MANAGING BUDGETARY PRESSURES

2017 CABRI conference framing paper

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Budget systems are beset by uncertainty. Public budgets are planned well in advance of the fiscal year and, in most cases, the amounts that can be spent are limited by law to a single year at a time. Yet, conditions can change for a number of reasons at any point during that period, requiring changes in the volume or distribution of spending. How well budget managers are able to deal with these pressures and retain or build budget credibility are crucial not only for fiscal outcomes, but also for trust in the budget system.

The 2017 CABRI conference will provide an opportunity for senior budget officials to learn from each other about how to manage budgetary pressures.

Conference focus and scope
Budgetary pressures are an unavoidable consequence of allocating scarce resources between limitless societal needs. As such, the preparation and approval of public budgets, and the management of ordinary in-year deviations from planned revenues and expenditures, mean that ministries of finance routinely contend with budgetary pressures. Countries with stronger budget institutions are better able to manage this year-to-year budgetary pressure in respect of their fiscal outcome targets and development objectives, also in times of scarcity. Budget managers in countries with weaker systems – more fragmented budget processes and less robust revenue and expenditure forecasting, cash management, in-year control, accounting and reporting systems – have a tougher time dealing with such pressures, also in times of plenty.

The focus of the conference, however, is neither on these routine pressures, nor on how to build the strong budget institutions required to manage them optimally. That is the ongoing concern of all efforts to build sound budget systems, which, in one way or another, has been the focus of many previous CABRI seminars. The key question for the 2017 CABRI conference is, rather, how governments can better prepare for and manage extraordinary pressures that either arise suddenly at any point during budget preparation and execution or which build up over several years, without veering towards unsustainable debt or disrupting service delivery. How do governments prepare for and/or cope with macroeconomic shocks, extreme weather events, unforeseen political demands or the build-up of pressure due to growing expenditure arrears, for example?

Strong arguments have been made that public budgets in Africa are both:

- more vulnerable to extraordinary pressures, due to volatile macroeconomic environments, undependable aid flows, high vulnerability to climate change events, high demand for public spending in low- and lower-middle-income contexts, and often unstable political contexts; and
- less able to respond to extraordinary pressures, due to narrow tax bases, overreliance on volatile trade taxes, underdeveloped capital markets and relatively low private capital inflows, and reliance on (sometimes unpredictable) foreign grants and concessionary loans to finance shortfalls between own revenues and expenditure.1

The conference is aimed at exploring successful ministry of finance strategies for managing these pressures, and achieving budget credibility, whether by way of preparation, avoidance or adjustment. Key themes for the conference include, on the technical side, fiscal risk management, contingency planning, fiscal space and fiscal resilience, and budgetary control and flexibility. However, insofar as budgets are political processes, the conference will also pay attention to processes and strategies to negotiate trade-offs and compromises, and strategies to communicate constraints and changes for stakeholder buy-in and long-term trust in the budget system.

This paper is intended to frame the content of the conference, setting out the terrain on the basis of current public financial management (PFM) knowledge and experience. The paper first discusses common causes of extraordinary budgetary pressures, and then considers common responses, drawing on good practice evidence. This is intended to provide key themes for discussion at the conference.

Causes of budgetary pressure
The focus of the conference is on the budgetary pressures arising when events occur that cause fiscal outcomes to

1 See, for example, Shick (1998), Prakash and Cabeson (2008) and Gelbard et al (2016). Caiden and Wildavsky, as far back as 1980, pointed to ‘functional redundancy’, or the ability of rich economies to produce more than they consume. When this ability is lacking, they argue, the result is ‘havoc with their budgeting and planning’ (Caiden & Wildavsky 1980).
deviate significantly from expectations or forecasts, whether on account of lower revenues or higher expenditures than anticipated. Such events are fiscal risk factors, which may be occasioned by macroeconomic shocks, or the realisation of contingent liabilities, obligations that arise when particular discrete events occur (IMF 2016). These obligations may be explicit, enshrined in a particular contract or law, or they may be implicit, involving a moral obligation or unexpected responsibility of government, which is not established by law or contract, but is based on public expectations, political pressures and the overall role of the state as society understands it (Bova et al. 2016).

