2017 CABRI Conference

MANAGING BUDGETARY PRESSURES

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Ouagadougou, Burkina Faso

2017 CABRI CONFERENCE

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FOREWORD

Budget managers are frequently confronted with changing circumstances during a fiscal year that disrupts even the best prepared spending plans. Some of these changed circumstances require no more than regular adjustments to plans, while others become chronic and have a significant effect on public finances. The latter are commonly referred to as extraordinary shocks, which are sudden and can pose a threat to fiscal stability and service delivery.

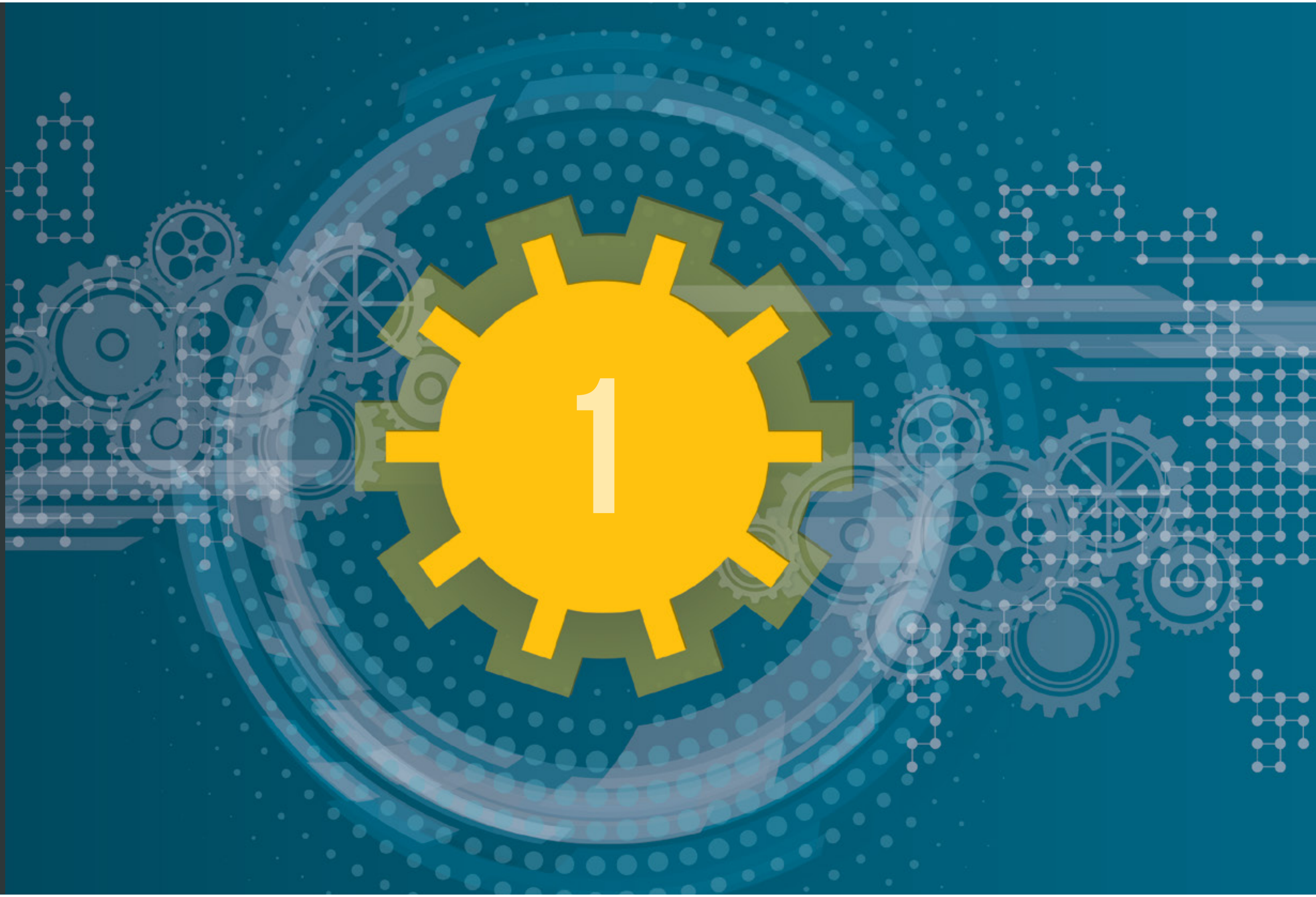
At the time of the hosting of the CABRI Conference in Ouagadougou in March 2017, several African countries were emerging from natural disasters and health emergencies. The best known of these is the Ebola epidemic that affected Liberia, Guinea and Sierra Leone, claiming over 11 000 lives and resulting in a significant contraction in GDP. Burkina Faso was recovering from devastating floods that were followed by unaffordable public sector wage demands; and South Africa was under pressure to increase subsidies to tertiary institutions and state-owned enterprises. Similarly, Nigeria and Lesotho were facing revenue losses from the decline in oil prices and customs revenue, respectively.

The conference in Ouagadougou provided a platform for peers from 26 African countries to share the experiences of various budgetary pressures, and how they managed in the midst of the crisis, what strategies were applied, and what they may do differently were the crisis to reoccur.

Once more, CABRI is grateful to our partners for their contribution to the conference content and financial support, as well as to those who shared their insights into both African and international experiences. And, lastly, a special thank you to the dynamic CABRI team for their willingness to go the extra mile to ensure the successful delivery of CABRI programmes. Thank you.

Neil Cole
Executive Secretary

SECTION 1
INTRODUCTION



CHAPTER 1: MANAGING BUDGETARY PRESSURES – THE 2017 CABRI CONFERENCE PUBLICATION

THE 2017 CABRI CONFERENCE

The ninth CABRI Conference was held in Ouagadougou, Burkina Faso, from 7 to 9 March 2017. Attended by 69 officials from 26 African countries, it examined how governments can prepare for and manage extraordinary budget shocks that threaten budget stability and the financing of service delivery.

Budgetary pressures are an unavoidable consequence of allocating scarce resources between potentially limitless societal needs. Ministries of finance routinely contend with budgetary pressures during the preparation and approval of public budgets, as well as when managing ordinary deviations from planned revenues and expenditures during the year. Countries with stronger budget institutions are better able to manage this year-to-year budgetary pressure than countries with weaker systems – that is, more fragmented budget processes and less robust revenue and expenditure forecasting, cash management, in-year control, and accounting and reporting systems.

The conference's focus, however, was neither on these routine pressures, nor on how to build the strong budget institutions needed to best manage them. Rather, the overarching question for the 2017 CABRI Conference was how governments can better prepare for and manage extraordinary pressures that either arise suddenly or build up over several years, without veering towards unsustainable debt or disrupting service delivery. It aimed to explore successful ministry of finance strategies for managing these pressures and achieving budget credibility. Key to understanding the pressures is that context matters.

The sessions were structured to allow senior budget officials to reflect on the budgetary pressures they have faced, how they managed them and what they learnt. Almost all the conference sessions presented a country case study followed by contributions from other countries from the floor. Sessions that followed this structure focused on managing the impact of natural and man-made disasters on countries' revenues and expenditures; managing the impact of macroeconomic shocks on countries' revenues; and managing large budgetary demands that have built up over years. A fourth set of pressures – the pressures that result from the realisation of off-budget contingent liabilities – were discussed through a fictitious case of a large bailout for a public water utility company. Participants had to identify what their responses would be and discuss how the case reflected experiences in their countries.

These substantive sessions were bookended by an introductory panel discussion that considered why many African countries are vulnerable to budgetary pressures and the importance of managing them, and a concluding session that examined common responses and approaches to being better prepared for crises. A copy of the conference programme and all materials can be found at www.cabri-sbo.org.

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THE CONFERENCE PUBLICATION

1: MANAGING BUDGETARY PRESSURES – THE 2017 CABRI CONFERENCE PUBLICATION

This publication reflects on the conference discussions and conclusions. It is structured around the presented country case studies, and is divided into two main sections. The introductory section provides an overview of the conference and the publication, and discusses the crises that the case study countries experienced, similarities in their immediate responses and longer-term efforts to be able to avoid risks or respond better in future, and the lessons learnt. The synthesis chapter (Chapter 2) also incorporates conclusions from the conference discussion on pressures arising from off-budget sources.

The second section comprises three chapters, each reflecting on the presented country cases of a specific category of pressure and the lessons learnt from the cases. The authors of these chapters used the country conference presentations and discussions as base materials, but elaborated on their themes with additional materials and examples.

These chapters are:

- **CHAPTER 3:** *When disaster strikes – fiscal responses to natural and man-made disasters,* in which Michael Castro reflects on how Liberia responded to the Ebola crisis, and Madagascar to high-intensity cyclones. The chapter also outlines the budgetary impact of the Central African Republic's political crisis, and the country's response. Moreover, it sets out options that countries should consider when faced with crises that are caused by factors outside their control.

- **CHAPTER 4:** *When chronic pressures turn into crisis,* in which Joana Bento discusses how South Africa, Burkina Faso and Côte d'Ivoire responded when long-term, bottom-up expenditure demands (the financing of tertiary education in South Africa and the public wage bill in Burkina Faso and Côte d'Ivoire) reached a crisis point, threatening to destabilise the budget. The discussion outlines options available to finance ministries when they are caught between bottom-up stakeholder pressure and top-down political pressure to undertake significant additional expenditures that may not have been budgeted for and may not be the best expenditure choices.

- **CHAPTER 5:** *When the purse is emptier – managing the budgetary impact of macro-fiscal shocks,* in which Danielle Serebro looks at how Nigeria and Lesotho coped with unforeseen drastic reductions in revenues caused by volatility in their main revenue source. The chapter provides insight into the fiscal volatility associated with depending on a single source of revenue and the longer-term reforms that countries should consider to reduce their vulnerability to external shocks.

CHAPTER 2: LESSONS FROM CRISES – AFRICAN RESPONSES TO EXTRAORDINARY BUDGET PRESSURES

By Alta Fölscher[1]

Budget managers are frequently confronted with changing circumstances during the fiscal year that disrupt even the best prepared budgets. Most pressures require no more than adjustments to plans using routine adjustment mechanisms built into the budget system, such as supplementary budgets and virements. Then there are extraordinary shocks, which can be sudden and significantly threaten budget stability and service delivery. The 2017 CABRI Conference examined how governments can better prepare for and manage these shocks without disrupting service delivery and incurring unsustainable debt.

The conference sessions drew on the experience of African countries in responding to extraordinary pressures arising from macroeconomic shocks and natural or "man-made" disasters, as well as when routine pressures are ignored over a long period. The country case studies included managing the impact of oil price shocks in Nigeria and Chad; the global financial crisis in Lesotho; the outbreak of Ebola in Liberia; cyclones in Madagascar; political conflict in the Central African Republic; the wage bill crises in Côte d'Ivoire and Burkina Faso; and the tertiary education financing crisis in South Africa.

This summary chapter looks at the lessons learnt from the participating countries on managing extraordinary budget pressures.

[1] *Alta Fölscher is an independent researcher and consultant working with CABRI.*

THE NATURE OF THE PRESSURE

> *How countries responded in the short term was less influenced by the type of crisis, than by the range of options they had available given their fiscal circumstances when the crises occurred.*

The conference considered a wide range of extraordinary pressures. These included continuous pressures (such as wage bill, tertiary education financing, recurring cyclone, and commodity price pressures) and once-off pressures (such as pressures arising from epidemics and political crises). Some of the pressures considered were caused by events outside of the governments' control (external events such as the global commodity price decline and natural disasters). Others resulted from events that governments could have prevented had they acted earlier (internal pressures such as from the public wage bill and the bailout of public enterprises). Some events affect revenues (commodity price changes), others increase expenditures (wage bill demands), while others have a dual impact, reducing revenues at the same as increasing expenditure (particularly natural disasters).

How countries responded in the short term was less influenced by the type of crisis than by the range of options they had available given their fiscal circumstances when the crises occurred. It is only in relation to countries' responses for the medium term that there is a correlation between the nature of the crisis and whether governments use the crisis to reform their budget system and the reforms they choose.

2: LESSONS FROM CRISES – AFRICAN RESPONSES TO EXTRAORDINARY BUDGET PRESSURES

COMMON RESPONSE PATTERNS

IMMEDIATE RESPONSES: MANAGING THE FISCAL IMPACT

All countries opted for expenditure measures. This involved cutting appropriated expenditure and reducing future budgets relative to existing forecasts. In cases where the crisis resulted in expenditure demands, it also involved reprioritising the remaining expenditure towards the priority area. Some countries, like Nigeria (see page 54 – 63), also immediately sought to make efficiency gains through better expenditure controls and cash management.

The case studies offered insight into the kind of expenditures governments target when adjusting budgets in the wake of a crisis. Most governments attempt to cut or postpone recurrent expenditure, particularly spending on economic items that can be postponed or cut in the short term, such as consultants, training, travel, transport and entertainment. For example, in response to a reduction in revenue from the Southern African shared customs arrangement, Lesotho reduced expenditure on international travel, training and workshops, office equipment, and maintenance (see page 47 – 53). The Central African Republic (see page 19 – 21) and Chad (see page 61 – 62) are the only countries among the case studies that also made cuts to expenditures that are normally considered to be more rigid, namely salaries, grants and pensions. While the Central African Republic cut all these types of expenditure, Chad opted to reduce civil servants' allowances only.

