to pro-cyclical fiscal policies that can amplify business cycles, and Dutch Disease (Kanda and Mansilla, 2014). Avoiding the impact of these risks on the fiscal position and macroeconomic stability requires strong institutions and often

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the establishment of a fiscal anchor or rule that enforces a sustainable fiscal position and countercyclical fiscal policy.

4. Against this backdrop, the paper looks at the potential role that fiscal frameworks and anchors could play in reinforcing fiscal sustainability in Oman. The authorities aim to further develop their fiscal frameworks to safeguard fiscal sustainability. They have already introduced policies to balance the budget by 2025 and contain central government debt below 60 percent of GDP over the medium term. These policies are important, and now there is need to deepen reforms by strengthening fiscal frameworks (including medium-term macroeconomic framework, fiscal strategy, fiscal governance, and medium-term budget framework, and expanding fiscal coverage beyond central government). A formal fiscal rule could then be considered. A fiscal rule is only as good as the institutions that support it.

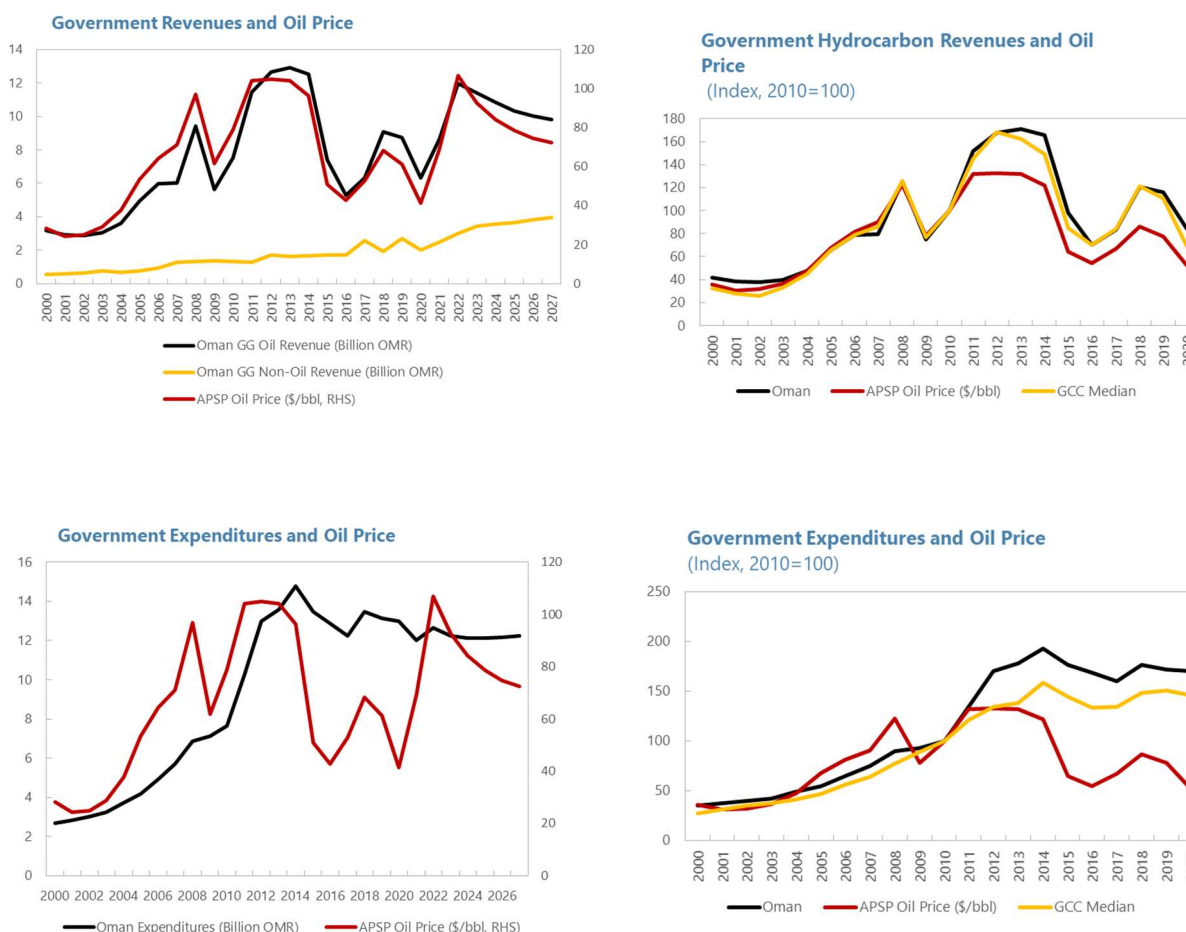
5. The paper is structured as follows: section II provides a retrospective on fiscal policy in Oman since the early 2000s; section III provides some considerations to strengthen fiscal frameworks, including options and challenges for adopting a long-term fiscal anchor and designing a fiscal rule for Oman as well as summarizing simulation results on fiscal outcomes for a variety of fiscal rules; and section IV concludes.

B. Retrospective of Fiscal Policy

6. Fiscal developments in Oman have been mostly driven by movements in oil and gas prices in recent decades (Figure 1). The prominent role of hydrocarbon production has in the past implied a pro-cyclical link between oil and gas prices, government spending, and economic outcomes.² Driving this relationship has been the large share of income from oil and gas in total government revenues.

- Government revenues are highly correlated with the oil price, with a correlation coefficient of 0.93 during 2000-2020. Hydrocarbon revenues averaged 83 percent of total budget revenues since 2000. Movements in hydrocarbon revenues in Oman have resembled its GCC peers. On the other hand, the non-hydrocarbon tax base is narrow representing on average about 7 percent of total budget revenues and the remaining from non-hydrocarbon non-tax revenues.
- The prominent role of hydrocarbon revenues in the budget has in the past implied a pro-cyclical link between oil prices and government spending, albeit to a lesser degree with a correlation coefficient of 0.53. The lower volatility of spending reflected in part constraints on reducing spending during periods of oil price slumps and increasing it during booms. However, during 2012-2019, Oman ramped up expenditures more than its GCC peers. Government spending has also reflected the tendency to set annual budgets on the basis of conservative oil prices during oil booms and then overspend when prices turned out to be higher than budgeted.

² Hydrocarbon includes oil and gas, and it is used interchangeably in this paper.

