Macro-Fiscal Nexus
An Overview

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Outline

- Key considerations and trade-offs
- Elements of framework
- Consistency and interrelationships
- Policy implications

Strategic Objective

- The strategic challenge is to convert exhaustible natural resource wealth into long-term sustainable growth and assets
  - Broad based increases in living standards
  - Reduction in endemic poverty
  - Increases in employment opportunities
  - Diversification and structural change

Stylized Facts In Resource-Rich Developing Countries

- Large development needs and structural reform agenda
- Exhaustible natural resources dominate the economy – inherent price volatility and potential for boom-bust cycles
- As the are often state owned, so government actions and policies have a very large impact
  - Inflation, Dutch Disease, crowding out and debt crises
- Weak administrative capacity – leads to inefficient spending and poor investment decisions
- The need for the state to capture the benefits of resource rents, natural resource taxation is different and much more complex than most other forms of taxation
- Under-spending on building assets for growth – both physical and human capital – holds back growth
- Role of foreign investors in promoting projects but problems of asymmetric information and dependency

Fiscal Framework

- Demand management
  - Expenditure needs vs. absorptive capacity
- Inter-temporal resource allocation
  - Expenditure vs. savings – levels and smoothing paths
- Revenue diversification
- Composition of expenditures
- Sovereign asset-liability management
- Consistency of policies

Revenues

- Revenue base:
  - Royalties
  - Production sharing
  - Income taxes
  - Equity stakes
- Need to capture resource rents is often done on case by case basis but this reduces transparency – role of Extractive Industries Transparency Initiative (EITI) to improve transparency and accountability
- Negotiations with foreign partners – difficulties include their better knowledge base, transfer pricing, costs control etc
- High dependence on natural resource revenues can lead to volatility in revenue base
- Revenue diversification is needed but this requires economy wide diversification
- Role of consumption based taxes e.g. VAT but need improvements in administrative capacity

Expenditures

- Demand management
  - Short term absorptive capacity constraints boost inflation vs. flattening supply curve to reduces costs
- Medium- to long-run spending, saving, and investing of resource revenues
  - How much should be consumed now and how much transferred to future generations
  - What assets should be acquired to make this transfer?
- Role of fiscal rules and savings schemes in guiding expenditures

Compositional Issues

- Within the sustainable envelope, what is the split between capital and current spending?
  - Development of public goods - basic infrastructure vs. capital intensive projects
  - Physical assets vs. human capital
  - Importance of maintenance and operational expenditures to preserve capital stock
- Political and social pressures for transfers and subsidies – particularly if growth is not inclusive and broad based

Fiscal Rules

- To smooth out volatility and promote savings
- Price smoothing
  - Within an estimate of sustainable primary balance, expenditures are smoothed out by revenue assumptions
- Transfer of revenues to a dedicated fund
  - Accumulates revenues and transfers to budget to finance expenditure under certain rules
  - Smoothes out volatility of revenues
- Time horizon affects choice of fiscal rule
  - Long RH: main focus is managing volatility (price smoothing rule)
  - Short RH: give prominence to exhaustibility and focus on growth enhancing projects

Sovereign Wealth Funds

- Stabilization and savings role
- Permanent income hypothesis (PIH) based
  - E.g. a fixed withdrawal of natural resource income based on implicit return on total resource wealth to finance expenditure
  - But can understate short-term capital needs to create public goods - growth outlook is lower
- Augmented PIH based
  - Allow scaling up of expenditures to support growth expenditures beyond that implied by PIH
  - But pace of scaling up is limited by absorptive issues
  - Decision when to scale back can be politically difficult
- Governance and transparency are important to avoid poor management
  - the *Santiago Principles* to ensure best practices regarding legal framework, institutional framework and governance framework, and investment policies and risk management

Sovereign Asset-Liability Management

- Savings of natural resource income to build up of assets for future generations
- But expenditures now to promote growth with some debt accumulation may be appropriate for projects with higher rates of return
  - Social rate of return higher than cost of debt
  - Accuracy of cost–benefit analysis
  - Working with development partners to ensure good governance of projects
- Need to minimize
  - Non concessional debt
  - Off balance sheet liabilities including via state owned enterprises and guarantees
  - Use of sovereign wealth fund to guarantee debts can be dangerous

Consistency of Policies

- Primacy of fiscal policies when there is a fixed exchange rate as the budget is the only tool of demand management to control inflation and Dutch disease problem of REER appreciation
- Under a more flexible exchange rate still need sustainable fiscal policies to avoid inflation-depreciation spiral
- Structural policies
  - Revenue diversification requires economic diversification
  - Expenditures can influence nature of structural change

Policy Implications

- Importance of sound fiscal policies
  - Maintaining macroeconomic stability and avoiding boom-bust cycles
  - Building assets for growth based on proper cost-benefit analysis
  - Savings for consumption smoothing and inter generational wealth transfer
- Consistency with other policies
  - Exchange rate and monetary policies
  - Promoting structural change
  - Creating an enabling environment and crowding in
- Difficult trade-offs but good governance, accountability, and transparency can help