The brunt of the fiscal impact of crises, however, is often borne by reducing and postponing capital expenditures. In Nigeria, the federal government implemented a series of short-term expenditure cuts, particularly to capital allocations, to offset reduced oil revenues. In Burkina Faso (see page 37 – 43), the burden of the adjustment for higher wage expenditure and other fiscal pressures was borne by much reduced investment expenditure. In 2014 the Burkinabe government implemented only two-thirds of its planned investment expenditure but 94% of its planned recurred expenditure. In response to an announcement that universities will not increase fees, South Africa cut its infrastructure expenditure to pay for the resulting increase in government subsidies (besides cutting goods and services across the board), but chose to protect large infrastructure projects and cut the conditional transfers to its provincial governments for social infrastructure projects (see page 32– 36). While that is arguably passing the pressure on to a lower, autonomous sphere of government, it still represents a choice between types and sectors of capital expenditure. South Africa is the only country that reported looking at its wider public-sector expenditure, cutting transfers to public entities that already had large cash surpluses.

In taking on large recurrent additional expenditures as a result of the crisis, countries sought to control more rigid expenditures, such as the wage bill, even if only over the medium term. Thus, South Africa halted the expansion of government employment, Côte d'Ivoire reduced recruitments targets (see page 37 – 43) and Lesotho opted for a hiring freeze.

These were not the only examples of wage bill measures forming part of the response plan. A common response is to look for expenditure savings by addressing ghost workers on the wage bill, a measure implemented by Burkina Faso, Chad, Côte d'Ivoire and Nigeria. Burkina Faso and Côte d'Ivoire also sought to make future wage bill pressures more predictable by introducing new wage grids, hoping that clearer rules on public-sector pay would stabilise the demands made by public-sector unions.

Chad is the only country among the case studies that reported reducing the size of government in response to lower availability of revenue. It audited projects and programmes and restructured the organisational charts of ministries and institutions.

Countries also reported efforts to protect certain sectors from cuts, or prioritise expenditure to sectors. A key example is Liberia, where the loss of revenue during and in the wake of the Ebola crisis and increased expenditure demands were met partially through expenditure measures that affected all sectors except those directly involved in the Ebola response (see page 22 – 25). Given the nature of the crisis, the government ordered all civil servants except those involved in the response to stay at home, thus reducing infection risks and non-salary expenditure. This, coupled with additional revenue and debt measures, allowed for much higher than planned expenditure in the health sector.

Seeking additional budgetary inflows, adding to debt

The degree to which the fiscal impact of the crisis can be absorbed in the short term by expenditure measures was limited. In the Central African Republic, Lesotho, Liberia, Madagascar and Nigeria, the combined impact of lost revenue and increased expenditure needs in the wake of the crises was too significant as a share of gross domestic product (GDP) to be absorbed by postponing, cutting or reprioritising expenditure. The governments of these countries, as well as Burkina Faso, were forced to increase borrowing, sometimes significantly. While governments usually planned for the borrowing increase to be short term, followed by renewed fiscal consolidation, this did not always happen as the outer years of the medium term brought their own expenditure pressures. This also applied to cases where governments expected the cuts to investment budgets to be made up by additional investment expenditure in the medium term. Often these pressures were related to the wage bill.

While the governments of Lesotho and Nigeria borrowed more in the short term, they also sought over the medium term to restructure their debt portfolios, seeking lower risk and higher efficiency.

Countries with reserves, contingencies and/or stabilisation funds often could not use these funds because they were already depleted and had not had sufficient time to be replenished, or had not been replenished due to routine government cash and expenditure pressures (see the Madagascar and Nigeria case studies).

Whether or not countries have access to donor funding to fill the gaps left by a crisis depends on the type of crisis. Only two of the eight case studies could draw on development partner funding to meet the new spending obligations arising from addressing Ebola (Liberia) and the aftermath of cyclones (Madagascar) respectively. In contrast, the financing gap of the Central African Republic widened even further after donor funding was withdrawn in the wake of its political crisis in 2013.

Overall, countries' responses to budgetary crises were multi-faceted, including efforts to increase available resources, cutting expenditure elsewhere, and postponing or minimising the effects of the crisis. In the short term, countries found fiscal space – flexibility in spending choices – by rebalancing their debt portfolios, cutting non-essential spending and mopping up idle cash balances. Most countries were adept at using the medium-term period to spread the cost or plan for recovery, even if these plans did not always materialise. These more immediate measures, however, were complemented by longer-term interventions to prevent a recurrence or deepening of the crisis, and build fiscal resilience. These efforts were more prominent in countries that were exposed to external shocks that had a high chance of recurring.

The next section looks at common reforms to reduce vulnerability and increase response capacity.

2: LESSONS FROM CRISES – AFRICAN RESPONSES TO EXTRAORDINARY BUDGET PRESSURES

LONGER-TERM RESPONSE: REFORMS TO REDUCE VULNERABILITY AND MITIGATE RISKS

Strong arguments have been made that public budgets in Africa are both more vulnerable to extraordinary pressures and less able to respond to these pressures.[2] They are more vulnerable due to volatile macroeconomic environments, unreliable aid flows, extreme weather events, high demand for public spending and unstable political contexts. At the same time, their narrower tax bases, overreliance on volatile trade taxes, underdeveloped capital markets, relatively low private capital inflows, and reliance on foreign grants and concessionary loans make them less able to respond to these crises.[3]

The case studies discussed at the 2017 CABRI Conference emphasised how higher vulnerability to crises and lower ability to respond are mutually reinforcing, often leaving countries more vulnerable than prior to the crisis. However, in the aftermath of budget crises, some countries undertook reforms to break this cycle.

Reducing vulnerability to risk

The case studies include interesting examples of how countries with more discrete crises resulting from external factors, and continuous crises resulting from internal factors, sought to reduce their vulnerability to risk.

In three of the countries, the crisis showed that overreliance on a single revenue source makes a country highly vulnerable to budget shocks. In each case the shock was external. The chapter on managing the impact of macro-fiscal shocks discusses efforts by the governments of Lesotho and Nigeria to diversify their revenue base by redirecting expenditure into energy and/or transport infrastructure (investment expenditure) that will support the development of their economies. Although the Liberia crisis was of a different nature, it demonstrated how overreliance on a single labour-intensive sector, mining, increased the fiscal impact of Ebola. In Liberia, too, post-crisis priorities included expenditure on roads and energy to reduce barriers to efficiency in its main economic sectors and thus speed up recovery and reduce exposure in future.

These countries also specifically included in their crisis response strategies efforts to maximise the efficiency of their existing spending by tightening public financial management (for example, Liberia and Nigeria) and increasing resources from existing tax bases by improving revenue administration (Lesotho and Nigeria).

Recognising that volatility in its shared custom revenue is a continuous risk, Lesotho introduced a core fiscal balance into its fiscal planning to allow policymakers to distinguish between core or permanent revenue and non-core or volatile revenue, and better assess the country's underlying fiscal position.

In Burkina Faso and Côte d'Ivoire, two of the three countries where the crises were internal and continuous, the response included significant reforms to minimise the risk. In both cases, long-deferred structural public-sector wage bill pressures reached a crisis point and, combined with cyclical (or annual) pressures, steered the public finances (further) off course. Both countries initiated reforms to public-sector employment and

[2] *See, for example, A Shick (1998) A contemporary approach to public expenditure management. Washington DC: World Bank; and E Gelbard, C Délechat, E Fuly, M Hussain, U Jacoby, D Mulaj, M Pani, G Ramirez, and R Xu (2016) Building resilience in sub-Saharan Africa's fragile states. Washington DC: International Monetary Fund.*

[3] *Caiden and Wildavsky, as far back as 1980, pointed to "functional redundancy", or the ability of rich economies to produce more than they consume. If this is not present, it "wreaks havoc with budgeting and planning". (N Caiden & A Wildavsky (1980) Planning and budgeting in poor countries. New Brunswick: Transaction Publishers).*

pay structures, including undertaking audits of the wage bill, improving payroll procedures, restructuring their engagement with public-sector unions and introducing new wage grids.

South Africa, the other case study in the chapter on continuous, internal pressures that reach tipping points, did not refer to any significant medium-term efforts to address its exposure to future recurrence of pressures to finance tertiary expenditure. This could be because the government viewed the crisis as a once-off pressure and expected future pressures from the tertiary sector to be managed through the annual budget process. However, the case study suggests that the National Treasury was too focused on responding to the specific pressure (to increase tertiary education funding) and did not reflect on how other pressures of a similar bottom-up political nature could be managed in future.

Buffering against risks, transferring risks

Only Madagascar successfully created a new contingency fund in response to its crisis. None of the other case study countries opted to increase use of domestic stabilisation or reserve funds and planning margins to provide buffers against risk. The case studies do, however, provide examples of ministries of finance using existing funds and reserves (insofar as they are funded at the time of the risk occurring, such as in Lesotho and Nigeria); explicit and "hidden" planning margins (such as the explicit margin included in Côte d'Ivoire's budget to cover cyclical wage bill increases); and deliberately underestimating revenue to buffer against continuous fiscal risks (such as in Burkina Faso and Côte d'Ivoire). Countries also noted the need to ensure that the rules on replenishing and spending buffer funds should be publicly transparent and enforced through tighter governance.

Madagascar, as the only case of a country facing an external continuous risk, provides an interesting example of how an array of measures have been put in place to build its response capacity. First, the country's budgeting system now makes use of models to calculate the probability of cyclones occurring and their likely impact, resulting in routine core budget allocations to provide for the likely costs of cyclones and other natural disasters. These domestic funds are complemented by quick access to donor funds under special provisions as part of ensuring that funds will be available to respond when cyclones strike. Second, the response strategy includes participation in the Africa Risk Capacity facility, which provides insurance against disaster risks. Insurance premiums are paid as expenditure line items in the budgets, while pay-outs further complement donor and domestic financing to rebuild after cyclones. Finally, funding has been directed towards developing a disaster prevention and management strategy, including ensuring that public and private infrastructure is built to standards that ensure they are less likely to be severely damaged in storms.

2: LESSONS FROM CRISES – AFRICAN RESPONSES TO EXTRAORDINARY BUDGET PRESSURES

LESSONS LEARNT FROM CRISES

Through the case studies and discussions, the 2017 conference highlighted several lessons for African countries from crises they have experienced in the last decade.

First, countries reported that pressures usually coincide, pushing them into budgetary crisis. This is similar to the international experience: a 2016 International Monetary Fund (IMF) global study found that fiscal risks are highly correlated. When something goes wrong, it is rarely an isolated event.[4] In Burkina Faso, for example, the cost of agreed increases in public-sector salaries coincided with decreased revenue due to lower gold and cotton prices, political instability and the impact of Ebola in neighbouring countries on tourism. In Liberia, the Ebola crisis coincided with reduced revenue from mining in the face of the global drop in commodity prices. In South Africa, the demand for more state funding in tertiary education came in the wake of several years of low growth and increased borrowing after the 2009 financial crisis.

While budgets are often able to absorb a series of pressures, in many cases one additional crisis can present a tipping point at which the public finances are destabilised. Building resilience therefore has to involve identifying and analysing sources of fiscal risk as part of budget preparation, and seeking measures to mitigate specific risks. These risks need to be continuously monitored, assessed and disclosed.

Second, countries reported that budget crises resulting from extraordinary pressures exposed their institutional weaknesses. In Liberia, for example, the Ebola crisis revealed the dependence on donor-supported human resources in the health sector, and weak co-ordination between the centre and the outlying areas. Crises, however, create the opportunity and political space to address these weaknesses.

Third, countries emphasised the need for good data and analysis so that finance ministries have options, and can weigh them up. In South Africa, for example, the National Treasury was able to quantify the cost of no fee increases to the state, and identify different combinations of expenditure savings measures to match the amount. In Burkina Faso and Côte d'Ivoire, good information on public-sector employment and pay was essential to estimate the cost of reforming wage grids, to stabilise cyclical wage bill pressures.

Fourth, the conference emphasised that good public financial management systems that can help prevent extraordinary pressures, particularly those largely within a country's control, are essential for managing crises. A specific case is preventing a crisis from off-budget sources through the systematic and transparent management of contingent liability risks.

Fifth, the conference considered the effects of crisis management on the credibility of the budget process. The case studies show that deviations from normal budget processes to adjust to a crisis can occur without undermining these processes when the cause of the crisis is external, and when it is more discrete.