Figure 1. Revenues, Expenditures, and Oil Price

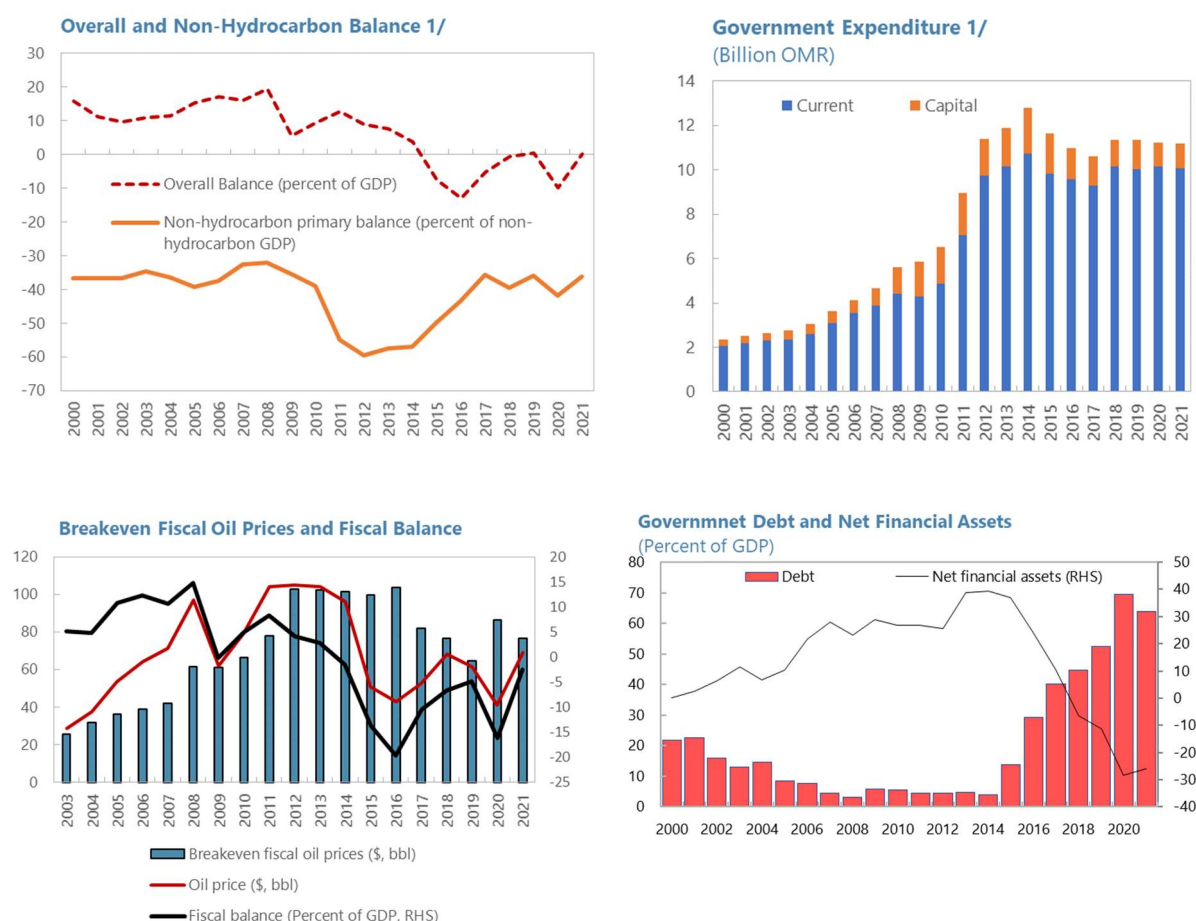
Sources: Country authorities; and IMF staff calculations. Calculations for GCC median include Oman.

7. Prior to 2020, policy frameworks were not sufficiently developed to deal with fiscal vulnerabilities. Fiscal policy was short-term oriented—largely conducted in the context of the annual budget—and reflected a policy preference to build fiscal buffers during booms that supported a gradual approach to any required adjustment when commodity prices fell. Revenue projections generally reflected the oil prices prevailing at the time of budget preparation, while expenditure allocations usually followed a bottom-up approach, with limited medium-term budget planning or consideration of fiscal sustainability.

8. The fiscal position generally deteriorated over 2014-2020. The decline in the overall fiscal balance was driven by movements in oil prices, reaching 14.6 percent in 2008 and -19.6 percent of GDP in 2016. The breakeven oil price—the price at which the fiscal balance would be

zero— increased sharply from early 2000s to 2016 and remained above actual oil prices, given limited progress in reducing government expenditures. Notably, there were large increases in wages and subsidies during 2010–2015. Efforts to contain expenditures intensified after 2016, as the government contained the wage bill and gradually removed fuel subsidies, while ensuring vulnerable groups were protected from the removal of subsidies. Nevertheless, central government debt rose from 29.3 percent of GDP in 2016 to 69.7 percent in 2020 (52.5 percent at end-2019), and net financial assets ratio—central government debt less deposits at depository corporations and OIA’s liquid assets—declined from 24.2 percent of GDP to -28.5 percent during the same period.

Figure 2. Fiscal Balance, Expenditure, and Net Financial Assets



Sources: Country authorities; and IMF staff calculations.

1/ Taking out expenditures relating to investment in the oil and gas sector.

9. To address rising fiscal vulnerabilities, the authorities announced the Medium-Term Fiscal Plan (MTFP) and broad public-sector reforms in 2020 (Box 1). The MTFP targets the elimination of the fiscal deficit over the medium term by boosting non-hydrocarbon revenue while restraining fiscal expenditure by improving its efficiency and targeting. In line with the Gulf

Cooperation Council Value-Added Tax (VAT) Treaty, Oman introduced a VAT in April 2021. The government is also preparing to introduce a personal income tax, adopting measures to improve tax collection, and containing expenditures. Furthermore, the government established the OIA to assume ownership of all government companies and investments that were earlier overseen by the MoF. Energy Development Oman (EDO) was also created to manage government investments in oil, gas, and renewables. Revenue of EDO will be shared with the government through royalty taxation, and dividend, after deducting operational spending and debt service.

Box 1. Medium-Term Fiscal Plan (2020-2024) 1/

Oman's Medium-Term Fiscal Plan (MTFP) is a holistic framework designed to achieve fiscal balance over the medium term. The MTFP was published on November 2nd, 2020, to address growing fiscal vulnerabilities and assist the government's adjustment plans. It is shaped and considered as an enabler for "Oman Vision 2040". The implementation of the MTFP will be guided by several economic programs and measures aiming to improve the business environment and stimulate investments, in addition to the launch of a social safety net that will reduce the impacts of the fiscal measures on selected groups of society.