A recent analysis of data collected on the sources of shocks to government debt in 80 advanced and emerging economies between 1990 and 2014 found 230 events, ranging from financial and banking crises to pressures triggered by the realisation of public private partnership (PPPs) contractual contingent liabilities (Bova at el. 2016). While the sample included only a few African countries, it nonetheless provides an evidence-based listing of the typical sources of budgetary pressures affecting all countries. Of course, the low- and lower-middle-income economies of Africa may be affected more frequently by some of the listed events than by others, while the average and median cost per event may be higher. For the sample of countries in the study, the average cost was about $6 per cent of GDP, with the median cost at 2 per cent, an indication of the possible debt impact of events.

Typical event types (arranged from the most to least frequent) were:

- **Macroeconomic shocks** in the form of sharp declines in nominal GDP are the most common type of event. The study found that, typically, public finances were hit by a macroeconomic shock once every 12 years, with an average fiscal cost the equivalent of around 9 per cent of GDP. For the conference, sharp declines in exchange rates, with the resulting impact on countries’ service costs for foreign currency denominated debt, would also count as a macroeconomic source of budgetary pressure.
- **The financial sector** was found to be an even larger source of shocks to public finances, although less frequent than macroeconomic shocks. Government rescues of troubled financial institutions happen once every 24 years, on average, and have an average cost of about 10 per cent of GDP (in one case, causing a fiscal cost of 57 per cent of GDP).
- **Natural disasters** are a relatively frequent but modest source of fiscal risks, costing 1.5 per cent of GDP on average.
- **State-owned enterprises (SOEs)** are a potentially significant and common source of onerous fiscal obligations, with government bailouts of troubled SOEs costing 3 per cent of GDP on average.
- **Subnational governments** are also a significant but less frequent source of fiscal risk, with rescues of troubled regional and local governments costing 4 per cent of GDP on average.
- **Legal cases** did not occur frequently; however, they were expensive, on average, at around 8 per cent of GDP. **Public private partnerships** are a relatively modest and infrequent source of fiscal risk, with government rescues of PPP projects costing 1 per cent of GDP on average. For the sample countries PPP costs only began to increase in the later years of the study period, in line with increases in the frequency of such contracts.
- **Private non-financial companies** were a modest and infrequent source of fiscal risk, with corporate bailouts or assumption of debt obligations costing 1.5 per cent of GDP on average.

The study also found that fiscal risks are highly correlated: when something goes wrong, it is rarely an isolated event. In the sample countries, while the average direct cost of a specific event was 6 per cent of GDP, the average increase in the debt-to-GDP ratio over the event was 15 per cent.

In addition to these events related to macroeconomic shocks and contingent liabilities, budget planning and implementation can also be thrown off course by political decisions and/or pressure on the finance ministry to finance new spending objectives, to increase expenditure on existing objectives or to provide tax exemptions and reductions beyond what was expected or planned for the spending year or over the medium term. Typical examples of such pressures are the financing of a higher-than-expected increase in the remuneration of public servants, increases in subsidies, reductions in tax rates, or the financing of costly, high-profile events.

A final source of budgetary pressure for consideration during the conference can be characterised best as technical budget institution weaknesses. In the ordinary course of events, the pressures that arise from these weaknesses can be routine (like coping with a manageable level of expenditure arrears year after year) but they can also be sudden and/or significant when compounded across government, such as when weak budget challenge capacity allows spending agencies to underrepresent unavoidable costs, when weak costing of large infrastructure projects results in significant additional outlays, or when lax financial management of large donor grants leads to corruption and reimbursement obligations.

In thinking through how ministries of finance can best manage various budgetary pressures, it is useful to categorise them as:

- exogenous (arising from events beyond government control) or endogenous (arising from events the probability of which can be influenced by the government); and

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2 Algeria, Angola, Egypt and South Africa were included in the sample.
3 Episodes were identified as occurring when nominal GDP growth falls by one standard deviation relative to its average.
4 Given that these costs in the sample were driven by court-mandated compensation for deposits frozen in countries after the collapse of the Soviet Union, the occurrence of legal obligations is likely to affect African countries less. However, compensation for state negligence can cause unexpected fiscal obligations.
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- continuous (or regular) or discrete (once off, with different probabilities of their occurrence).5