[4] *IMF (2016) Analyzing and managing fiscal risks: Best practices. Washington DC: IMF.*

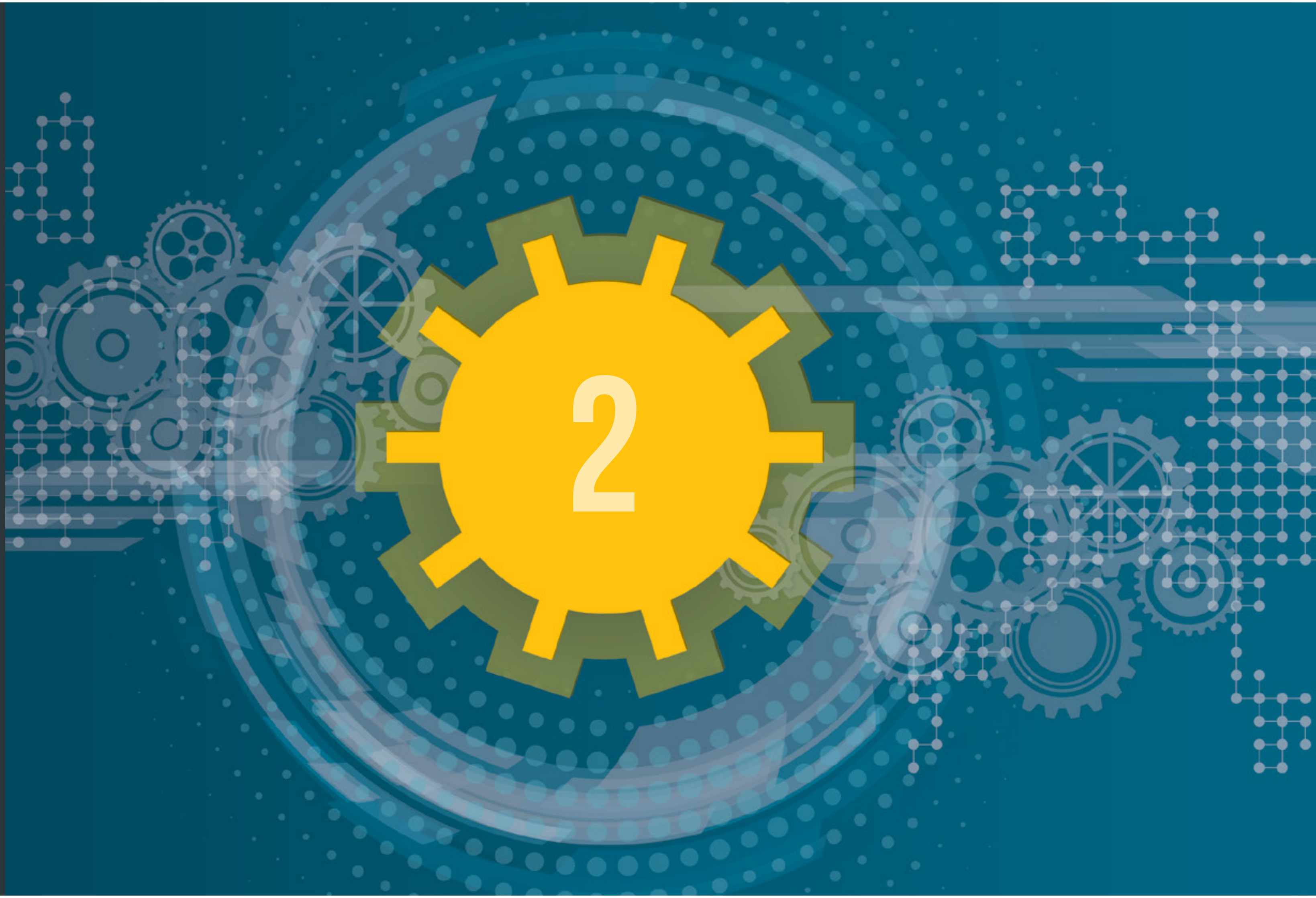
"Identifying and collaborating with key players help finance ministries see the problem in its entirety, identify available options, and bring players together to implement a unified approach."

Thus, Liberia took extraordinary measures when Ebola struck, including bringing the budget process forward and adjusting expenditure rules to quickly get money to where it was needed. However, where crises are more internal and continuous, making decisions outside of routine processes sets an example that leads other stakeholders to try to get their demands funded "through the back door". For example, the South African case study notes how financing tertiary education outside the budget process helped create an impression that money can always be found for demands that come with the right kind of political pressure. And the cases of Burkina Faso and Côte d'Ivoire highlight how longstanding practices of applying political pressure to have wage bill demands funded are not easily turned around. Once lost, the credibility of processes and commitments is difficult to restore.

Finally, conference participants discussed the important role of finance ministries in reducing the effects of budgetary pressures, given political pressure on budgetary decisions. This is perhaps best illustrated by the case studies on internal, bottom-up spending pressures, where politically expedient decisions are made that are not always within the control of, or do not follow technical advice from, finance ministries. Participants agreed that finance technocrats have a duty to communicate trade-offs so that political decision makers are forced to confront pressures, are able to make informed choices and can be held accountable for their decisions. Political decision makers can, however, only be held accountable if the trade-offs and choices are also communicated to those who hold them to account. At the same time, participants agreed that finance ministries cannot act alone. Identifying and collaborating with key players help finance ministries see the problem in its entirety, identify available options, and bring players together to implement a unified approach. The conference discussion on managing off-budget pressures, for example, from bailouts for public enterprises, advanced these kinds of strategies to reduce the impact of these pressures on budget stability and the credibility of the budget process.

SECTION 2

COUNTRY CASE STUDIES



CHAPTER 3: WHEN DISASTER STRIKES – FISCAL RESPONSES TO NATURAL AND MAN-MADE DISASTERS

INTRODUCTION

By Michael Castro[5]

The best planned budgets are subject to external shocks that are at times unforeseen. Managing fiscal responses to these shocks can be challenging even for the most experienced senior budget officials.

One set of unforeseen external shocks relates to a sudden change in the level of economic activity and/or demand for public intervention due to natural or man-made disasters. The size of these events usually means that governments need to make large adjustments to in-year fiscal and budget frameworks.

The 2017 CABRI Conference devoted a session to discussing countries' choices when facing fiscal shocks over which they have little control. Liberia, Madagascar and the Central African Republic shared their recent experience of natural and man-made disasters. Alieu Fuad Nyei, Assistant Minister in the Ministry of Finance and Development Planning, presented the Liberia case; Onintsoa Harilala Raoilisoa, Director of Budget Programming in the Ministry of Finance and Budget, presented the Madagascar case; and Jean Richard Bassanganam, Director of Budget in the Ministry of Finance and Budget, presented the Central African Republic case.

In Liberia, the West Africa Ebola outbreak halted the country's commodities-led economic growth – along with most economic activity. Madagascar's natural disaster risks include drought and cyclones that wreak havoc across all sectors. In contrast, the crisis in the Central African Republic was driven by internal armed conflict that placed a severe strain on the country's limited fiscal space.

What common approaches do senior budget officials take to deal with these unforeseen events? What role does context play in which approach works best? What are the lessons learnt and how can countries build resilience to overcome these natural and man-made disasters? This chapter focuses on the budgetary pressures faced by Liberia and Madagascar due to natural disasters, and their response to these pressures.

Key lessons from the case studies

Natural and man-made disasters are unpredictable. Following macroeconomic and financial sector shocks, natural and man-made disasters are the most frequent budgetary pressure that senior budget officials face.[6] These events can be divided into two categories: external discrete events (rare events) and external continuous events (regular events). The Ebola outbreak in Liberia and the conflict in the Central African Republic can be characterised as discrete events, while Madagascar's cyclones are regular events.

[5] *Michael Castro is the Programme Manager: Budget Transparency and Accountability in the CABRI Secretariat.*

[6] *CABRI (2017) Managing budgetary pressures: 2017 CABRI Conference framing paper.*

3: WHEN DISASTER STRIKES – FISCAL RESPONSES TO NATURAL AND MAN-MADE DISASTERS

Senior budget officials commonly deal effectively with both categories of event through contingency funds, reserves and budget reallocations. Liberia and Madagascar used a combination of these mechanisms to manage their respective crises, while the Central African Republic significantly reduced its debt obligation payments to be able to reallocate funds to the expenditure budget. Countries with external continuous events can also manage these risks by using costing mechanisms to pre-empt the potential costs to the budget and include appropriate budgetary allocations. Madagascar, for example, uses several modelling techniques during budget formulation to integrate the cost of natural disasters in the budget.

Context plays an integral role in determining which mechanisms are most appropriate for a country. Key factors determining a country's options include its macroeconomic situation and fiscal space when the crisis occurs, and its ability to work with development partners to manage crises. Nevertheless, there are also similarities between countries in how these factors unfold during crises. First, natural and man-made disasters have serious implications for the macroeconomic assumptions used to determine the budget. Productivity loss in the country's major sectors equates to a drastic drop in budget revenue. This loss of revenue led the Central African Republic, Liberia and Madagascar to apply different mechanisms. Second, these disasters cause new expenditure demands. To manage the Ebola crisis in Liberia, the Ministry of Finance and Development Planning minimised duty staff to control cost, and coordinated with subnational authorities, existing networks and development partners. The Ministry of Finance and Budget of Madagascar used reserve funds for an emergency response to cyclones. The Ministry of Finance and Budget of the Central African Republic reallocated funds to the social sectors, justice and public safety by reducing salaries, grants and pensions elsewhere.

While each context is different, there are key lessons about how to improve institutions and plan better for the future that are applicable to a variety of shocks and contexts. Commodities-driven economies like that of Liberia learnt the hard lesson of economic diversification to shield themselves from these kinds of shocks. Production in the mining sector accounted for 17% of GDP and 56% of total exports in 2014.[7] Ebola brought this main economic activity to a sudden halt in 2015, resulting in a significant reduction in revenue. This led the country to invest more in other sectors such as agriculture to be able to manage such fiscal pressures better in future. Countries like Madagascar that are predisposed to recurring natural disasters should routinely identify these risks and determine their potential impacts on the economy and budgets. Models can be used to determine the parameters of these risks and their implications on economic growth and debt. Planning for natural disasters helps develop tools to build resilience in the national budget. Institutions, procedures and guidelines can help countries better manage their response to disasters and implications for the budget. Finally, armed conflicts generally result in the loss of development partners, which is what happened in the Central African Republic (see Box 1). The loss of aid can motivate country leaders to implement reforms to improve public financial management.

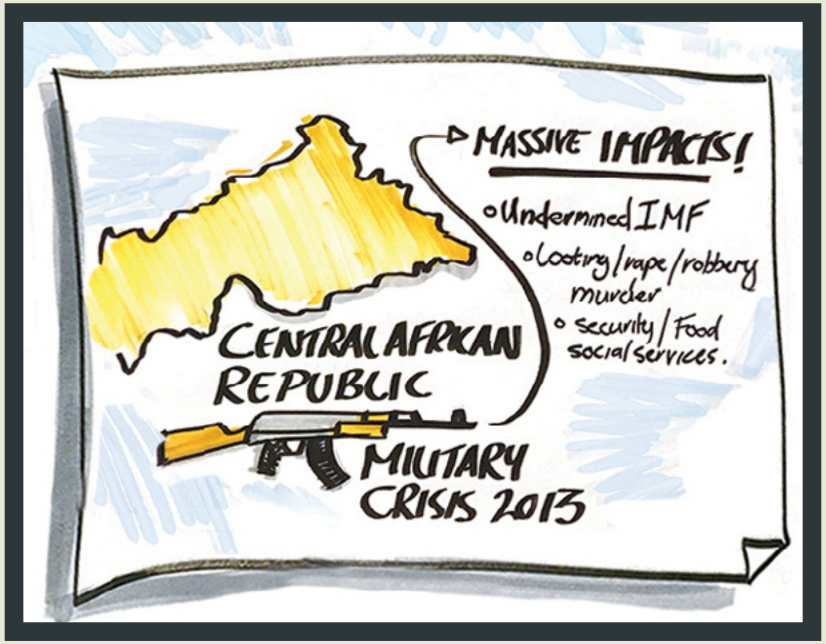
The following sections provide an overview of the disasters in Liberia and Madagascar, their context-specific mitigation strategies, and how they now plan better for future disasters.

[7] *United Nations Development Programme (2014) Assessing the socio-economic impacts of Ebola virus disease in Guinea, Liberia and Sierra Leone: The road to recovery.*

BOX 1

SHOTS FIRED: CONFLICT IN THE CENTRAL AFRICAN REPUBLIC

The conflict in late 2013 in the Central African Republic severely damaged the country's economy, security and social fabric. Conflicts have a major impact on budget formulation and execution, and the Ministry of Finance and Budget had an enormous task on its hands.



To address the issues caused by the armed conflict, the ministry reallocated funds and reduced domestic debt repayments by 50%, increasing the deficit by default in 2014. Reducing debt payments ensured that resources were aligned to the country's priorities following the conflict.

In addition to reducing its debt repayments, the Ministry of Finance and Budget of the Central African Republic reduced salaries, grants, infrastructure and pensions to be able to increase spending in the social sectors and in justice and safety post-conflict.

Conflict essentially stops all economic activity. Macroeconomic assumptions used to develop the budget no longer hold. In the Central African Republic, the real GDP growth rate forecast for 2013 was 4.3%. Updated estimates from the Ministry of Economy, Planning and International Cooperation revised growth to -11.1%. The decline in the real GDP growth was due to a decline in revenue from exported goods, including the suspension of oil and mining exploratory work. As a result, revenue from taxes and customs were well below estimates, affecting government's cash flow.

Conflict in the Central African Republic also stopped the flow of development aid to the country. Development assistance accounted for almost 40% of the revenues in the country's budget. While the cut in development assistance constrained the country's fiscal space, senior budget officials viewed this as an opportunity. Loss of aid can motivate leaders to implement reforms to promote good economic governance. This is key to being prepared for future disasters.