The MTFP is based on five pillars:

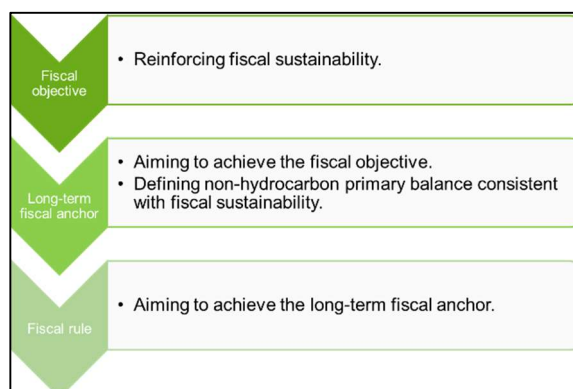
- *Supporting economic growth* through improving business environment and encourage domestic and foreign direct investment.
- *Diversifying and enhancing government revenues* through increasing non-hydrocarbon revenues as a share of GDP to protect against oil price volatility and mobilize domestic resource efficiently.
- *Rationalizing government expenditures* through prioritization, increased efficiency, and larger involvement of the private sector.
- *Enhancing the social safety net* through targeting government support for vulnerable groups, increasing social cohesion, and promoting intergenerational equity.
- *Strengthening public financial management* through fiscal structural reforms and enhanced capacity development.

1/ <https://www.mof.gov.om/MediumTermFiscalPlan>

10. Oman has made good progress in improving central government fiscal reporting and there is scope to expand data coverage beyond the central government. Since February 2021, the MoF has been publishing the monthly Fiscal Performance Bulletin, with high level aggregates on revenues, expenditures, financing, and economic developments. Some details on central government fiscal outturns are also published in the monthly statistical bulletin by the National Centre for Statistic and Information (NCSI). Nonetheless, there is a limited data collection and dissemination on fiscal operations beyond the central government. As part of the fiscal governance reforms, the MoF intends to regularly publish central government debt management operations.

C. Strengthening Fiscal Frameworks and Anchors

11. Fiscal frameworks enable country authorities to establish mechanisms to reliably ensure that the key objectives of fiscal policy are met. The objectives of fiscal policy differ according to the time horizon in question, ranging from long run fiscal sustainability to short-medium term macroeconomic stabilization (or, for example, economic development), and fiscal frameworks enable authorities to pursue both short and long run objectives in a coherent and consistent manner.

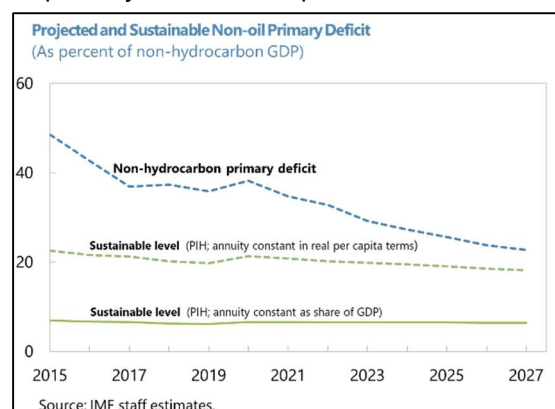


12. In the long run the key objective of fiscal policy is fiscal sustainability. The concept of fiscal sustainability is based on posing the following question: given the current fiscal stance, if the authorities decide to take no further fiscal measures from now onward, can they maintain that posture over the long run? If they can do so, the fiscal position is considered sustainable (and the fiscal sustainability gap is then zero). However, if the fiscal stance is not sustainable, lack of corrective fiscal measures eventually leads to a situation where fiscal assets are depleted and the debt-GDP ratio rises continuously without bound, with interest payments taking an ever-increasing share of government expenditure. This crowds out non-interest spending and increases fiscal financing difficulties until a point is reached where the government is forced to take drastic action to put the fiscal position on a path consistent with sustainability (Kanda 2011, Kanda and Mansilla 2014). Fiscal frameworks typically ensure consistency with fiscal sustainability by adopting a long-term fiscal anchor. The anchor defines a target (or ceiling or floor) for an important fiscal variable which, if met, would ensure that the overall fiscal path is consistent with sustainability.

- In many non-resource-rich countries this is done by adopting a ceiling for the debt-to-GDP ratio—limiting fiscal deficits to levels consistent with a constant or declining debt/GDP path over the long run—which in turn ensures that fiscal financing needs are contained to manageable levels. In line with this, IMF (2021) defines public debt as “...sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level”.
- For resource rich countries, such as Oman, explicit account has to be taken of large financial assets and the time horizon of hydrocarbon resources in assessing fiscal sustainability.

13. The most common approach to defining a long-term fiscal anchor in resource-rich countries is based on the Permanent Income Hypothesis (PIH). Here, fiscal authorities estimate net wealth—measured as net financial wealth (financial assets minus debt) plus resource wealth (the present value of future hydrocarbon revenues)—and determine the “sustainable” flow of income from this wealth that can be spent each year while keeping wealth constant (either in nominal terms,

real terms, real terms capita, or as a share of GDP, depending on the authorities' views on intergenerational equity). The anchor is then defined as the non-hydrocarbon primary balance consistent with financing needs not exceeding the sustainable flow of income from net wealth. For Oman, this anchor is estimated to be a nonhydrocarbon primary deficit of 19 percent of nonhydrocarbon GDP (which would keep wealth constant in real per capita terms). Steadfast implementation of MTFP will cause the nonhydrocarbon primary deficit to decline to 24.7 percent of nonhydrocarbon GDP by 2027, significantly reducing the gap with the fiscal position consistent with intergenerational equity, but indicating also that additional consolidation would be needed beyond the medium term to achieve full fiscal sustainability. Once the anchor is achieved, total net wealth would be kept constant although its composition changes over time: the share of hydrocarbon resource wealth will decline over time as hydrocarbon reserves get depleted or as climate change reduces the value of those reserves, but this decline will be offset by an increase in net financial wealth as hydrocarbon revenues are saved and invested.



Box 2. An Overview of the Permanent Income Hypothesis

The permanent income hypothesis (PIH) is a consumption theory that has evolved into a benchmark for designing a long-term macro-fiscal policy to mitigate resource management challenges. The hypothesis aims to answer what is the appropriate savings (and sustainable spending) of resource revenue to maintain fiscal sustainability and intergenerational equity.

