Oil Boom Tests Producing Countries

Consumers around the world may cheer when the price of gasoline to fill their cars falls even slightly. But the frequently sharp changes in the price of oil and related foreign exchange inflows, together with the nonrenewable nature of the resource, complicate macrofiscal management in oil-producing countries.

In response, a number of oil producers have established special fiscal institutions (SFIs), such as oil funds, fiscal rules, fiscal responsibility legislation, and budgetary oil prices, to help fiscal management (see box). In some cases, the establishment of these institutions has also been triggered by political economy and institutional considerations, for example in some countries in which governments have had difficulties containing spending.

A study by the IMF's Fiscal Affairs Department examines how governments of oil-producing countries have managed their fiscal policies in response to the recent oil revenue boom, and the role of SFIs in fiscal management in these countries. The IMF study covers countries in which fiscal oil revenue accounted for at least 20 percent of total fiscal revenue in 2004 and for which sufficient information was available.

Jorge Silva/Reuters

Refinery in Anzoategui, Venezuela: Fiscal balances improved in many oil producers following the sharp oil price rise since 1999.

Fiscal responses

The study notes that the average price of oil tripled from $18 a barrel in 1999 to $53 in 2005 and rose further in 2006. The associated increase in oil exports and fiscal oil revenues has had major macroeconomic and fiscal implications for oil producers that depend heavily on oil revenues. The paper outlines three main fiscal responses of oil producers to the oil boom:

- On average, during 2000–05 governments used close to half of the additional fiscal oil revenue to increase non-oil primary spending and/or lower non-oil primary revenue. Oil producers turned overall fiscal deficits in the late 1990s into growing fiscal surpluses. The variance across countries, however, is significant.
- Higher oil revenues allowed oil producers an opportunity to increase public spending on priority economic and social

Special Fiscal Institutions Help to Manage Oil Revenues

Oil funds have proliferated in recent years. Their policy objectives include stabilization, financial savings, asset management, and fiscal transparency. They typically have relatively rigid operational rules for depositing and withdrawing resources, often based on the expectation that removing "high" oil revenues from the budget will help moderate and stabilize expenditures, and reduce policy discretion. But the evidence shows that in some cases rigid oil fund rules have been changed, bypassed, or eliminated. As oil prices have risen, oil funds are increasingly focusing on long-term saving objectives. The resources of some oil funds are earmarked for specific purposes.

Fiscal rules and fiscal responsibility laws are mechanisms intended to permanently shape fiscal policy design and implementation. They are often enshrined in constitutional or legal provisions. Oil funds are more common, but fiscal rules and fiscal responsibility laws can have a more critical role because they are intended to constrain overall fiscal policy. In several cases, fiscal rules or frameworks have been weakened over time or ignored.

Budgetary oil price forecasts. Most oil producers have used a conservative oil price or revenue forecast to determine a budget's resource envelope. Such assumptions are viewed as a prudent way to reduce the risk of a large deficit or fiscal adjustment in the event of an unanticipated decline in oil revenue. However, while there is a case for an element of prudence in budget oil forecasts, the use of artificially low oil prices as a strategy to contain spending is unlikely to be sustainable and may lead to spending inefficiencies.

The IMF study covers oil-producing countries in which fiscal oil revenue accounted for at least 20 percent of total fiscal revenue in 2004 and for which sufficient information was available: Algeria, Angola, Azerbaijan, Bahrain, Brunei, Cameroon, Chad, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Iran, Kazakhstan, Kuwait, Libya, Mexico, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Timor-Leste, Trinidad and Tobago, United Arab Emirates, Venezuela, Vietnam, and Yemen.

goals, which could be an appropriate response to rising oil prices. At the same time, many oil producers that have increased spending rapidly show low indices of government effectiveness, which may raise questions about their ability to use the additional resources effectively and efficiently.

• The long-term fiscal sustainability of a number of oil producers improved between 2000 and 2005, assessed on the basis of a standardized sustainability benchmark, but in a few it deteriorated, mainly because of the expansion in non-oil primary deficits. Some countries remain vulnerable to oil price shocks and the possible need for adjustments.