3: WHEN DISASTER STRIKES – FISCAL RESPONSES TO NATURAL AND MAN-MADE DISASTERS

MANAGING THE BUDGETARY IMPACTS OF THE EBOLA CRISIS IN LIBERIA

THE CALM BEFORE THE STORM: LIBERIA'S CONTEXT AND FISCAL SPACE

Civil conflict dominated 14 years of Liberia's recent history, leaving the country with poor infrastructure (including poor health facilities), high poverty rates, and internal displacement. The post-conflict, democratically elected government sought to reverse this trend and tackle these developmental challenges. With the help of development partners, the government implemented various programmes to build Liberia's health infrastructure, educational systems and the many other sectors neglected during the conflict. Yet, the country's healthcare infrastructure still lacked inputs necessary to provide basic healthcare, let alone manage an epidemic.

The stability after the civil war allowed Liberia to focus on its economy, which mainly comprises mining (iron ore, diamonds and gold), agriculture and agroforestry (palm oil and rubber), and services. The rise of commodity prices between 2010 and 2014 drove Liberia's real GDP growth up to 8.7% in 2013. This expansion of the economy increased government revenue, allowing the government to invest in infrastructure projects.

While these much-needed investments spurred economic growth, Liberia remained a poor country, relying heavily on development partners and remittances. Specifically, the resulting increases in government revenue were not enough to bridge the infrastructure gap, including repairing hospitals that were damaged in the civil conflict and, importantly, generating a reliable power supply throughout the country. The private sector, public healthcare and educational facilities relied on generators, resulting in rising operational costs as the price of petrol rose. This severely limited private-sector diversification, including the expansion of manufacturing. In addition, Liberia's lack of paved roads constrained its most promising sectors – agriculture and agroforestry – by limiting local, regional and global market access. All of these factors meant that before the pandemic struck, government revenues still relied heavily on the mining sector.[8]

MONROVIA: CALM TURNS INTO A STORM

The Ebola outbreak in West Africa started in Meliandou, Guinea. Liberia's first two cases of Ebola were confirmed in March 2014 in the Foya district of Lofa county, near the border with Guinea.[9] As more cases of the Ebola virus were reported in Monrovia and other parts of the country, officials turned to the country's only large referral hospital: the John F. Kennedy Medical Centre. Unfortunately, this hospital was heavily damaged during the civil conflict and never repaired. The country did not have the necessary facilities to deal with Ebola. As the World Health Organization reported: "No hospital anywhere in the country had an isolation ward. Few medical staff had been trained in the basic principles of infection prevention and control. Facilities had little or no personal protective equipment – not even gloves – and virtually no knowledge about how to use this equipment properly."[10]

The lack of capacity to handle the first reported cases of Ebola created the conditions for multiple chains of transmission. Healthcare staff, patients, visitors, relatives who cared for patients, ambulance and taxi drivers, and neighbours became transmitters of Ebola, affecting entire neighbourhoods. The number of cases grew exponentially, putting severe stress on already strained resources. By September 2014, Ebola had reached a critical level, having infected almost 2 000 people and claimed the lives of over 1 000. "By that time, 14 of the country's 15 counties had

[8] *Ibid.*
[9] *World Health Organization (2015) One year into the Ebola epidemic: A deadly, tenacious and unforgiving virus, http://www.who.int/csr/disease/ebola/one-year-report/liberia/en/.*
[10] *Ibid.*

reported confirmed cases. Some 152 healthcare workers had been infected and 79 of them had died, representing a significant loss of talented and dedicated doctors and nurses at a time of immense need."[11]

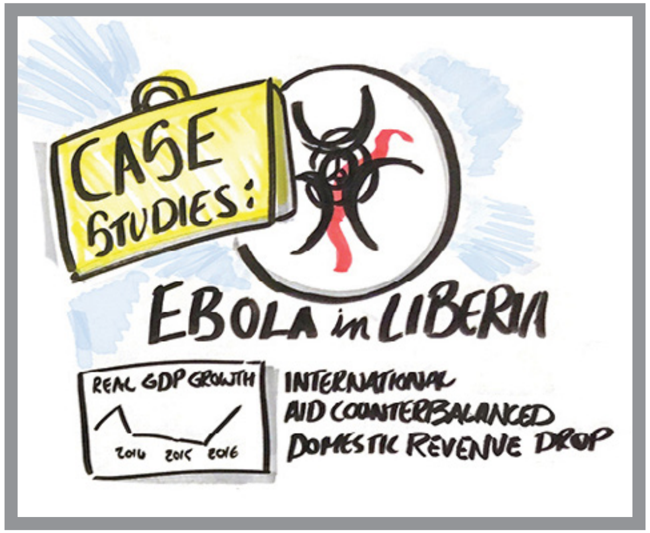
Given these circumstances, with their revenue implications and expenditure demands, how did the Liberian government manage the crisis?

NATIONAL EBOLA RESPONSE STRATEGY: COPING WITH THE EBOLA CRISIS

On 26 July 2014, President Ellen Johnson Sirleaf declared Ebola a national emergency and established the Ebola National Task Force.[12] The taskforce comprised representatives from the health sector and the national security forces, as well as officials from the Ministry of Finance and Development Planning. To stem the outbreak, this National Task Force instituted the following:

- Borders were closed.
- A curfew was instituted from 9:00 PM to 6:00 AM.
- Compulsory health screening was introduced for people entering and leaving the country.
- Communities affected by Ebola were quarantined.
- Cremation of people who died from Ebola was made mandatory in Monrovia.

The government viewed the public health crisis as a matter of national security. Managing the risk of the crisis was



essential to the country's economic and social fabric. What were the fiscal measures that the Liberian government needed to implement to manage the risks posed to the public finances as a result of the crisis?

THE FINANCE MINISTRY'S ROLE IN MANAGING THE CRISIS

The biggest pressures on the budget started before the 2014/15 National Budget was passed. To respond to the Ebola outbreak immediately, the Ministry of Finance and Development Planning submitted the 2014/15 Budget to the National Legislature much earlier than expected. This budget increased allocations to health, infrastructure and security to address the immediate demands to manage the Ebola outbreak. On-budget expenditure increased by 60% for staff, medication and equipment. Additionally, the government issued an executive order that suspended duties on imported supplies related to Ebola. Infrastructure spending increased by 111% to provide roads for healthcare workers to reach the most remote parts of the country. Spending in the security sector increased by 26% to enforce the curfew and secure quarantined areas. Overall, total government expenditure increased by 24% in the fiscal year.

The Ebola outbreak in Liberia severely affected the country's revenues. Production in the mining, agriculture, agroforestry and services sectors declined by 8%. How was the Ministry of Finance and Development Planning able to manoeuvre in this severely constrained fiscal space? It minimised costs by suspending all capital investment projects, except those directly linked to the Ebola fight. This was also done to avoid the meltdown of the country's financial sector. Government contractors seek financing from banking institutions prior to receiving payment from the government. If all projects were suspended, the risk of government contractors not paying the financial institutions would have been high: this was a factor in protecting infrastructure spending. Furthermore, the ministry reduced the recurrent operational costs of ministries, agencies and commissions to only salaries by

[11] *Ibid.*
[12] *Ministry of Finance and Development Planning (2014) The government of Liberia and development partners' contributions in response to the Ebola crisis.*

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having civil servants stay at home. Ministries, agencies and commissions involved in the response effort were not affected by this policy directive. While these measures compensated somewhat for the loss of revenue, they were insufficient to meet the scale of the crisis.

To meet the costs of the Ebola response, the Liberian government worked with development partners. External revenue in the form of grants allowed the government to increase Ebola-related public spending. The Ministry of Finance and Development Planning established the National Ebola Trust Fund to "pool resources from the Government of Liberia, corporate and development partners, as well as ordinary citizens and friends of Liberia, to effectively combat the Ebola outbreak."[13] At the height of the crisis, the Ministry of Finance and Development Planning operated out of the Ministry of Health to cost the response, monitor expenditure, and be able to respond better to constantly changing demands. Regular meetings with the Cabinet, the Economic Management Team, as well as the budget and finance officers in the ministries, agencies and commissions allowed the ministry to provide fiscal updates, adapt/review existing policy measures and monitor policy measures.

Despite these measures to contain non-Ebola expenditure and increase external revenue to meet Ebola-specific demands, the government's debt increased to 36% from 27% of GDP as a result of the crisis. The government had to request supplementary budget allocations from the National Assembly, which were granted, including a US$20 million emergency allocation in 2014.

LESSONS LEARNT: HOW BEST TO PLAN FOR FUTURE CRISES?

Managing budgetary pressures like the Ebola outbreak in Liberia provides an opportunity to evaluate how best to mitigate risk in the future. The Ministry of Finance and Development Planning started this process immediately after Liberia was declared Ebola-free in June 2015. The Economic Stabilization and Recovery Plan outlines the Liberian government's approach to better plan for future crises. The approach has two broad strategies: economic diversification to recover economic growth, strengthen resiliency and reduce vulnerability; and strengthening public finances and ensuring service delivery.

Liberia has identified various ways to diversify its economy and revitalise economic growth that is inclusive and creates jobs. These include building an enabling environment for the agricultural and agroforestry sectors. While budgets can still promote tax incentives in the mining sector to maintain existing investments, adding value in the agriculture sector is imperative to reduce Liberia's reliance on mining revenues. To spur innovation and growth in the services and manufacturing sectors, Liberia plans to increase electricity generation and distribution. Addressing road infrastructure needs is also vital to maintaining investors' current investments in the mining sector.

The 2015/16 financial year highlighted the need for economic diversification to strengthen service delivery, and fiscal resilience to reduce vulnerability to external factors. In the aftermath of the crisis, Liberia had to reduce its expenditure by US$13 million in 2015/16 compared to previous estimates, including a reduction of recurrent expenditure by 35%. This was because two factors lengthened the Ebola-associated revenue shortfalls. First, the foreign aid that was so crucial to increase public spending in 2014/15 was reduced by half in 2015/16, before economic activity fully recovered. This showed that assistance provided by development partners is not permanent, and could be considered as a contingency or reserve fund. Second, the Ebola outbreak in Liberia highlighted the vulnerability of revenue from commodities to changes in the global market. Changes in the global price of iron ore and rubber reduced the royalties from minerals by 67% for the 2015/16 financial year. Despite occurring well after Liberia was declared Ebola-free, it served to continue the revenue shortfall caused by Ebola. Thus, budgetary pressures in a country like Liberia are not solely a result of external discrete events like an Ebola outbreak. Economic diversification is crucial protection against these events and other fiscal risks over the long term.

[13] *Ibid.*

Furthermore, the Liberian government realised that improving the health system and addressing other human capital needs was also important to reduce the effects of shocks like the Ebola outbreak. Prior to the crisis, healthcare workers in Liberia were mostly funded by development partners. In Liberia's long-term interests, the government started to place these workers onto government payrolls. While this added additional pressure on already scarce resources in the short term, the intent was to build resilient health systems in the long term. This allows government to have more control over the number of health personnel and to help build stability in the system. Government also realised that reliable energy supply and roads will help improve access to quality health services, and thus help contain future viral outbreaks and limit their cost to public budgets.

Improving healthcare systems can also change cultural attitudes and norms. Traditional burials in Liberia contributed to the spread of the Ebola virus through rituals that include touching the infected cadaver. Public education efforts explaining why these traditions could not be observed during times of crisis helped change traditional practices.

To efficiently meet these additional expenditures, the Liberian government aimed to strengthen public finance by:

- Improving revenue administration to increase tax compliance.
- Enhancing economic governance to ensure accountability in the use public finances.
- Prioritising public expenditure to ensure efficiency in the use of limited resources.

These objectives were highlighted during the Ebola outbreak. According to Alieu Fuad Nyei, Assistant Minister for Expenditure in the Department of Fiscal Affairs, Ministry of Finance and Development Planning, the need for decentralisation is one of the key lessons learnt during the Ebola outbreak. "A higher concentrated government is an inefficient one," he argued during the conference. It is also slow to respond. Decentralised services can respond to crises like an Ebola outbreak faster than the central government, because they are located where the needs are. In the future, improving the coordination with subnational authorities and existing networks will be imperative to fill gaps in service delivery and promptly address crises.

In summary, the Ebola outbreak in Liberia highlighted that the sector service delivery shortfalls that allow crises to balloon are often not solely the result of deficiencies in one sector. Healthcare is not just a health issue. During the Ebola crisis it became clear that the weak healthcare system was compounded by the lack of infrastructure (in health and other sectors), insufficient human capital, weak public education systems and poor central/regional coordination.