Depending on how discrete and exogenous an event is, the government may choose not only to accommodate it through changes to fiscal or budget policy, which would require a process to decide the course of action, but also to mitigate the budget impact in the short term through strategic engagement, communication and negotiation or to address its cause in the long term through changes to budget institutions. For example, endogenous continuous events such as regular rescues of SOEs or political pressure to finance a steep increase in fuel subsidies may be mitigated in the short or long term through adjustments to budgeting institutions. Exogenous discrete events, such as unusually severe floods, may be dealt with most effectively by way of mechanisms such as contingency funds or reserves. Exogenous continuous events can be managed with the use of costing mechanisms to determine reasonable budget allocations, thereby removing them as extraordinary pressures. Communication of the fiscal consequences of an event, and engagement of the finance ministry with stakeholders throughout the event, would also differ, depending on the category into which the event falls.

Whether an event is clearly endogenous, exogenous and discrete or continuous would be clear for some, but for others it could depend on the exact nature of the event and country

5 This categorisation framework draws on IMF (2016).

Natural disasters such as floods and drought can place unforeseen pressures on the budget
circumstance. Table 1 categorises the types of event highlighted above in six categories, depending on the likelihood of the event being endogenous or exogenous and discrete or continuous.

For endogenous events, it is also useful to look at common underlying causes in the budget system or political economy, insofar as these may influence when and how finance ministries respond. Several institutional origins of weak fiscal performance in Africa can be identified:

The common-pool problem: While the common-pool problem is endemic to budgeting (insofar as individual decision-makers compete for public resources and fail to internalise the current and future cost of their choices), in many countries fragmentation of the budget process limits the degree to which the ministry of finance can address the problem through a centralised budget process (see, for example, Harden and Von Hagen 1995).

Time inconsistency of preferences: Governments facing budgetary pressures, with political costs should they not be accommodated, will fail to fully internalise the costs of leaving debt to succeeding administrations (see Alesina and Tabellini 1990).

The optimism bias: Recent literature has found a bias towards overestimation of economic and fiscal variables in official forecasts, compared to private forecasts. In Africa, for example, governments tend to ignore volatilities associated with commodity prices, and plan budgets according to best or better case scenarios. Frankel and Schreger (2016) found across a sample of 23 countries that official forecasts were systematically positively biased, with the longer they predate the fiscal year for which the estimate is made, the greater the bias. Interestingly, they also found European official forecasters were reluctant to forecast violations of the 3 per cent deficit of GDP cap in the stability and growth pact, suggesting that fiscal rules (as budgetary institution response to fiscal risk), such as the growth pact, can be circumvented through optimistic economic and fiscal forecasts.

Budgeting problems: While all countries have well-specified formal budget institutions, in practice budgetary pressures arise on account of informal practices that dominate how budgets are really planned and executed and the relationship between the two. A well-known descriptive list of such problems is presented by Schick (1998):

- unrealistic budgeting, where the approved budget is commonly accepted as a farce;
- hidden budgeting, where the real budget is known only to a select few;
- escapist budgeting, where the government authorises expenditures knowing that they will never occur;
- repetitive budgeting, where the budget is revised frequently during the fiscal year to adjust to current needs and restraints;
- short-term budgeting, where budgets are made for one year without considering the medium- or longer-term implications; and
- corrupt budgeting, which arises ‘when formal rules are unworkable and government operates through extra-legal means’.

Underlying these weak budgeting practices are often weak incentives for compliance with formal institutions, underpinned in turn by weak or dysfunctional accountability relationships between principals and agents, within and outside of the state. Besides uncertainty, Simpson and Welham (2014) identify two interrelated drivers of poor budget credibility that arise from principal/agent problems, namely:

<table>
<thead>
<tr>
<th>Table 1: Categorising causes of budgetary pressures</th>
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<tbody>
<tr>
<td><strong>Usually endogenous</strong></td>
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<tr>
<td>Subnational government bailouts</td>
</tr>
<tr>
<td><strong>Sometimes exogenous, sometimes endogenous</strong></td>
</tr>
<tr>
<td>Macroeconomic shocks (e.g. oil price increases)</td>
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<tr>
<td>Extreme natural disasters (e.g. severe floods,</td>
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<td>earthquakes and droughts)</td>
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<tr>
<td>Private non-financial company bailouts</td>
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<tr>
<td><strong>Usually continuous</strong></td>
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<tr>
<td>SOE bailouts</td>
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<tr>
<td>Legal cases (e.g. claims against state hospitals)</td>
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<tr>
<td>Political pressure (e.g. to undertake unplanned</td>
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<tr>
<td>expenditures/provide tax exemptions or rate</td>
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<tr>
<td>reductions)</td>
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<tr>
<td>Macroeconomic shocks (e.g. exchange rate</td>
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<td>volatility)</td>
</tr>
<tr>
<td><strong>Sometimes continuous, sometimes discrete</strong></td>
</tr>
<tr>
<td>Technical budgeting institution weaknesses</td>
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<tr>
<td>(e.g. expenditure arrears and budget overruns;</td>
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<tr>
<td>overestimation of revenues/underestimation of</td>
</tr>
<tr>
<td>expenditures)</td>
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<tr>
<td>Macroeconomic shocks (e.g. commodity price</td>
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<td>volatility)</td>
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<tr>
<td>Low-level nature events (e.g. seasonal floods,</td>
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<td>recurring drought, low-intensity earthquakes)</td>
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</table>
• **signalling**, in which a country publishes a budget that will not be undertaken, but instead is intended as a (false) signal to gain the support of external stakeholders, whether the public, the legislature or external funders. Gelbard et al. (2016) highlights the apparent compliance with foreign donor conditionalities in proposed budgets, but deviation from them in reality; and

• **unruly agents**, in which self-interested subordinates in the government (institutions, elected officers and officials, contractors) fail to deliver the stated priorities of the government, taking advantage of the inability of principals (the president, in Simpson and Welham’s (2014) model of the budget system, but also the electorate, legislature, and the ministry of finance, in practice) to perfectly monitor their actions.

### Responses to budgetary pressures

How do governments generally respond to these pressures, given their causes, and what do we understand about good practices? Ministries of finance can respond to budgetary pressures, depending on their nature, by accommodating or mitigating their impact on fiscal outcomes (aggregate and distributional) in the short term, while building more pressure-resistant systems (through improvements to fiscal policy and budget systems) to mitigate their impact in the long term.

#### A long-term view

**Building resilience**: The literature emphasises fiscal resilience as being key to the ability of governments to respond to fiscal shocks with minimum disruption of the budget. Fiscal resilience requires fiscal space, a function of stronger government financial positions, favourable debt dynamics, higher revenue-raising capacity and expenditure flexibility (Gelbard et al. 2016). It is also logical that fiscal space is a requirement for countries to respond to exogenous macroeconomic shocks with countercyclical fiscal policies.

As indicated in the introductory paragraphs, ministries of finance in Africa often fall short on one or more of these requirements. At the same time, there is evidence that the countries that between the 1990s and 2013 moved out of fragility to become more able to promote security and development, and to respond to fiscal shocks, did so having implemented sound policies and having built stronger fiscal institutions to widen their fiscal space. Specifically, they succeeded in broadening their tax bases (narrowing the gap between those who pay for and benefit from public expenditures, and improving incentives for accountability for the quality of expenditures) and improving control over spending, in combination facilitating sound policies, leading to manageable fiscal positions and sustainable debt. Gelbard et al. (2016), however, note differences between fragile resource-rich and fragile resource-poor countries, in the correlation between improved budget institutions and fiscal policy space, with fragile resource-rich states experiencing a lower correlation than fragile resource-poor countries.

If resilience in the long term is dependent on fiscal space characterised by stronger financial positions and favourable debt dynamics, which fiscal institution improvements are more likely to result in better fiscal outcomes than others?

Three studies have paid attention specifically to budget institutions and fiscal outcomes in Africa – Prakash and Cabezon (2008), Dabla-Norris et al. (2010) and Gelbard (2011).

Dabla-Norris et al. (2010) constructed an index of the quality of fiscal institutions in low-income countries (including many African countries) against both the stages and characteristics of budget systems, including in the latter the centralisation of decision-making, the existence and effectiveness of rules and controls, the sustainability and credibility of the budget, and its comprehensiveness and transparency. The study provides econometric evidence of the relationship between budget institutions and fiscal performance, particularly between greater fiscal discipline and the scope for conducting countercyclical policies.

Key findings are:

• The most significant institutions are those related to planning and implementing the budget, and to the sustainability (e.g. through the use of medium-term expenditure frameworks and improved forecasting methods), comprehensiveness and transparency of the budget. Dabla-Norris et al. (2010) note, however, that the lower impact of institutions such as the legislature and the external audit agency may have more to do with their existing weak foothold in budget systems than with their potential future development.