Fiscal management, role of SFIs

Countries' experiences highlight the importance of sound institutions, public financial management systems, and medium- to long-term perspectives to ensure the quality of spending and the sustainability of fiscal policies. The evidence suggests that the quality of institutions (including in such areas as accountability and the quality of public administration) matters for fiscal outcomes and that priority should be given to enhancing public financial management systems where appropriate.

Developing a medium-term framework can help link annual budgets to longer-term policies and fiscal sustainability objectives, and enhance risk analysis. The budgets of many oil-producing countries are characterized by short-term horizons, with little reference to longer-term policies and objectives.

Medium-term frameworks that explicitly incorporate a longer-term perspective can help promote predictability, improve resource allocation, and enhance transparency and accountability. They can also be specifically designed to help address the fiscal risks posed by volatile, unpredictable, and exhaustible oil revenues.

Strong institutions

The study also finds that, under appropriate institutional frameworks, well-designed SFIs may help support sound fiscal policies, though they are not a panacea. Successful SFIs require strong institutions and political commitment.

The development of SFIs should not detract from other, more fundamental public financial management and governance reforms as appropriate. In addition, international experience suggests the advisability of adopting some specific principles for the design and implementation of effective SFIs.

Oil funds should be integrated with the budget to enhance fiscal policy coordination and public spending efficiency, the study says. They should not have the authority to spend. Financing funds should be preferred to funds with rigid rules. Mechanisms to ensure transparency, good governance, and accountability should be in place.

Although the implementation of quantitative fiscal rules remains challenging in oil-producing countries, fiscal responsibility laws with comprehensive procedural and transparency requirements may work better to sustain the credibility of the fiscal framework, the study says. Success, however, hinges on proper design, consistency with public financial management capacity, and enforcement of the provisions. ■

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Finance for Africa's Post-Oil Deficits

Oil prices—more so than those of most other commodities—have proved highly volatile and are hard to predict. In the current oil-price boom, many oil-producing governments are seeking to draw the right lessons from previous boom-bust cycles and are trying to avoid basing long-term spending plans on fickle revenue streams. In Africa, this is particularly pertinent because oil reserves (which will run out fairly soon in some countries) have largely failed to translate into accelerated rates of socioeconomic development.

Governments face a choice between designing a path of gradual fiscal adjustment while overall fiscal balances are in surplus or having to reduce public expenditure abruptly once oil revenues start to decline, often to the detriment of the most disadvantaged segments of society. To that end, the research literature has used estimates of oil (and gas) reserves to define a long-term fiscal policy strategy that has governments accumulate (net financial) assets during the years of oil production, generating additional fiscal space during the post-oil years.

Within this forward-looking framework, the optimal policy would set (consumptive) spending at a constant level of GDP, equal to the expected annuity value of oil wealth and non-oil revenue. By implication, governments invest the remainder of current oil revenues in alternative forms of wealth (in this case, financial). These assets generate a rate of return from which governments can finance a primary deficit indefinitely when oil reserves are depleted.

These benchmarks of sustainability, simulated in the IMF Working Paper "Old Curses, New Approaches? Fiscal Benchmarks for Oil-Producing Countries in Sub-Saharan Africa" (IMF Working Paper 07/107, May 2007), imply that the current fiscal policy stance of most sub-Saharan African oil producers will need to be adjusted. Even on the basis of optimistic assumptions on key parameters, including those on the size of economically exploitable oil and gas reserves, most of these oil producers will not be able to maintain the current level of public expenditure.

A clearly defined medium-term policy path thus defines current budgets in line with the benchmark ratios on public consumption, combined with efforts to increase the effective rate of returns on (financial and physical) investments. Improving public financial management can help prevent a repetition of previous boom-bust cycles and improve socioeconomic indicators in countries where large segments of the population have, thus far, benefited only marginally from national oil wealth. ■

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