> *"Decentralised services can respond to crises like an Ebola outbreak faster than the central government, because they are located where the needs are."*

3: WHEN DISASTER STRIKES – FISCAL RESPONSES TO NATURAL AND MAN-MADE DISASTERS

BUDGETING BETTER FOR NATURAL DISASTER IN MADAGASCAR

UNDER CONSTANT THREAT: CYCLONES AND THE ECONOMY

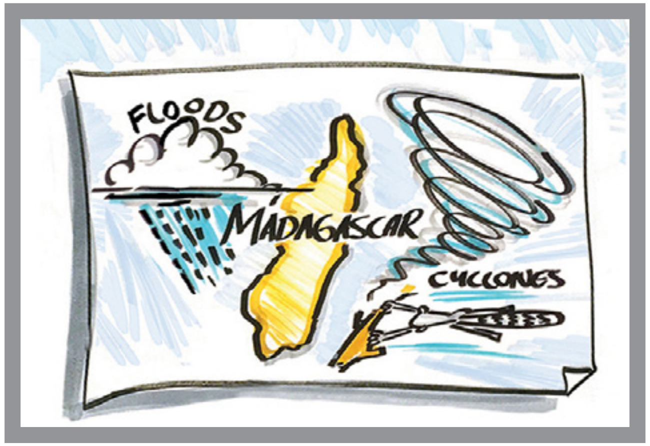
Madagascar is rich in natural resources. The island includes tracts of arable land that sustain agriculture, a sizeable coastline for its fishing industry, and vast forests for its logging industry. These industries still account for a quarter of the country's GDP and employ about 80% of the population, even though deforestation and soil erosion are increasingly constraining revenues and jobs in agriculture and logging. In addition to agriculture, fishing and agroforestry, the Malagasy economy is made up of textiles, mining and tourism. Exports of textiles and apparel boomed after the country gained duty-free access to the United States and European markets in the early 2000s. The rise in prices of commodities such as nickel, titanium, cobalt, iron, coal and uranium helped attract foreign mining firms that invested billions of dollars in the country. Madagascar's vast coastline and forests attracted tourists, doubling the contribution of tourism to GDP in 20 years.

The 2009 coup halted the country's economic growth and productivity. The departure of development partners, foreign mining firms and other investors left the government cash-strapped and with few resources to keep the economy growing and meet development challenges. This economic stagnation exacerbated poverty and the poverty gap. Extreme poverty rose from 68.7% in 2001 to 80% in 2010, declining slightly in 2012 to 77.8%.[14] The poverty gap (the average shortfall from the poverty line) is about 40% (2010 figures), which is substantially worse than the average for sub-Saharan Africa of 16.5%. This reflects the depth of Madagascar's poverty.[15]

The political instability following the coup limited the country's ability to keep its most productive sectors growing. Power outages limited the productivity of the textile industry. Moreover, Madagascar's failure to comply with the requirements of the United States' African Growth and Opportunity Act led to the termination of the country's duty-free access to the United States in January 2010. Delays in issuing mining permits coupled with the fall of commodities prices crippled the mining sector. Poor infrastructure and a limited airport network in the country constrain growth in the tourism sector. Overall, the longer-term development challenges, combined with political instability, have weakened the country's economy and public finances, and left it ill-equipped to be resilient to natural disasters.

As an island nation, Madagascar is one of the African countries most exposed to natural disasters such as cyclones and droughts. Its location in the Indian Ocean makes the country vulnerable not only to low-intensity, more frequent cyclones, but also to high-intensity, rare cyclones. On average, three to four cyclones reach Madagascar per year. In addition, between now and 2100 the most intensive cyclones are expected to steadily increase in strength by up to 46%, according to Madagascar's Meteorology Department. This intensification increases Madagascar's exposure to rising sea levels and storm surges. Cyclones also have a devastating effect on the country's infrastructure (such as schools, health centres and roads), but the country cannot afford to rebuild infrastructure after every storm. Citizens and businesses are forced to use sub-standard techniques to rebuild, increasing the vulnerability to future cyclones. Cyclones, through their direct impact on infrastructure and resulting effects on economic activity, and the cost to the public purse, impede economic growth, reducing revenue and increasing vulnerability.

[14] *World Bank (2016) Programme Document for the Madagascar Public Finance Sustainability and Investment Development Policy Financing Operation.*
[15] *Ibid.*



CYCLONES GALORE: FAME, IVAN, JOKWE AND CHEDZA

The cyclone season in Madagascar is from mid-November to April. In 2008, three major consecutive cyclones reached Madagascar. Cyclone Fame was a Category 2 cyclone that hit the island in January 2008. Cyclone Ivan, a Category 4 cyclone, struck in February 2008. Cyclone Jokwe, a Category 3 cyclone, reached Madagascar in March 2008. These cyclones affected 17 of Madagascar's 22 regions and caused damages and losses of about US$333 million. The farming, livestock and fisheries sector, which employs the majority of Malagasies, lost US$103 million. The housing and public administration sectors were left with damages and losses totalling US$127.6 million, while the transportation sector had damages and losses totalling US$45.7 million.

The combined effect of these storms accounted for 4% of GDP in 2008. Real GDP growth dropped by 0.3% in 2008. Due to lower agricultural exports, lower tourism revenue and increased imported goods, the balance of payments account dropped by 38% in the same year. The damages to public infrastructure such as public schools, health centres and ministries also severely hampered the government's ability to respond to these storms, while their repair placed additional demands on the budget. The overall budget deficit increased from 4.9% to 5% of GDP in 2008.

Cyclone Chedza in 2015 also had a significant negative economic impact on the country. Tourism was significantly affected, exacerbating already suppressed economic growth in the country. In addition to the cyclone, strikes in Air Madagascar halted the sector. As a result, real GDP growth declined from 3.3% to 3.1% in 2015. With a constrained fiscal space, the Malagasy government had limited options to respond to the constant threats.

MADAGASCAR DISASTER RISK REDUCTION PLAN: FROM DISASTER RESPONSE TO PREVENTION

The Ministry of Finance and Budget had few options to deal with the impact of cyclones. In the short term, budget reallocations were the first step that the ministry took. However, they were nowhere near sufficient to cope with the storm damage and aftermath, and the constrained fiscal space left little room for additional expenditure. Disaster relief from development partners helped the Ministry of Finance and Budget with humanitarian assistance, but this was limited to short periods after the disasters. Due to its constrained fiscal space, as well as a lack of capacity to assess what would be appropriate cover, the Ministry of Finance and Budget had not included disaster risk management in budget formulation prior to the 2014/15 series of storms.

To fill this capacity, the ministry received technical support from development partners such as the World Bank, the United Nations Office for Disaster Risk Reduction, the Central European Initiative, and the Indian Ocean Commission to develop and implement models that assess the impact of natural disasters so as to adequately cost the risk they pose into the budget formulation process. Several models are used to accommodate the complexity of budgeting and planning for natural disasters. With the help of the United Nations Office for Disaster Risk Reduction, the Ministry of Finance and Budget now uses the CATastrophe SIMulation model (CATSIM)[16] to simulate the effects of potential natural disasters on the country and undertake cost-benefit analyses of different responses and their implications for economic growth and the country's debt. The CIVEMPERT model allows the ministry to assess the country's risk profile to better plan for natural disasters. Both of these models allow

[16] *International Institute for Applied Systems Analysis: http://www.iiasa.ac.at/web/home/research/researchPrograms/RISK/CATSIM.en.html.*

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the government to consider other natural disasters such as earthquakes, floods and droughts.

In addition to investing in better forecasting models, the government undertook an extensive Post Disaster Risk Assessment in 2010. This assessment focused on designing a cyclone-resistant construction code. It divided the country into four zones depending on the level of risk each one faced (based on codes from Reunion and Tonga) and then revealed the weaknesses of existing disaster response mechanisms by zone.

Finally, with a US$1.2 million grant from the Global Facility for Disaster Reduction and Recovery, Madagascar developed a National Disaster Risk Reduction and Climate Change Adaptation Plan. The plan includes measures to build resilience to cyclones in the sectors most often affected, including through the establishment and implementation of climate-proof infrastructure codes, making existing on-budget spending climate-sensitive, establishing a disaster contingency fund and improving emergency planning capacity.

ENSURING THAT FUNDS ARE AVAILABLE WHEN DISASTER STRIKES

Better understanding of the long-term costs and average annual impacts of cyclones did not, however, resolve the issue of constrained resources. In addition to the tools to cost the risk of exposure to disaster appropriately, the Malagasy government has instituted several mechanisms to ensure that the funds are available when needed.

The first mechanism is a contingency fund, which was set up more recently following support from the Global Facility and others. It replaced or supplemented the use of a general reserve fund/planning margin, which was inadequate or unavailable to cover disaster response needs when disasters occurred.

BOX 2

THE USE OF CONTINGENCY AND RESERVE FUNDS IN BUDGETS

Contingency and reserve funds are funds that are set aside from a country's own resources to manage risks. A contingency/emergency fund is usually allocated to a special account for a limited set of pre-identified risks, to be accessed when these risks occur. Contingency or emergency funds usually have a legal basis, either in countries' constitutions or in the foundation budget law. This is because the funds are established as an earmarked account next to the central revenue account. Contingency funds require strategic planning to ensure that these funds are replenished and/or financed: in effect, they are about "saving for a rainy day". Contingency funds require a commitment from the finance ministry and the executive, as well as the legislature, to ensure that they are only spent on the purposes for which they were set aside. They can build up over many years. Ministries of finance should set up institutions, procedures and guidelines on how these funds are spent, if this is not specified in law.

Reserve funds (or planning margins) represent a margin that is set aside at the time of planning the budget to manage as yet unidentified external risks, revenue shortfalls and/or unavoidable and unforeseen expenditure demands that arise during the planning period (or fiscal year). It is another form of "rainy day" planning. Similar to contingency funds, reserve funds require discipline from the executive and legislature to ensure these funds are not spent without sufficient cause, leaving the fiscal space for later years.

In most cases, while funds such as contingency funds and reserve funds can help countries reduce the effects of natural disasters, these funds are insufficient to tackle the impact of a natural disaster.

The contingency fund, a special treasury account, is managed by the National Office of Risk and Disaster Management, which was established in the Prime Minister's Office to coordinate disaster risk and response management in government. This mirrors disaster management practice worldwide (see Mozambique example in Box 3).

In practice, funds from the account are mostly used to fund subsidies and ensure food security during natural disasters.

Another factor in Madagascar is that even if funds are allocated in the budget, the actual transfer of cash to the fund's special treasury account can occur only later in the year. The fiscal year in Madagascar is from January to December. During the first quarter of each fiscal year, tax revenue is still low. The first quarter of each year is when cyclones tend to occur. Thus, it may happen that when a cyclone occurs there is not yet cash available to finance response actions. Sound cash management in the fund is integral to having resources available to use the special contingency and general reserve funds.

Cash may also be unavailable because the fund is not replenished from the budget in years that disasters do not occur, even when the budget line is available. In practice, this means that the fund's function, namely to save up for when disaster strikes, is not fulfilled. A regular actual transfer to the contingency fund is needed to ensure that it is funded to be used when disaster strikes.

A second mechanism is the World Bank Immediate Response Mechanism, which is an allowance granted to selected countries to access US$5 million or 5% of their existing undisbursed contracted World Bank support (whichever is the largest) to finance disaster responses in emergencies. This allows funding to flow within weeks rather than months of an emergency.

A third mechanism is the African Risk Capacity facility, which provides insurance against disaster risk. The Malagasy government asked the facility to develop country-specific insurance policies to cover losses and damages caused by natural disasters. The country risk profile developed by the ministry helps the government include the insurance premiums as expenditure line items in the budget. Good practice also suggests that in addition to including the costs of insurance premiums, the budget should include information on the purpose of the contingent liability and the gross exposure of the contingent liability.

LESSONS LEARNT: MADAGASCAR'S RESPONSE TO FREQUENT NATURAL DISASTERS

Under constant threat, the government of Madagascar made a significant effort to include the risks from natural disasters in its budget formulation process. It understood that it could no longer only focus on disaster response, but also needed to plan better for the future. Given the multiple natural disaster risks that Madagascar faces throughout the fiscal year, it is imperative to identify the risk and its potential impact on the economy and budget. The government developed models to determine the parameters of the potential negative effects and conducted a cost-benefit analysis of different mitigation and adaptation strategies, and their implications on economic growth and debt. The country's National Disaster Risk Reduction and Climate Change Adaptation Plan includes strategies to make existing budgetary spending climate-sensitive, and the country put in place three key mechanisms to finance response efforts, should disaster occur.

BOX 3

THE MOZAMBIQUE INSTITUTE FOR THE MANAGEMENT OF DISASTERS

Immediate response mechanisms are central to natural disaster management. African countries often use a centralised office to manage and coordinate the government's response to a natural disaster. In Mozambique, the Institute for the Management of Disasters (Instituto Nacional de Gestão de Calamidades) manages the country's response to natural calamities. Resources are centralised to respond quickly to such disasters. However, the institute may not always be well funded to respond to the full extent of the disaster.

CHAPTER 4: WHEN CHRONIC PRESSURES TURN INTO CRISIS

INTRODUCTION

By Joana Bento[17]

The budget is a political statement that outlines how governments intend to deliver their policy objectives. During the budget process, technical and political decisions usually follow an iterative process, where ministries, departments and agencies negotiate their envelopes and advocate for the most efficient allocations.

Budget processes can struggle to take into account the impact of unexpected shocks on the annual budget. The past decade has highlighted a series of unforeseen shocks, namely the global financial crisis and the collapse of commodity prices, which have led governments to reduce public investment and increase their borrowing requirements. A large share of the shocks, however, was caused by pressures resulting from decisions largely within the government's control, such as government bailouts and the cost of social security entitlements. In these cases, the decisions were foreseeable but the budget did not fully account for the risk they posed.

Beyond technical choices, the political balance of powers can affect budgeting decisions. Budget officers often act as referees between unlimited demands and limited resources, guided by the political preferences of the government of the day. The two case studies in this section highlight unique challenges with demands for increased expenditure. In both instances, chronic budgetary pressures – present when the budget was prepared but not prioritised – finally turned into crises.