For resource-rich economies, the management and preservation of wealth over time is essential due to the exhaustibility of resource revenue, especially for countries with a relatively short reserve horizon.

The PIH provides the framework to addressing intertemporal choices. It designs a constant path of maintaining a net wealth position over time by determining the amount of consumption (saving) for current and future generations.

So how much consumption should be targeted? This depends on how the marginal utility of a unit of consumption out of the resource wealth is maximized across time. Two broad approaches exist for long-term management of natural resources (IMF 2015):

- The **standard PIH approach** focus on perfect consumption smoothing across generations. The consumption target is a constant share of the net wealth every year. Two variations of this approach are the Modified PIH and the Fiscal Sustainability Framework that allow for deviation from the standard PIH approach to meet large infrastructure needs for low-income countries. The drawdown under the modified PIH would be offset by fiscal adjustment in the future to rebuild financial assets to the same level as under the standard PIH, while takes into account the expected impact of higher investment on growth and non-resource revenues under the fiscal sustainability framework.
- Under the **"bird-in-hand" approach**, countries would save all oil revenue as financial assets, with only the yield from the accumulated financial assets spent.

14. However, in the near to medium term, the focus of fiscal policy tends to be on macroeconomic stabilization, subject to the fiscal path not deviating substantially from fiscal sustainability. Notably, fiscal policy should be countercyclical to help stabilize the economy. In times of economic boom, tightening fiscal policy helps contain aggregate demand pressures, which in turn helps contain external imbalances and inflation. On the other hand, in times of economic slack, a looser fiscal policy helps support aggregate demand, jobs, and economic growth. The scale of tightening or loosening envisaged should reflect the size of the output gap as well as the need to pursue a medium-term fiscal path that on average does not deviate substantially from the long run fiscal anchor. Moreover, the volatility of hydrocarbon prices creates additional challenges for macroeconomic stability. Notably, sharp increases in hydrocarbon prices tend to stimulate pressures for additional fiscal spending out of these windfall revenues, which however lay the seeds of future fiscal crises when hydrocarbon prices experience sharp declines that lay bare the need for politically difficult expenditure measures to ensure sustainability. Other near to medium term objectives could include supporting growth, social safety net reforms to improve resource allocation, etc., but these are typically constrained by the macroeconomic stabilization and sustainability objectives.

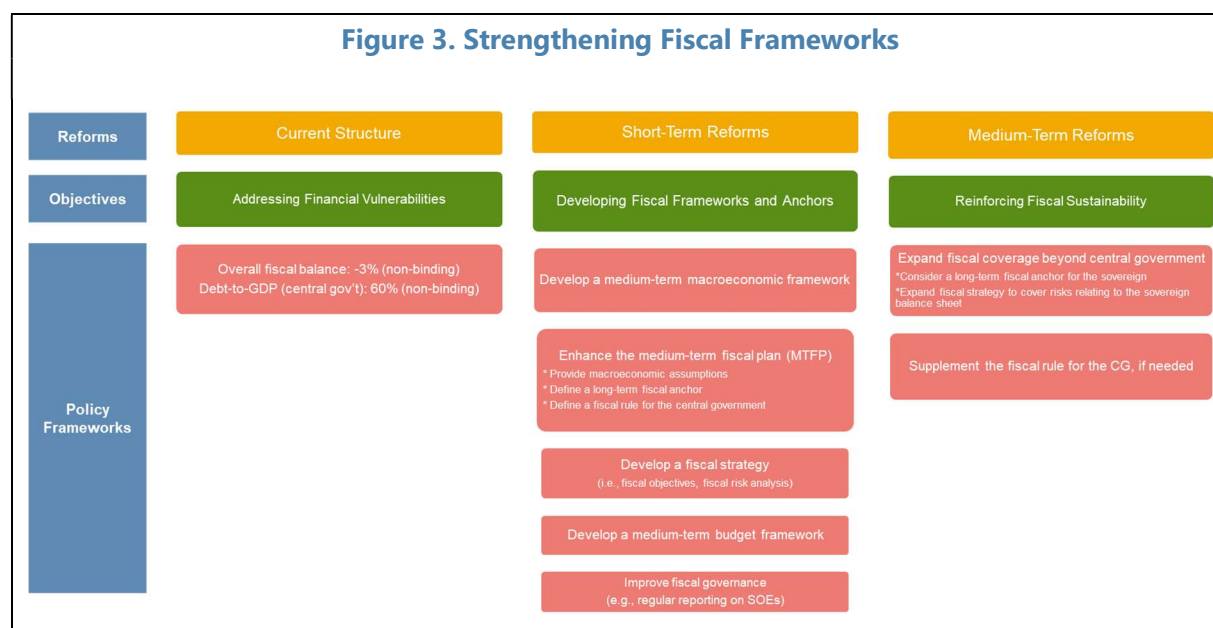
15. A fiscal rule is often adopted to guide medium-term policy making consistent with the long-term fiscal anchor. Fiscal rules are defined as constraints on fiscal policy through a simple numerical target on fiscal aggregates such as expenditure, revenue, the budget balance, or cyclically adjusted balance. The primary function of fiscal rules is to constrain the government's use of fiscal discretion. Rules are often enshrined in legislation, signaling the importance attached by the government to reinforcing fiscal sustainability, and detail the circumstances under which the rules can be amended. In Oman, the government has an implicit fiscal deficit ceiling of 3 percent of GDP, but this is not legislated.

16. A number of desirable features should be considered in selecting an effective fiscal rule. The use of criteria, as highlighted by Kopits and Symansky (1998), ensures that the rules will be able to correct policy biases—by ensuring sustainability and economic stabilization—and perform efficiently—through simplicity, operational guidance, resilience, flexibility, and ease of monitoring and enforcement. In particular:

- *Sustainability*: compliance with the rule should ensure long-term debt sustainability.
- *Stabilization*: following the rule should not increase (and might even decrease) economic volatility. Economic stabilization requires that the rule lets automatic stabilizers operate and/or allows discretionary countercyclical changes in taxes or expenditures.
- *Simplicity*: the rule should be easily understood by decision makers and the public.
- *Operational* guidance: it should be possible to translate the rule into clear guidance in the annual budget process. Budget aggregates targeted by the rule should be largely under the control of the policymaker.
- *Resilience*: the rule should be in place for a sustained period to build credibility, and it should not be easily abandoned after a temporary shock.