• While budget institutions seem to matter in shaping fiscal responses in low-income countries, they could matter more in their ability to ensure adequate financing in bad times than in their ability to contain spending in good times.

• The findings indicate that a more transparent and comprehensive budget seems to have greater significance for fiscal outcomes than do rules and top-down procedures. This might suggest that for low-income countries, procedures that facilitate external monitoring are more credible mechanisms for ensuring proper fiscal responses than are procedures that facilitate government self-monitoring. Another way of looking at this, Dabla-Norris et al. (2010) suggest, is that procedural checks and balances in the budget are ineffective in the absence of ‘deeper’ checks and balances in the political system. Also, they suggest, greater centralisation of the budget process in the hands of the executive, without strong transparency requirements and public oversight, may be counter-productive for fiscal discipline.

Prakash and Cabezon (2008), however, suggest that there is a stronger correlation between hierarchical budgets or PFM systems, as in Francophone Africa, and better fiscal discipline, which echoes previous results for Latin America and Europe. This implies, the authors posit, that there is a good argument.

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7 See Gelbard et al. (2016). Countries included in this group in the analysis are Cameroon, Ethiopia, Mozambique, Niger, Nigeria, Rwanda and Uganda.
for strengthening the fiscal roles and responsibilities of the finance minister.

Gollwitzer (2016) applied a very similar methodology to that used in the Dabla-Norris et al. (2016) study, but to African countries only and with updated data sources and data. The index of budget institution quality used both the phases of the budget cycle and characteristics of budgeting institutions around the budget cycle, including the degree of centralisation, the presence of rules and controls, the presence of institutions to support the sustainability of budgets, and the comprehensiveness and transparency of budgets. Key conclusions are:

- There are large differences in institutional quality across the African continent, which sounds a note of caution for the conference to pay attention to how countries may face different effective options in response to extraordinary budgetary pressures, including trade-offs between short-term and longer-term responses.
- Gollwitzer (2016) shows that good budgetary institutions are associated with lower levels of external government debt and, although less significantly, with a higher primary balance.
- There is a significant correlation between external debt and the sub-index on centralisation (measuring who has the legal power and sets the agenda during budget preparation, the ability of legislatures to amend and set the executive veto, and whether finance ministries withhold appropriated expenditure). This is in line with the Prakash and Cabezón (2008) study’s findings on hierarchical systems. Note, however, that the correlation is with external debt levels, and does not take into account the impact of centralisation practices on the quality of expenditure that does occur.
- There is also a significant correlation between the budget balance and the transparency sub-index (measuring publication of draft budgets, macroeconomic forecasts, assumptions and risks; public hearings during budget approval; and publication of in-year and detailed year-end reports and performance targets).

It is also noteworthy that Simson and Welham (2014) record the use of similar budget institutions to build credibility in the face of principal/agent problems in the three countries studied (Tanzania, Uganda and Liberia), increasing control by the finance ministry (including through cash budgeting) and reducing the autonomy of line agencies, and improving transparency. However, they also note the costs of increasing control by the finance ministry.

This accords with the findings of a recent study by Di Francesco and Alford (2016), who note that ongoing centralisation of control and standardisation of budgeting approaches countervails efforts in budget reform to decentralise decision-making to managers, so that budgets respond better to local situational needs for flexibility. The authors argue that there is considerable scope for rebalancing control with flexibility, particularly given the non-routine problems facing governments, for which traditionally centralised, control-driven public administrative structures are not equipped. They propose rule variability – the institutional capability to vary the way in which rules are applied within basic rule sets – as a viable option for recalibrating control and flexibility in the public sector, together with earned autonomy, as a new form of responsive regulation, while emphasising that such variability needs to occur within certain parameters, including fiscal parameters set and maintained by the finance ministry.

The wisdom of implementing budgeting institutions (and budget processes) that will build fiscal resilience over the longer term is undeniable. The evidence suggests that this should include processes that defragment and centralise budgetary decision-making (while acknowledging and managing trade-offs between centralised standardisation and control and decentralised flexibility), that are more comprehensive, and that support budget sustainability and budget transparency. At the same time, however, countries should also implement short-term measures to prevent, mitigate or accommodate extraordinary budgetary pressures.