The first case study explores how South Africa's "fees must fall" movement, a public contestation over university fee hikes, affected the budget. It is based on the presentation made by Michael Sachs, Deputy Director General in the South African National Treasury in charge of the Budget Office, at the CABRI conference.[18] The second case study examines the pressures that arise from managing public wages in Côte d'Ivoire and Burkina Faso. These cases were presented by Traore Tiede, Director of National Budget at the Ministry of Economy and Finance in Côte d'Ivoire, and Vieux Abdoul Rachid Soulama, Director General of Budget at the Ministry of Economy, Finance and Development in Burkina Faso. Although these shocks are different in nature and context, they show similar patterns.

> *"Responses to these types of pressures require a great deal of strategic communication to make the trade-offs clear and decision makers accountable."*

[17] *Joana Bento is a public finance management specialist in the CABRI Secretariat, responsible for budget transparency and accountability.*
[18] *At the time of publication, Michael Sachs had resigned from his position at the National Treasury.*

4: WHEN CHRONIC PRESSURES TURN INTO CRISIS

These shocks usually start as social demands that governments chose to include in the budget to preserve political capital. The complex space between bottom-up and top-down pressures is what makes these types of shocks particularly difficult to manage.

First, the decision-making process is largely taken away from the budget office and efficiency criteria are assigned secondary importance. In this situation, effectively communicating the costs and benefits of the policy choices to policymakers becomes even more important. Responses to these types of pressures also require a great deal of strategic communication to external actors and agents – to make the policy trade-offs clear and decision makers accountable. Yet, transparency does not guarantee that trade-offs are effectively understood. Countries also need institutions and think tanks well versed in these social issues that can enrich the public debate and speak to ordinary citizens.

Second, although they occur during a fiscal year, the shocks are the result of pressures that build over the medium term. They often point to institutional weaknesses in public financial management and/or policy pressures that were not addressed. That is precisely what makes them difficult to manage: by the time governments acknowledge these shocks, the credibility of institutions is already compromised, which exacerbates social discontent and diminishes the executive's power to present credible policy alternatives.

Managing the risks cannot only depend on the processes, practices and instruments of finance ministries. For instance, many African countries introduced fiscal rules to counter political agendas and influence on the budget, ensuring government does not borrow beyond its limits. "Rules fortify politicians who want to be fiscally prudent, but they do not stand in the way of those who are determined to spend more or tax less than the rules allow" (Schick, 2003).[19] Politicians still have a say in budgetary decisions, and the social pressure underlying these shocks acts as a powerful political incentive. Effectively managing these budgetary demands not only depends on the credibility of the institutions that govern the budget process, but also on the capability of a finance ministry to effectively communicate – to citizens and policymakers – the costs of policy choices.

[19] *https://www.oecd.org/gov/budgeting/43494591.pdf*

4: WHEN CHRONIC PRESSURES TURN INTO CRISIS

FEES MUST FALL: MANAGING THE COST OF INCREASING STATE FINANCING FOR HIGHER EDUCATION IN SOUTH AFRICA

DEMANDING MORE ACCESSIBLE HIGHER EDUCATION: THE SHOCK IN CONTEXT

In October 2015, South Africa's Minister of Finance delivered the medium-term budget policy statement – which presents the country's projected economic context and fiscal policy objectives for the following three years – in Parliament amid protests outside the building.

University students were protesting the increase in higher-education fees. South Africa's universities are autonomous; they set their fees while government contributes about 30% of their funding. Earlier in October, when the University of the Witwatersrand announced a 10% fee increase for the following year, protests erupted on its campus. The campus was closed, but the protests rapidly spread across the country as other universities announced their fee increases. This marked the beginning of South Africa's "fees must fall" movement.

At the time, South Africa was facing a challenging economic outlook, with sluggish GDP growth since 2013, which put pressure on the fiscal deficit and weakened its debt position. Low and fragile growth also meant that the government was confronted with difficult trade-offs between tackling fiscal and external imbalances and addressing social challenges (unemployment, poverty and inequality). At the same time, public-sector wage settlements had exceeded inflation, placing further strain on the ability to budget for social spending.

The medium-term budget policy statement is an important event in South Africa. It manages expectations for the budget and supports predictability in government's fiscal and budget policy stance over the medium term. In 2015 it was particularly important: international investors were eyeing a strong policy stance on fiscal consolidation while rating agencies were evaluating the creditworthiness of South African debt. Since 2012, the medium-term expenditure framework (MTEF) had been set within a context of fiscal consolidation and the National Treasury had committed to using this framework as a set ceiling for the three years. Any new policy within the medium term had to be within those ceilings.

On 23 October, two days after the Minister of Finance delivered the medium-term budget policy statement, the President announced that there would be a freeze on university fees. This decision called for the National Treasury to accommodate an estimated additional expenditure of US$1 billion in the following three years.

> *In South Africa, we are fortunate to have a well-established and robust medium-term expenditure framework underlying our budget, and although those institutions are strong, they are constantly being tested.*
>
> *– Michael Sachs at the CABRI Conference*

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Photo credit: Ashraf Hendricks/GroundUp

RESPONSE: WEIGHING FISCAL DISCIPLINE AGAINST SOCIAL DEMANDS

On 9 December, a team from the National Treasury met with Cabinet to present the full range of response options and their implications. Budget managers had to present a strategy for financing the unbudgeted US$1 billion over the next three years. The options were either to work within MTEF limits by reprioritising existing expenditure or to increase revenues by raising taxes or taking on additional borrowing, or some combination of these.

The economic outlook limited the choices available for addressing this fiscal shock. Increasing revenues by raising taxes would further hamper economic growth. Raising additional borrowing would put a strain on South Africa's fiscal sustainability over the medium term and possibly trigger junk status by rating agencies. The possibility of expanding overall expenditure faded even further when the surprise removal of the finance minister increased uncertainty over the economic outlook and pressure on the 2016 budget due in February. In the days following the minister's dismissal, the rand depreciated by 10.5% and half a trillion rand was wiped off the value of South African bonds and stocks as investors took flight. Although the rand and markets recovered during 2016, the event arguably contributed to slowing economic growth, which resulted in an even tighter fiscal space and a more unpredictable budget.

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Within this context, the National Treasury preferred reprioritising expenditure, while recognising the importance of minimising the impact on social projects. In a transparent process, it presented the political leadership with options and trade-offs to reprioritise spending within the existing limits. Ways in which funding could be met within the ceiling included:

- Shutting down non-performing government programmes.
- Cutting the allocations to large public infrastructure projects.
- Postponing government's social infrastructure programmes.
- Shifting resources from the country's sector education training authorities – that are funded by earmarked taxes outside of university education – which were running surpluses at the time.
- Cutting administrative budgets by imposing a cut on all programmes and freezing wages across the public sector.

While working within the limits, the government restricted the choice of responses. Cutting large infrastructure projects or freezing public-sector wages was not an option. In the end, budgets were cut from national government across line items, particularly the expansion of government employment and transfers to public entities with large surpluses. Provincial budgets were also affected, specifically conditional grants to provinces' social infrastructure projects.

To compensate for the 0% fee increase in the 2016 academic year, government increased subsidies to universities. The subsidies were set to grow at an annual average rate of 10.9% in the following three years, while allocations to the National Students Financial Aid System, which provides support to underfunded university students, were increased by 18.5%. In the 2016 budget, R5.6 billion was added to university subsidies, of which R2.5 billion was allocated to the financial aid system. An additional R8 billion was allocated to new unfunded students for the 2016 academic year and beyond. The policy, however, was implemented under the assumption that there would be normal fee increases in the following years.

LESSONS LEARNT: PRIORITISING SHORT-TERM OVER MEDIUM-TERM TRADE-OFFS

The combination of bottom-up and top-down pressures made the tertiary fee issue difficult to manage. The widespread media coverage of the student protests created sympathy for students' demands. At the same time, different levels of government were capitalising on these bottom-up pressures to further their political and financial agendas. What follows are lessons that can be drawn from this case study.

Maintaining budget credibility

In the short term, the National Treasury was able to respond to the shock, demonstrate flexibility in the fiscal system and retain investors' confidence. The response options pleased credit rating agencies and foreign investors, who evaluated the policy decision as a continued commitment to fiscal consolidation. However, the response choice had a different effect on the fiscus and on budget credibility in the medium term.

Inadvertently, the National Treasury had signalled that the budget was an unlimited pot of resources, as long as there was enough social and political pressure. Government demonstrated that demands could be fulfilled – even outside the budget process – if it was pushed hard enough. Departments and agencies realised that there was an opportunity to make increased budget bids for policies they had been developing over the last 10 years that address specific social pressures. Furthermore, the following year, when the discussions about university fee increases for 2017 started, protests calling for fully free higher education reignited and significantly worsened. In fact, the same reprioritisation exercise had to be done for the 2017 budget. So, although South Africa demonstrated flexibility in responding to the problem immediately, it compromised the credibility and efficiency of the allocative budget process going forward.

Communicating policy/cost implications

When bottom-up and top-down pressures combine, the power to make decisions about policy choices is largely taken away from the budget office. The National Treasury's role in this instance was to inform decision makers about the policy options and implications of their choices. While budget institutions were effective in responding to this shock without undermining the fiscus, they were ineffective in making policymakers and political leadership confront the long-term trade-offs.

The National Treasury's weakened position was partly because the costs of this policy choice were not strongly communicated or understood, despite a transparent budget process. Student protests in South Africa were covered extensively in the media and there was widespread public debate on reprioritising resources and reforms in the education system. However, the trade-offs from additional funding to higher education were difficult to communicate to South Africans.

Access to and participation in higher education in South Africa, as with many other countries, is dominated by more affluent individuals. The main problem for the poor in South Africa is not that they cannot afford higher education. The issue is that less than 5% of them qualify for entry into universities.

Lessons from elsewhere show that free higher education in highly unequal societies mainly benefits the already privileged (political and business elite), who have the social, cultural and economic capital required to access, participate in and succeed in education.[20] This is especially relevant in countries with significant disparities in the quality of primary and secondary schooling between poorer and more affluent communities, such as in South Africa. Lower tertiary education fees actually widen, rather than reduce, inequality across the system, except where universities have taken steps to cross-subsidise students internally. By agreeing to finance lower university fees, the South African government was effectively compromising pro-poor policies – including primary education and social grants – to allow cheaper access to higher education to predominantly wealthier citizens. A question that remains to be answered is whether making these trade-offs clearer to the public would have eased the pressure and allowed for a more sustainable solution to the crisis.

A challenging policy-budget link

Protests over fee hikes were not new to South Africa: universities in the country's disadvantaged communities had long been contesting the costs of higher education, though they had largely been ignored by the media. The pressure of funding higher education had been building for many years prior to the events in 2015. Since the democratic process began in South Africa in 1994, universities have seen a considerable increase in student numbers. However, funding to these institutions has not matched the growth in demand for higher education that resulted from the opening of admission to all members of society. Since government was not adequately funding universities, they needed more autonomous funding, mostly through student fees.

Despite an increase in grants and subsidies to tertiary education, particularly financial aid programmes, the proportion of historically disadvantaged groups in the higher education system remains disproportionate to their share of the population.[21] In addition, they are less likely to complete their studies – a legacy of unequal

[20] *P Langa, G Wangenge-Ouma, J Jungblut and N Cloete (2016) "South Africa and the illusion of free higher education" in University World News, Issue 402.*

[21] *Council for Higher Education (2015) Vital Statistics Public Higher Education 2015. Council for Higher Education: Pretoria.*

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education provision during apartheid. The protests also raised the issue of a missing class: students who qualify to go to university, but cannot afford to pay university fees and do not qualify for educational subsidies directed at poorer members of society. The challenge for policy planning in the post-apartheid era is to achieve the right level of prioritisation between pro-poor policy programmes and policies that address the legacy of apartheid-generated imbalances for those who are not necessarily poor. At the same time, this prioritisation needs to weigh short- and long-term investment outcomes in the whole education system.

Responding to the specific shock vs. managing the pressure

The National Treasury's response was effective in addressing the shock, but not in easing the underlying political and budgetary issues that gave rise to the pressure. Furthermore, the response may have weakened the budget process at the cost of the National Treasury's ability to finance long-term policy objectives and plans. The fees must fall movement highlighted an accountability issue in the link between long-term policy objectives and budgetary planning. Chronic pressures require strong institutions that balance technical considerations and

political pressures to proactively attend to developmental needs while considering social transformation, within sustainable fiscal limits. When these institutions are not in place, budgetary pressures articulated by certain groups of citizens can easily drown out the developmental needs of the whole. The fees must fall movement may have also signalled an institutional bias towards political decision-making over optimally efficient allocations. Budget officers can strictly follow due processes to ensure they fulfil their technical mandate, but ultimately, they are guided by political agency. Yet, it is events like these that provide an opportunity to recognise and address those institutional weaknesses.

DEMANDING HIGHER WAGES IN THE PUBLIC SECTOR: THE CASES OF BURKINA FASO AND CÔTE D'IVOIRE

In many developing countries, the government is the biggest employer. The literature suggests that the size and scope of the public sector has increased considerably since the early 1970s, and while the wage bill has stabilised in advanced economies, it has been increasing in low-income economies.[22] In these countries, administrative delivery functions have broadened while social needs have called for an increase in service delivery capacity, particularly in health, education, sanitation and security. Furthermore, social and political pressures, such as youth unemployment, often result in governments implementing extensive recruitment programmes without considering real needs, inflating the wage bill and putting fiscal sustainability at risk.