- *Flexibility*: the rule should be flexible enough that it can be modified in case of permanent economic shocks. Escape clauses can provide adequate flexibility, but they should be introduced with pre-established rules to trigger them.
- *Ease of monitoring and enforcement*: compliance with the rule should be easy to verify, and policy makers should be held accountable for deviations from the rule.

17. Notwithstanding the significant progress made, fiscal reforms in Oman would best be situated within a broader framework for fiscal policy making (Figure 3). This would entail developing or strengthening: (i) a medium-term macroeconomic framework, which would provide multiyear projections of key economic variables; (ii) a medium-term fiscal framework (MTFF), which would provide multiyear targets or ceilings on aggregate fiscal variables given projected economic variables, subject to sustainability and macro stabilization constraints; (iii) a fiscal strategy document, which translates the MTFF into a statement on medium term fiscal policy priorities and contains fiscal risk analysis; (iv) a medium-term budget or expenditure framework (MTBF or MTEF), which would translate the overall budget envelope from the MTFF into a set of multiyear expenditure ceilings and policies; and (v) an annual budget, which remains the basis for legal appropriations of expenditure but should be consistent with all of the above. Each item, while crucial on its own merits, has interlinked and critical prerequisites for developing and successful implementation of fiscal rules (IMF 2009, 2015). The focus of this paper is on items (i) to (iii). Previous technical assistance from the IMF provided recommendations for introducing a MTBF and strengthening annual budget preparation.



18. There is a scope to provide greater depth underpinning Oman's MTFP. The document begins with a brief description of global and national economic developments. It also reports fiscal developments since 2014, albeit in a highly aggregated manner, showing total revenues,

expenditures, fiscal balance in nominal terms for the next five years, the share of non-hydrocarbon revenues on total revenues, and the fiscal balance and debt as a percentage of GDP. However, the MTFP does not describe the rationale for the proposed deficit path and the macroeconomic assumptions underlying the fiscal projections. Similarly, the MTFP sets out the five pillars underpinning the fiscal consolidation process—supporting economic growth, revenue enhancement and diversification, expenditure rationalization and efficiency, social safety net, and public financial management and governance—but does not provide details on their fiscal impact. In addition, the MTFP does not report fiscal scenarios, illustrating how fiscal outcomes would be affected by macroeconomic outlook, or provide sustainability analysis.

19. Fiscal risk analysis and management are a key component in strengthening the MTFP.

Fiscal risks are factors that may cause fiscal outcomes to deviate from forecasts. The sources of fiscal risks can be exogenous and outside the government's direct control (e.g., oil price shocks) or endogenous and within the control of government (e.g., risks stemming from SOEs). Fiscal risks can be managed with a combination of mitigation, provisioning, and accommodation. While the MTFP should provide sufficient fiscal space to accommodate the realization of fiscal risks, improving oversight and management of SOEs could help to mitigate the related risks. Ongoing SOE reforms are welcome and would enhance competition and efficiently manage public resources. Oman Investment Authority and Capital Market Authority are working together to develop a Code of Governance for SOEs—based on the OECD guidelines on Corporate Governance of SOEs—to strengthen corporate governance.

20. Greater fiscal transparency can help strengthen the credibility of fiscal reforms.

Communication on fiscal policy, underpinned by strong fiscal frameworks, contributes to improving fiscal credibility (End and Hong, 2022). Reporting of fiscal developments and outlook, including their underlying assumptions and deviations from them, in line with international standards such as the IMF Fiscal Transparency Code (IMF 2019) is critical for effective fiscal management and accountability. The monthly Financial Performance Bulletin could provide more detail on macroeconomic and fiscal performance, more narrative, and more analytical content. The annual fiscal accounts document could analyze compliance with fiscal targets. In case of non-compliance with the MTFP, the document should explain the causes and the short-term policy options to correct the fiscal path. In addition, a published fiscal risk statement would provide a vehicle for outlining the key risks to the fiscal outlook, describing how these risks affect the MTFP, and summarizing the government's policies for mitigating and managing the risks.

21. Expanding fiscal coverage beyond the budgetary central government will provide a more comprehensive picture on the sustainability of the broader public sector.

The current coverage leaves out important spending units such as [139] SOEs that could have significant implications for the sovereign's balance sheet. The ownership of all government investments and public enterprises (excluding Petroleum Development Oman) previously overseen by the MoF transferred to OIA in 2020. These SOEs operate in 11 sectors and with 36,000 staff, accounting for approximately 28 percent of GDP (about US\$18.2 billion) at end-March 2021. SOE debt (excluding Petroleum Development Oman) increased from 16 percent in 2015 to 42 percent of GDP in 2021,

with explicit government guarantees to SOEs amounting to about 10 percent of GDP. Furthermore, since September 2021, expenditures on gas and oil sectors were hived off the central government budget to EDO.

22. Commonly used fiscal rules have their strengths and weaknesses. Box 3 provides an overview of various rules. A number of commodity-exporting countries have adopted fiscal rules (Annex I).

Box 3. Overview and Assessment of Selected Fiscal Rules

Overall balance rule: it imposes a ceiling on the headline deficit in percent of GDP. It is simple and easy to communicate to the public. The overall budget balance is closely linked to debt dynamics, making the rule effective in supporting debt sustainability. The large impact of externally driven changes of the oil prices on the overall balance could give misleading signals about the underlying fiscal position and fiscal risks. The rule can also lead to a procyclical fiscal stance (e.g., consolidating to offset the cyclical decline in revenues in bad times and expanding spending in good times).

Golden rule: it imposes a ceiling on the overall deficit net of capital expenditures (also called current balance), aiming to protect capital expenditures which are key to long-term economic growth. This rule is consistent with intergenerational equity, shifting the burden of financing public investment projects from current to future generations that will be the main beneficiaries of such projects. However, it may favor creative accounting through reclassification of unproductive expenditures as investment to circumvent the rule. The rule can also allow excessive borrowing and weaken the link between the targeted deficit and debt dynamics, creating possible risks to debt sustainability.

Cyclically adjusted rule: it imposes limits on the overall balance, correcting for the effects of business cycle fluctuations on revenues and expenditures. By disconnecting spending from cyclical revenues and letting automatic stabilizers operate freely, such rule can be used to stabilize the path of expenditures. Changes in the cyclically adjusted balance are, in principle, closer to the discretionary fiscal efforts, whereas an equivalent decline in the nominal fiscal balance might simply reflect a deterioration in cyclical conditions. However, monitoring and enforcing cyclically adjusted balance rule is challenging, as it requires timely and reliable estimates of the output gap, which is often hard to estimate, particularly in countries that are undergoing structural changes and those with poor data quality. Cyclically adjusted balances are also prone to frequent ex-post revisions resulting from measurement errors of potential output.