**A shorter-term view**

Building budget processes that support fiscal resilience to exogenous shocks are likely to entail somewhat longer-term undertakings. What shorter-term mechanisms, then, can finance ministries deploy to minimise their fiscal exposure (also to endogenous factors)?

Key mechanisms are:8

- Given the high fiscal cost of realised contingent liabilities, exercising direct controls, ceilings or caps on issuing guarantees is a common measure to limit exposure. For example, about 60 per cent of the countries included in the Bova et al. (2016) study, placed limits on guarantees and controlled their issuance, and 75 per cent limited the liabilities of subnational governments, or required them to comply with fiscal rules.
- Regulation, incentives and other indirect measures are employed more often for risks that arise outside of government, such as financial sector exposure. However, they are also used to manage SOEs, for example by imposing performance targets on SOE boards, or requiring value for money assessments for PPPs.
- Risk transfer, sharing or insurance mechanisms are less frequently used. For example, about two-thirds of the countries in the Bova et al. (2016) study sample insure public assets against the impacts of natural disasters, while about a quarter reinsure or securitise their credit guarantee portfolio.

Provisioning is used by many countries as a buffer against risks. Examples of provisioning are: commodity exporters establishing stabilisation funds as buffers against lower commodity prices; establishing explicit deposit insurance funds; having planning margins, contingency reserves and/or

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8 This section draws on Bova et al. (2016) and IMF (2016).
emergency funds in budget structures. Logic suggests that provisioning is a sound response to manage budgetary pressures that arise from continuous (or somewhat continuous) exogenous risks, such as recurring weather events or macroeconomic volatility. If efforts to improve budget processes and institutions (including centralised controls and improved transparency) do not succeed in preventing continuous endogenous factors from occurring, provisioning may be an appropriate response, to provide for SOE bailouts, for example. At the very least, it will assist in the cost of the factors being internalised. However, as noted by Phaup and Kirschner (2010), such provisioning for budgetary pressures – particularly if these are caused by more discrete events – requires trade-offs of current consumption for saving and mitigation, and procedural safeguards against opportunistic efforts to divert disaster savings to other uses.

All of these mechanisms should be supported by fiscal risk disclosure and analysis practices. The following are key findings of a recent IMF survey of fiscal risk analysis and disclosure practices based on the IMF’s budget institution database for 58 countries, as well as the International Budget Partnership’s Open Budget Survey database and the IMFs fiscal accounts database:

• Only about 30 per cent of countries publish quantitative macro-fiscal sensitivity and scenario analyses. Furthermore, only a few countries go beyond an examination of the main fiscal aggregates to changes in individual parameters (e.g. commodity prices and exchange rates) to conduct more integrated, model-based scenario analyses that explore the impacts of shocks to a number of parameters simultaneously.
• Some form of long-term fiscal sustainability analysis is published by about 40 per cent of countries, of which half limit such analysis to long-term projections for age-related problems. Very few explore multiple long-term scenarios for government revenue and expenditure based on a range of assumptions.
• Only 28 per cent of countries publish balance sheets, and these are backward-looking and limited to financial assets and liabilities. Very few countries forecast developments in respect of their assets and liabilities.
• Two-thirds of countries discuss specific fiscal risks in their budget documentation, but very few publish a quantified risk statement listing specific risks and the likelihood of their occurring.

Given the importance of fiscal transparency in building fiscal resilience, the findings above suggest that more can be done by African countries to prevent or mitigate future risks through better risk management and disclosure. Of course, this is predicated on the availability of specific risk data and macroeconomic and demographic data, which in some cases may require investment by governments in data systems.

A final set of responses that will benefit from conference participants sharing experiences has to do with mitigating the impact of endogenous risks through the structures, processes and roles of the budget, during budget preparation, approval and execution. Two particular aspects are key in this regard:
• How do budget managers communicate trade-offs and decisions to stakeholders. According to Rubin (2016: 10):

  The point...is that public officials must not only do the right thing for the community and follow the public will, as best they understand what that is, but also figure out a way to explain and justify their choices. They are engaged in a dialogue in which there are always other arguments, whose advocates represent legitimate interests. Equally important, engaging in this dialogue is a way of getting the public involved and getting across information about budgetary decisions in a way that people can understand.
References