The management of the wage bill has important fiscal and macroeconomic implications. Raising government wages can stimulate inflation, which can compromise the stabilising role of fiscal policy and lead to burgeoning public debt levels during economic downturns. High compensation spending can also reduce priority spending on public infrastructure and social protection, crucial for economic growth and poverty reduction.[23] However, the wage bill is a quick and easy way for governments to build political capital, which can outweigh more technical considerations and trade-offs in the medium to long term.

Wage bill pressures can materialise in many ways. Cyclical pressures, such as compensation demands from labour unions, can unexpectedly increase the wage bill and put a strain on in-year budgets. However, there are also structural pressures, such as normal salary progressions or recruitment programmes, that contribute to inflating the wage bill. Although these pressures do not necessarily affect in-year budgets, they do affect medium-term frameworks to the detriment of the complementary inputs to public service delivery, such as public infrastructure, maintenance or even textbooks for schools.

In West Africa, historically, the public-sector wage bill has been high despite rising budget deficits, which led to considerable state debt. The wage bill was one factor in the large fiscal imbalances experienced before 1994, contributing to high inflation rates, which led to the depreciation of the CFA franc by 50%. As part of its convergence targets, in 1994 the West African Economic and Monetary Union (WAEMU) took a strong stance against the high burden of the wage bill on its member countries. Its fiscal rules dictate that the ratio of the wage bill to total tax revenue should not exceed 35%.

Burkina Faso and Côte d'Ivoire have historically had the highest share of public compensation in the total budget, compared to the rest of the region, at 40% to 45%. The two countries have never managed to come below the 35% threshold, despite efforts to contain and reduce the wage bill. The WAEMU directives also set a rule on fiscal deficit levels, which should be lower than 3% of a country's GDP in any given year. These fiscal rules limit the scope to use additional borrowing as a response to wage bill pressures, and the trade-off is often met by reducing capital expenditure.

Compensation and employment policies have come under scrutiny in recent years, after the introduction of fiscal rules in 1994, particularly as the fiscal imbalances that led to these rules were in part caused by wage bills. As set out in the two case studies, the most pressing issues include the continuous realignment of actual pay across sectors or with prescribed scales; increased employment; and adjustments to catch up public-sector pay after long freezes. While wage bill pressures can occur in-year, as public-sector unions and employees make demands, they are more often the result of an accumulation of years of pressure. They usually need to be addressed by multi-year interventions, often within uncertain macro-fiscal contexts.

Within this context, pressures on different fronts have prevented Burkina Faso and Côte d'Ivoire from fully pursuing their strategies to contain their wage bills. The following two sections present how the two countries have attempted to manage the pressures ensuing from the public-sector wage bill over the years.

[22] *IMF (2016) Managing government compensation and employment – Institutions, policies and reform challenges.*
[23] *Ibid.*

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CÔTE D'IVOIRE: ACCRUING WAGE BILL PRESSURES

Despite worldwide economic uncertainty, Côte d'Ivoire has experienced remarkable economic growth since 2011. In 2015, real GDP grew by 8.6%, driven by strong investment and economic consumption.[24] The 2016–2020 National Development Plan's focus is on achieving strong and inclusive growth, particularly through private development stimulated by public infrastructure projects and improved service delivery. However, the fiscal space for capital investment projects has gradually been eroded by increased operational expenditure, especially the wage bill.

Over the last two decades, the wage bill has grown rapidly in Côte d'Ivoire, putting considerable pressure on the fiscus. This pressure has been both structural and cyclical. Cyclical wage pressures occurred as a result of in-year union demands for salary increases, allowances and advantages, which were granted to different spheres of government (such as research grants or additional work time), as well as exceptional recruitment (the disarmament, demobilisation and reintegration programme).

Negotiation outcomes from the in-year demands varied widely across and within sectors, mostly because government did not follow a strict compensation policy. The disparity between civil servants' pay was clear: public officials would have the same years of experience, education and rank and yet be on a different salary pay scale.

Over the years, the government has been confronted with unexpected salary demands, often a consequence of the growing frustration with the disparity in pay. Because these demands are unexpected and negotiation outcomes difficult to predict, they are usually not taken into account when the budget is prepared. Wage settlements have called for difficult negotiations with teachers, nurses, doctors or the armed forces while the country is in complete lockdown. Addressing cyclical pressures often required in-year adjustment mechanisms from the government of Côte d'Ivoire. Yet, this only represents a fragment of its wage bill pressure.

The cyclical pressures have often occurred in combination with the more structural pressure created by automatic salary progression. Before 1988, public servants in Côte d'Ivoire were guaranteed a base salary increase for every two years of service. However, due to the wage pressure on the budget, all increases were frozen. Yet, from 2000 to 2013, wage costs nonetheless increased by 129%, mostly due to considerable expansion in government employment as well as special status and advantages granted to certain public enterprises and the health and education sectors. Côte d'Ivoire's challenge has been to strike a balance between improving civil servants' purchasing power while ensuring that the wage bill does not become a pressure on the budget – including tax revenue and borrowing – and erode the budget for capital expenditure. In 2009, the former government committed to a retroactive and gradual unfreezing of wages, starting in 2014. This meant that from 2014, the government has needed to account for a backlog of 26 years of wage premiums in the wage bill going forward, an estimated 125 billion CFA francs (about US$232.5 million).

Response to building wage bill pressures in Côte d'Ivoire

The Ivoirian government designed a broad set of responses to address wage bill pressures. For more cyclical pressures, it often includes a 3% provision to meet unforeseen expenditure in the budget proposal. Any remaining pressure is covered by revenue collected in excess of the budget projections. Historically, total revenues in Côte d'Ivoire have exceeded expectations, reducing these shocks and allowing the government to respond without extensive cuts to social expenditure or increased debt. However, accommodating these ad-hoc pressures has contributed to the significant shift in the balance between recurrent and capital expenditure.

For structural pressures, government treated the future ongoing cost of the adjustments separately from the once-

[24] *IMF (2016) Côte d'Ivoire Article IV Consultation Report.*

off payment of arrears. In response to ongoing structural wage pressures, government focused on medium-term compensation and employment policies. It adopted a 2014–2020 strategy to bring the wage bill to 35%, in line with WAEMU directives. The strategy aims to shift the emphasis from short-term response actions to a medium-term sustainability approach through reduced recruitment targets and a new wage grid to address equity issues – which would make cyclical wage pressures more predictable.

Absorbing budgetary pressure due to the once-off payment of wage arrears was also part of the medium-term strategy. In 2014, the financial impact of civil servants' promotions was budgeted for, including promotions that had been on hold since 1988. The government negotiated on a case-by-case basis, and adopted different strategies depending on the sector. The main concern was to negotiate a payout that would not place the full burden in one fiscal year, but rather stagger it over a period of time. To that end, multiple simulations of response options were performed in order to consider the full range of options and their financial implications. For 2014, 78.9 billion CFA francs, 63% of total wage arrears, were included in the annual budget. Arrears and bonus payments to the education and health sector took a large share of this allocation.

In December 2016, the National Assembly approved a total budget of CFA6 501 billion (about US$11 billion) for 2017, most of which was financed through domestic resources. The wage bill accounted for 24%, and although this represents a decline in the share of compensation of employees in the total budget, it still accounts for 38% of total tax revenue – slightly above the 35% threshold imposed by WAEMU directives. Despite this, the government was committed to ensuring that it delivered on its promises, while gradually adjusting to the new directives.

Ensuring that the ongoing wage bill negotiations were aligned with government's strategy and budget, particularly regarding the gradual unfreezing of arrears since 1988, proved difficult as the negotiations were public. Public workers were closely monitoring concessions made by the executive to different sectors of government. As such, past union agreements were jeopardised because politicians were seen to concede more favourably to some demands than to others.

In May 2017, the military took to the streets, shutting down most of the country, to demand increased bonuses and pension benefits that the President had promised earlier that year. Short of invading the presidential palace, the government had no option but to concede to the demands of the armed forces. This had a considerable impact on the credibility of the wage bill strategy in the medium term and weakened the government's negotiating position going forward.

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BURKINA FASO: WAGE PRESSURES IN THE MIDST OF POLITICAL UNCERTAINTY

Between 2014 and 2016 Burkina Faso faced a firestorm of budgetary pressures from political events, shifts in global markets and a regional pandemic. In the middle of this firestorm, a set of public wage issues also emerged, putting further pressure on the budget).

In 2014, after 25 years in office, President Compaoré sought to amend the Constitution to remain in power. This sparked mass outcry from the Burkinabe population. Compaoré was forced to resign, and a transitional government was established despite attempts from the presidential guard to stage a military coup in favour of the ousted President. While the political transition was relatively peaceful, the economy was a lot more volatile.

In 2014 and 2015, economic growth decelerated to 4%, from a 7% average between 2010 and 2013. The economic cost of political upheaval was exacerbated by a drop in commodity prices, specifically gold and cotton – the country's two leading exports. The Ebola outbreak in West Africa also negatively affected tourism and services in the region. The decline in the gold price adversely affected mining royalties, while the popular insurrection resulted in a long service interruption to the revenue and customs administration, and the onset of widespread tax avoidance practices.[25] As a result, Burkina saw a decline in domestic resource growth of 12.1% in 2014, followed by a slight increase of 2.2% in 2015. In 2014, domestic revenues reached 17.3% of GDP, 2 percentage points of GDP below the levels initially projected, before falling by a further 1.2% of GDP in 2015.[26]

Evolution of the wage bill in Burkina Faso

There were also growing pressures to increase spending on salaries. Since 2000, the public wage bill had been growing faster than GDP, driven by a large increase in public employment, even though sector pay levels declined. Since 2012, staff costs had been increasing considerably and disproportionally to domestic income, at an average of 14.5% per year, as the government came under pressure to make up for years of below-inflation increases to existing employees. Agreements on the compensation of public officials made by the previous government included a 25% increase in the salaries of government employees, increases in allowances for teachers and health workers, and increases in housing allowances for state employees. As a result, and in combination with low growth after the political transition, the wage bill put considerable strain on the government's fiscal space.

Despite these pressures, Burkina Faso started implementing a set of strategies to contain the wage bill from 2012. It started with the pre-approval of new recruits by the centre of government, particularly for non-priority sectors. It also completed a personnel census to audit the wage bill in 2012; adopted biometric enrolment in 2013; improved information technology capacity to allow for more automated payroll management and review processes; implemented cash payment operations to identify ghost workers and other irregular payments in 2015; and, in the same year, adopted legislation to make it compulsory to formally identify incoming and outgoing officials on appointment documents to allow for automatic updating of their salary status.[27]

In November 2015, the new government agreed to the adoption of a new civil service code, which introduced a revised wage grid, and integrated contractual staff as permanent civil servants. The implementation of the new code, and of other sector-specific wage agreements (for example, with the judiciary), permanently increased the wage bill by an estimated 0.4% of GDP in 2016.

Burkina Faso's increasing wage bill is also largely due to high indemnities and allowances granted to specific government sectors (housing and transportation allowances). These are

[25] *IMF (2016) Burkina Faso Article IV Consultation Report.*
[26] *Ibid.*
[27] *IMF (2016) Article IV.*

Back home I often hear people objecting, saying: We cannot eat roads! But the fact is, if you don't have roads to fetch your food, what are you going to eat?

– Vieux Abdoul Rachid Soulama, Director General of Budget at the Ministry of Economy, Finance and Development in Burkina Faso

often put forward as a strategy for retaining highly skilled workers who would otherwise move to the private sector. Like Côte d'Ivoire, the challenge for Burkina Faso was to expand on much-needed public services, especially in the health and education sectors, while containing the wage bill within sustainable fiscal limits.

Burkina Faso's response to growing pressures

Regulations are often in place to prevent changes in appropriations, including the wage bill. As such, the Burkinabe government has always attempted to anticipate and budget for both structural and cyclical pressures, including wage increases. When unexpected demands occur, they are often deferred to the outer years of the medium-term framework.

Even so, these demands are often unpredictable, and in Burkina Faso they coincided with macro-fiscal shocks that affected the budget's implementation. In the past, the impact of these pressures was cushioned partially by conservative revenue forecasts, which were often lower than actual revenue collection in the years leading up to the economic shocks (by as much as 30%). This, however, was not the case in 2014, when actual revenue was 86% of projected revenue, but the situation could have been much worse had revenue forecasts been more optimistic.[28]

To accommodate the shock, the Burkinabe government adopted a supplementary budget. While measures were introduced to curtail superfluous recurrent spending (for example, by limiting foreign trips, reducing the size of the government's car fleet, and reprioritising some staff cost items over others) and allowing arrears to accumulate, the burden of the adjustment was borne by much-reduced investment spending. In addition to wage bill pressures, expenditure on security increased considerably from 2014, given social unrest and militant attacks. This led to a relative shift from investment to recurrent spending in the budget balance. During the 2014 fiscal year, the government executed 94% of the recurrent expenditure target, but just two-thirds of planned investment expenditure.[29]

The political transition has increased expectations of the country's pace of development and created significant pressures to increase recurrent spending, particularly as a means to tackle urban youth underemployment.[30] Although economic activity started to rebound in 2016, after two years of weak growth numerous budgetary pressures remain. While unions continue to argue for further salary increases, planned investments in the social sectors, as well as physical infrastructure, will generate significant recurrent costs over time. The implementation of upcoming budgets is associated with higher risk of social tensions and demands. At the same time, the expansion of government services will be critical to achieve much-needed improvements in service delivery.