Structural rule: it is an extension of cyclically adjusted rules (Bornhorst et al. 2011), as it adjusts the overall balance beyond the business cycle by correcting revenue and spending for one-off fiscal measures and other economic cycles, such as those related to asset or commodity prices. The structural budget balance allows for the smoothing of oil price volatility when setting spending decisions. Specifically, expenditure is set based on an estimate of the long-term oil price—say, a 5 or 10-year average—and a target for the structural balance.

Expenditure rule: it sets a target on total, primary, or current spending. The rule is typically set in absolute terms (levels) or growth rates and occasionally in percent of GDP (and non-resource GDP for commodity exporting countries), with a time horizon that typically ranges from three to five years (Lledó et al. 2017). Expenditure rules in levels and growth rates allow automatic stabilizers to operate on the revenue side in times of adverse shocks, while expenditure rules set as a ratio of GDP tend to be procyclical.

Revenue rule: it sets floors or impose ceilings on government's income proceeds. Neither revenues floors nor ceilings constrain spending, and therefore the rule does not ensure achieving fiscal sustainability. It can also complicate macroeconomic stabilization efforts by, for example, hiking taxes in bad times.

Non-resource primary balance rule: it excludes resource revenues and resource expenditures, which is more suitable for assessing long-term sustainability and fiscal risks in resource rich countries. The rule gives good signals about the underlying fiscal stance, with an increase in the non-resource primary deficit indicating a loosening of fiscal policy arising either from higher expenditure or a relaxation of non-resource revenue collection.

Box 3. Overview and Assessment of Selected Fiscal Rules (concluded)

A reduction in the non-resource primary deficit would signal fiscal consolidation. The short-run macroeconomic impact of a loosening/tightening the non-resource primary deficit is similar to increase/decrease in the overall deficit in a conventional economy (Medas and Zakharova, 2009). Non-resource primary balance is usually normalized by non-resource GDP to avoid the fluctuation caused by commodity prices and to better reflect the domestic economy.

Assessment of Fiscal Rules

| | |
|--|---|
| Overall Balance <ul style="list-style-type: none"> + Easy to communicate and monitor + Closely linked to debt sustainability + Clear operational guidance - Could lead to procyclicality - Could adversely affect quality of adjustment | Golden (overall deficit net of capital expenditure) <ul style="list-style-type: none"> + Protect public investment + Intergenerational equity - Weak link to debt sustainability - Creative accounting |
| Expenditure <ul style="list-style-type: none"> + Easy to communicate and monitor + Allow macroeconomic stabilization + Clear operational guidance + Could ensure debt sustainability if well-designed - Could adversely affect quality of adjustment - May reduce incentive to raise revenues | Revenue <ul style="list-style-type: none"> + Raise revenue or limit tax burden - Weak link to debt sustainability - Could lead to procyclicality |
| Cyclically Adjusted and Structural <ul style="list-style-type: none"> + Foster economic stabilization + Good operational guidance - Difficult to compute and monitor | Non-Resource Primary Balance <ul style="list-style-type: none"> + Easy to monitor + Could encourage non-resource revenue generation - Difficult to communicate - Narrow coverage and weaker link to financing needs/debt |

Source: IMF 2018a; and authors.

23. While all desirable features may not be simultaneously achievable with a single fiscal rule, the choice should reflect Oman's circumstances. The more flexible the rule to adapt to macroeconomic shocks, the more complex its design is likely to be (e.g., rules that correct for the impact of business cycles by targeting cyclically adjusted balances). Another trade-off could exist between resilience and operational guidance, where rules that include flexibility provisions (e.g., escape clauses) might complicate the budget process as fiscal targets can change with circumstances. Furthermore, using multiple rules has become a global trend that emerged after the financial crisis, as countries sought to address shortcomings and trade-offs involved in single rules (what is referred to as second generation rules, Eyraud et al. 2018). It has a drawback, however, of increasing the complexity of the framework and potential inconsistencies and overlap between the rules.

24. On balance, a rule based on the non-hydrocarbon structural primary balance could be appropriate for Oman.³ Such rules have the benefit of disconnecting spending from the volatility of oil and gas prices and economic fluctuations. Delinking expenditure decisions from commodity price volatility requires saving some of the hydrocarbon revenue when prices are high and drawing on these savings to finance expenditure when prices fall. However, estimating cyclically adjusted balance or structural rules could be challenging because of the assumptions utilized to define the

³ Annex II provides illustrative simulation of fiscal outcomes for selected fiscal rules.

targeted balance. In addition, monitoring compliance requires timely and reliable estimates of the output gap—as real-time assessment of the cyclical position of the economy is difficult especially given ongoing structural reforms under Vision 2040—and long-term commodity prices, which can be challenging to prepare regularly. Therefore, further developing institutional capacity within the MoF and enhancing data quality will be perquisites in developing these rules. In the meantime, complementing the implicit overall balance rule in the MTFP, a rule on the non-hydrocarbon primary balance can be explicitly linked to the long-term fiscal anchor.

D. Conclusion

25. Strong fiscal frameworks are important for Oman because of its significant reliance on hydrocarbon resources. The high fiscal reliance on hydrocarbon revenues—which are non-renewable resources—combined with the volatility of oil and gas prices have resulted in large swings in public expenditures and consequently GDP growth. This increases the need for well-designed fiscal frameworks to reinforce fiscal sustainability while taking into account stabilization, development, and intergenerational equity in the use of hydrocarbon resources.

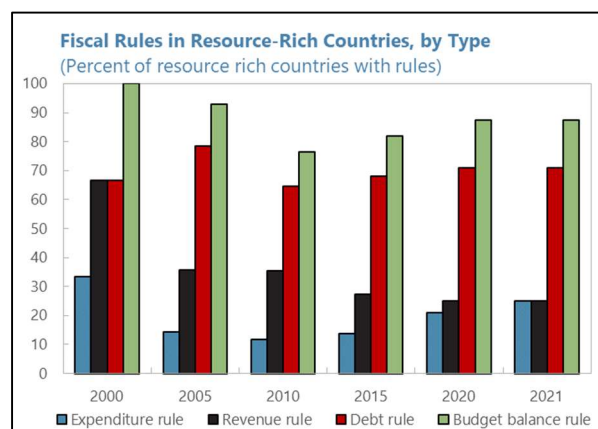
26. Once fiscal frameworks are well-developed, a formal fiscal rule could be considered as a way of reinforcing fiscal frameworks. Successful implementation of fiscal rules is generally preceded by a period of fiscal consolidation and strengthening fiscal frameworks. The eventual introduction of a fiscal rule could help the government achieve its long-term fiscal policy objective, but the focus should be first on further strengthening fiscal frameworks. One key question before the government is to define its long-term fiscal anchor, where it would provide a guide to formulate fiscal rule(s). In thinking about its long-term fiscal anchor and a possible fiscal rule, the authorities will have to balance short-term macro-management, medium-term development, and longer-term saving goals.

Annex I. Fiscal Rules in Commodity-Exporting Countries¹

Countries' experiences show that fiscal rules have the potential to prevent excessive deficits, smooth shocks, and address intergenerational equity challenges, particularly when supported by strong institutions.

1. Fiscal rules have become common in resource-rich countries. The number of resource-rich countries with fiscal rules increased from 6 in 2000 to 24 by 2021, and such countries are increasingly using more than one fiscal rule. Rules targeting the budget balance are the most common, combined in many countries with a public debt rule. Expenditure rules are gaining popularity among resource-rich countries. In most resource-rich countries, standard fiscal rules are modified to take into account fiscal sustainability and commodity price volatility. While some such

countries target traditional fiscal aggregates such as the overall balance and debt, non-resource balance and structural balance rules are more common among resource-rich countries.



2. Generally, rules for commodity exporters can be classified in two categories, depending on the rule's main objective (IMF 2018a):

- *Rules to cope with price volatility and achieve macroeconomic stability:* using fiscal rules for stabilization purposes is particularly relevant for countries with long commodity reserve horizons, where exhaustibility is not a primary concern. Within this category, potential rules include—but not limited to—revenue split, price smoothing, structural balance, and expenditure rules.
- *Rules to ensure fiscal sustainability and an equitable intergenerational allocation of resources:* while all commodity-exporting countries need to ensure the sustainability of public finances, this issue is particularly relevant in countries with a relatively short commodity reserve horizon. Given the prospect of resource depletion, the main purpose of fiscal rules is to determine the amount of savings (and sustainable spending) for current and future generations (IMF 2012).

¹ Based on Fiscal Rules and Fiscal Councils Database (2021) and authors.

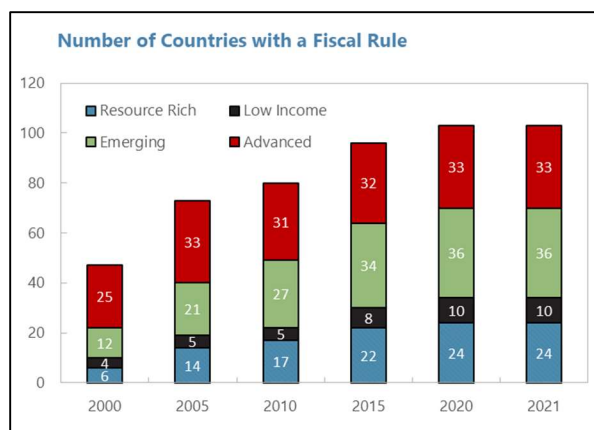
3. Botswana (expenditure rule, since 2003): a ceiling on the expenditure-to-GDP ratio is set at 40 percent. Botswana also introduced a debt rule in 2005 that limits domestic and foreign debt each to 20 percent of GDP.

4. Chile (structural balance rule, since 2001): under the structural balance rule, government expenditures were budgeted in line with a structural balance target and structural revenue, that is, revenues that would be achieved

if: (i) the economy were operating at full potential; and (ii) the prices of copper and molybdenum were at their long-term average (10-year). Starting from the 2015 budget, the government no longer adjusts revenues based on long-term prices of molybdenum. The expenditure is the residual, after subtracting the structural balance target from the estimated structural revenue. The implementation of the rule has changed over time: from 2001–07, a constant target for the structural balance (a surplus of 1 percent of GDP was defined to help eliminate debt and accumulate assets for the future); in 2008, the target was changed to 0.5 percent of GDP; and in 2009, the target was set at zero, and an escape clause was introduced to accommodate countercyclical measures—which helped Chile weather the global financial crisis. A fiscal council established in 2013 to oversee two existing independent committees—on potential GDP and long-run copper price—and ensure such parameters are correctly used in the computation of the structural balance. The council also advises the Minister of Finance on issues regarding the structural balance rule. The council, whose views are made public, but not binding, to help enhance the rigor and transparency of the rule.

5. Norway (non-oil primary balance rule, since 2001): the fiscal rule ties the non-oil primary deficit to the investment income of the sovereign wealth fund (SWF). Net cash flows from oil and gas are transferred to the SWF to accumulate financial assets and the government can use only the yield from these assets for spending. The rule sets a ceiling on the non-oil primary deficit not to exceed 3 percent of the accumulated financial wealth, which corresponds to the expected long-run real rate of return of its SWF. However, the transfer from the SWF could be higher during downturns for the purpose of countercyclical stabilization and expenditure smoothing.

6. Russia (evolving rules, since 2007): its first fiscal rule (2007–2009) targeted a long-term non-oil deficit of 4.7 percent of GDP to be achieved by 2011, was suspended in 2009 to allow for a fiscal package to stimulate the economy during the global financial crisis. The rule was abolished in 2012 and replaced with a redesigned fiscal rule beginning in 2013. The revised rule (2013–2017) set a ceiling on expenditures equivalent to the sum of oil revenue (measured at the benchmark oil price), plus non-oil revenues, plus a net borrowing limit of 1 percent of GDP. Benchmark oil revenues are calculated according to a 10-year backward looking oil price rule. Oil revenues above the “benchmark” oil price need to be saved in the Reserve Fund until it reaches 7 percent of GDP. Once the Reserve Fund reaches this threshold, at least half of excess oil revenues should go to the National Wealth Fund, while the remaining resources would be channeled to the budget to finance



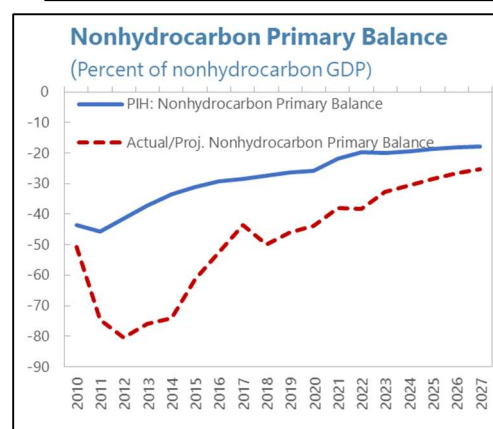
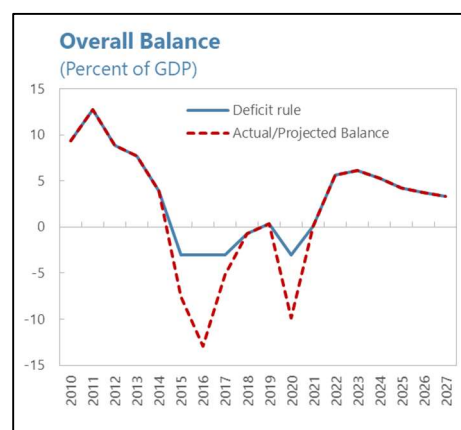
infrastructure and other priority projects. When oil prices are below the benchmark, the Reserve Fund could be tapped to maintain expenditures. In case of a prolonged decline in oil prices, the benchmark oil price formula is reset to equal the three-year backward average. However, after the 2014 oil shock, the rule did not allow a fast-enough adjustment of the benchmark oil price, which led to its suspension in 2015 (as its continued implementation would have led to unwarrantedly large non-oil fiscal). In 2018, the authorities started the implementation of a modified fiscal rule targeting a non-oil primary deficit of 1 percent of GDP in 2018 (and zero for 2019 and beyond)—at a fixed benchmark oil price per barrel of \$40 (in real 2017-dollar terms) with a proposed annual adjustment by the US CPI inflation.

7. Timor-Leste (non-oil primary balance rule, since 2005): annual transfers from the Petroleum Fund to the budget are equal to the Estimated Sustainable Income (ESI), set at 3 percent of government wealth. The government wealth is estimated as the sum of financial assets in the Petroleum Fund and the net present value of expected future petroleum revenues. This formulation is in line with the permanent income hypothesis approach and the ESI is updated annually (i.e., the path of the non-oil primary fiscal deficit is calculated based on the PIH model), allowing for deviation from it to scale up public investment.

Annex II. Illustrative Simulation of Fiscal Outcomes Using Fiscal Rules

The simulations, which are for illustrative purposes only, are carried using historical data (2010-2020) and projections (2021-2027) to illustrate how Oman's budgets would have performed under the selected rules.¹ Designing fiscal rules that would yield the right mix of sustainability, simplicity, counter-cyclicality and policy guidance is a complex exercise that goes beyond the scope of this paper. For the simulations, the first step is to determine the fiscal balance in each fiscal year based on each rule. If the actual fiscal balance (depending on the rule) has a better outcome than the ceiling implied by the rule, then the rule will not be binding, and actual figures are used for that year.² Otherwise, the fiscal outcome will be bound by the rule-implied ceiling. While these simulations are illustrative and carried out only for selected rules, the results show a nonhydrocarbon primary balance rule, and an expenditure rule are more binding in ensuring long-term debt sustainability and economic stabilization compared to an overall balance rule. In particular:

- *Overall fiscal balance rule:* this rule tends to lead to a procyclical stance. During the boom in oil prices in 2010-2014, the rule would have permitted a ramping up of spending as higher oil revenues enabled the deficit rule to be met quite easily, with overall fiscal surpluses masking the expansionary fiscal policies where non-hydrocarbon balance deteriorated sharply (from -50 percent in 2010 to -80 percent of non-hydrocarbon GDP in 2012). Such a rule was also rarely binding except for 2015-2017 (after the 2014 oil shock) and 2020 (during the dual shock of the pandemic and a collapse in oil prices).
- *The non-hydrocarbon primary balance rule:* the rule excludes hydrocarbon revenues and expenditures and is therefore a better measure of the impact of fiscal policy on domestic demand. For the simulations: (i) for 2010-2020, the non-hydrocarbon primary deficit ceiling as a percent of non-oil GDP is set based on the average

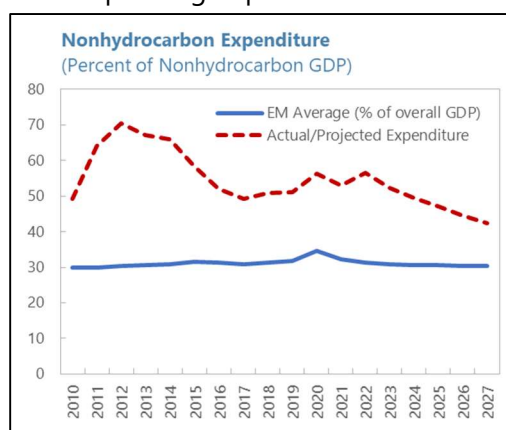


¹ Balances are adjusted to take out hydrocarbon capital and operation expenditures, which is consistent with internationally accepted practice.

² Taking out expenditures relating to investment in the oil and gas sector.

of PIH benchmark for a particular year³; and (ii) for 2021-2027, the ceiling corresponds to 2021 medium-term benchmark calculated using the PIH. The results indicate that the rule would have been binding during 2010-2020. The rule would also have been consistent with long-term fiscal sustainability and would have been more countercyclical compared to the overall balance rule. Nevertheless, setting a non-hydrocarbon primary balance rule can be challenging. The estimation and communication of the equilibrium level for fiscal sustainability can pose challenges. In addition, a suitable mechanism has to be designed to structure the adjustment in cases when there is a sizeable gap between the current non-oil primary deficit and the equilibrium level and to allow for periodic revisions of the medium-term benchmarks to reflect changing conditions (e.g., assumed long-term oil and gas prices, proven reserves and production levels, rate of return on financial assets).

- *The expenditure rule*: the rule imposes a ceiling on government spending in percent of nonhydrocarbon GDP, where the ceiling is estimated based on emerging economies average of expenditure to GDP. The simulation results show the rule would have been binding and steadfast implementation of the MTFP would significantly narrow the over the medium-term. An important drawback of this rule is that it leaves revenues outside the coverage of the rule. Hence, were revenues falling as a share of GDP, the rule could allow for widening deficits over time, since the expenditure-to-GDP ratio would remain broadly constant under the rule.



³ As previously estimated by the IMF staff at that point of time.

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