[28] ODI (2017) Under pressure: Executing the budget in an uncertain world, paper prepared for the 2017 CABRI Conference.
[29] 9.1% of GDP, compared to a projection of 13.7% of GDP.
[30] Almost 65% of Burkina Faso's population is under the age of 25 years, and the youth emerged as a driving force for change in the process that led to the popular uprising.

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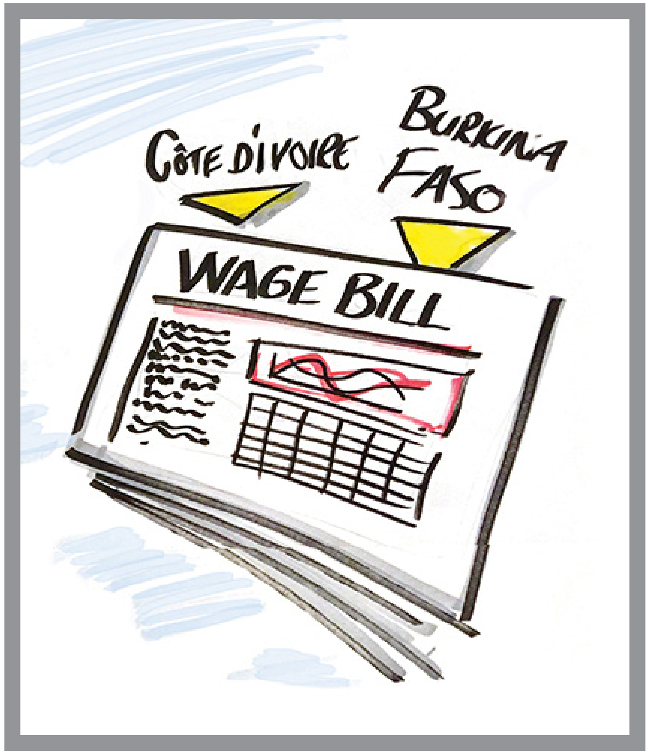

LESSONS LEARNT FROM WAGE PRESSURES IN BURKINA FASO AND CÔTE D'IVOIRE

The wage bill is particularly difficult to manage because it is often both a bottom-up and a top-down pressure. Public wage spending is largely influenced by political cycles, where concessions are made in times of low political capital and governments have nothing to lose. Low-income developing countries appear to be more susceptible to this phenomenon. During election years, the public-to-private-wage ratio in these countries increases by nearly 3% on average.[31] Finance ministries operate in a complex space, reconciling long-term structural pressures with short-term cyclical shocks. Long-term strategies are difficult to implement because they easily fail to take into account the political incentives to deviate from the plan.

Documenting information on public service remuneration

Data on the total amount and composition of the wage bill remains inadequate.[32] Poor or fragmented information on compensation and payrolls often limits the scope of government interventions. Both Burkina Faso and Côte d'Ivoire lacked adequate information on civil service pay, in terms of the amount of pay and to whom it is paid. This reduced their ability to identify cost-saving measures, for instance, by eliminating ghost workers, which is an easy and apolitical way of decreasing the burden of the wage bill. Obtaining disaggregated information on payroll allows governments to break down costs and identify policy interventions that limit the impact of cyclical and structural wage bill pressure on the fiscus, providing additional flexibility to respond to budgetary pressures.

Because the wage bill is both a bottom-up and top-down pressure, the most important role of the finance ministry is to communicate the costs of policy choices to decision makers. Governments need an accurate and in-depth breakdown of labour costs to communicate the fiscal implications of their policy choices. Providing reliable and timely information on these cost and policy options is critical to decision makers aware of and accountable for political decisions that have a financial impact on the budget.

[31] *IMF (2016) Managing government compensation and employment.*
[32] *Ibid.*

Negotiating based on reliable facts

Supporting facts/data can also strengthen the government's position during negotiations with labour unions. Labour unions often publicise their disputes to mobilise support for their members. During those disputes, governments navigate a complex web of interactions between public servants and the media, requiring skilful strategies to preserve the institutions' credibility. An effective negotiation strategy, supported by reliable data, will also include effective communication of the facts, thereby managing public workers' demands and proactively setting their expectations for the future.

Fair, consistent and transparent remuneration policies

A coherent remuneration policy can help ensure that there are no discrepancies in compensation packages between public workers of similar status. The policy must be clear about qualifications, experience and location, and have strict directions for salary progression. The demands from different labour unions are often exacerbated because wages have been negotiated without considering the outcomes of past negotiations with other unions or groups, even for the same industry and function. Governments can easily lose credibility in their negotiating position when they are seen to concede to some union demands more than others. While absorbing the once-off cost of these concessions can be tempting in anticipation of further strikes, it jeopardises the implementation schedules of previous wage settlements as well as governments' future containment plans. Although a clear remuneration policy would not prevent public-sector workers from demanding higher wages, it can strengthen the government's position in negotiating with labour unions.

Fiscal space to implement government's employment and wage policies

Medium-term implementation schedules for wage measures provide relief from immediate pressures in cases of limited fiscal space to act on a sudden shock. They are also prudent, as containing wages and employment within short-term fiscal limits usually results in new crises down the line. However, medium-term wage measures also need to be backed by strategies to increase domestic revenue for governments with limited flexibility to cut expenditure. This is essential to ensure that any increase in the wage bill does not erode essential social expenditure and public investment spending. WAEMU countries, in particular, cannot only reduce expenditure as they are constrained by the 35% wage rule and deficit rules. In order to sustain the size of government needed to implement development policies, and pay public officials adequately, governments need to strengthen domestic resource mobilisation, particularly tax revenues, while decreasing reliance on external aid.

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CHAPTER 5: WHEN THE PURSE IS EMPTIER – MANAGING THE BUDGETARY IMPACT OF MACRO-FISCAL SHOCKS

INTRODUCTION

By Danielle Serebro[33]

International macroeconomics reveals that each successive wave of crises exposes possibilities for crisis that were overlooked in earlier analysis.[34]

Chad, Lesotho and Nigeria are not countries that can be neatly grouped together on socioeconomic grounds. But, despite their different socioeconomic contexts, they have all experienced large revenue contractions associated with their integration into the global economy and dependence on international trade. Globalisation has the potential to increase African countries' economic performance. However, the associated dependence on volatile revenue sources implies a high risk of fiscal instability.

At the ninth CABRI Conference, senior budget officials from Chad, Lesotho and Nigeria discussed the measures they took when this risk materialised after the global financial crisis.

Motena Tsolo (Chief Executive of Economic Policy, Lesotho Ministry of Finance and Development Planning) discussed the impact of the global financial crisis on Lesotho's Southern African Customs Union (SACU) revenue. Nigeria's Ben Akabueze (Budget Director in the Budget Office, Federal Ministry of Finance) and Chad's Alain Mahamat Kimto (Budget Director, Chad Ministry of Finance) explained how the reduction in the oil price from 2014 placed significant pressure on their budgets. These events were sufficiently disruptive to force the respective ministries of finance to make significant in-year adjustments to their fiscal stance and budgets. Lesotho's finance ministry attempted to mobilise domestic resources, diversify the economy beyond textiles and cut wasteful expenditure. Nigeria's response to the deterioration in its revenue base involved expenditure controls, structural reforms to facilitate economic diversification and improved management of the country's limited resources. Chad initiated significant expenditure cuts and sought to increase tax revenue.

While certain external shocks, such as some natural or man-made disasters, are unforeseen, the shocks discussed in this chapter were foreseeable, considering the global economic cycle, and, to an extent, inevitable. Overdependence on single external sources of revenue made Chad, Lesotho

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[34] *Krugman P (2006). Will there be a dollar crisis? Available at: http://www.econ.princeton.edu/seminars/WEEKLY%20SEMINAR%20SCHEDULE/SPRING_05-06/April_24/Krugman.pdf*

"As the world becomes increasingly interconnected and globalised, someone signing a piece of paper in Washington or Beijing can send shock waves around the globe, making the jobs of [budget officials in Africa] more difficult than they should be."

– Paulo de Renzio, International Budget Partnership at the CABRI Conference

and Nigeria vulnerable to fluctuations in the global economy. Despite the inevitable nature of the pressures, none of these countries had adequate measures in place to reduce their budgetary impact.

In countries dependent on volatile revenue sources, stabilisation funds are a valuable risk mitigation tool. These funds take advantage of revenue windfalls during boom times to smooth expenditure and provision for unavoidable troughs. At the time of the 2014 crisis, Nigeria's excess crude contingency account had largely dried up, making recovery more tenuous than previous oil price crashes. Chad, recognising the importance of mitigation measures, attempted to introduce a savings fund, but was unsuccessful due to inadequate revenue. The case of Nigeria shows that it is important to make the objective of these funds clear – whether they are for short-term stabilisation or a long-term investment for future generations.[35]

Diversifying resources is also crucial for reducing the impact of economic fluctuations. Since their recent crises, Lesotho, Nigeria and Chad have focused on diversifying their economies. Prior to the international crisis, Lesotho had made minimal progress in developing sources of revenue independent from the SACU and its textile industry. Subsequently, Lesotho has emphasised industrial infrastructure to diversify production and exports, and has identified tourism, agriculture and mining as key sectors for stimulating diversification. The Federal Government of Nigeria (FGN) is focused on diversifying the economy through advanced industrialisation and increasing the productivity of the agricultural and minerals sectors. It believes that investment will lead to diversification and is campaigning to attract foreign and domestic investors and boost market confidence. The government of Chad is also working on diversifying its economy and increasing domestic and concessional financing.

Increasing tax revenue was regarded as important in reducing vulnerability in Nigeria and Lesotho. The FGN is committed to improving revenue from non-oil sectors. This will be achieved by improving tax compliance and broadening the tax base by increasing registration of

[35] Lesotho did not have a contingency fund in place at the time of the crisis. It attempted to build its international reserves beyond the level committed to in the SACU agreement. This, however, does not act as a buffer against domestic revenue contractions

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businesses and creating an enabling environment for small and medium enterprises. Since the global financial crisis, Lesotho has reviewed and restructured its methods of revenue collection to reduce revenue loss. Measures were introduced to broaden the tax base, and improve systems and capacity.

Containing costs, particularly recurrent costs, and convincing actors of the importance of cost-cutting measures, was central to all three countries' response strategies. In Lesotho, the Ministry of Finance used Parliament to communicate the importance of cutting recurrent expenditure and remaining within budget ceilings. The FGN has prioritised sensitising ministries, departments, agencies and state authorities to the country's fiscal constraints. For Nigeria, it has also been important to communicate the importance of implementing mitigation measures to limit future fiscal pressures to its autonomous subnational governments.

These external shocks placed significant pressure on the three countries' economies, but they also provided an opportunity to ensure the budget is better able to handle future pressures. Although Lesotho's SACU revenue is volatile and leaves the country vulnerable to developments in South Africa, which remains under economic pressure, the decline in this revenue is unlikely to be sustained. However, three years since the price of oil began to fall, crude oil continues to hover around US$50 a barrel. As movements in policy and technology lead to stricter emissions standards, the proliferation of electric cars and the use of other fuel sources, oil demand may decline, permanently suppressing prices. It is critical that oil-dependent countries accept that this contraction in oil revenue may become the "new normal" and develop viable contingency plans independent of oil revenues.

This chapter provides brief case studies of the measures taken by the three countries to respond to their crisis. It details the actions taken by Lesotho's Ministry of Finance in responding to the impact of the global crisis on Lesotho's revenues, and Nigeria and Chad to the fall in oil prices on theirs.

THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON LESOTHO'S PUBLIC FINANCES

The global economic crisis had debilitating effects on Lesotho's economy due to its continued dependence on the South African economy and increasing integration into the global economy. Exports and remittances declined and there was a sharp drop in SACU revenue receipts. This reduction in inflows led to a significant deterioration of both the current account and fiscal balances, limiting Lesotho's fiscal space and economic development.

This case study discusses the impact of the global crisis on Lesotho's public revenue streams and reflects the potential volatility associated with dependence on external sources of income. It considers the Ministry of Finance's attempts to mobilise domestic revenue and cut wasteful expenditure in response to this external macroeconomic shock.

DEPENDENCE ON SACU REVENUES: VULNERABILITY TO THE INTERNATIONAL CRISIS

The expansion of Lesotho's economy in the decade preceding the 2007 financial crisis was largely driven by the growth of the manufacturing sector and SACU revenues. The SACU, which includes Lesotho, Botswana, Namibia, Swaziland and South Africa, provides for free trade between member countries and has facilitated economic growth in its smaller members, including Lesotho. Revenue is shared between member countries according to a formula with a customs component, excise component and development component. The customs share is determined based on each member's share of intra-SACU imports. The excise component is based on each member's share of GDP. The development component, fixed at 15% of total excise revenue, is allocated per the inverse of the member's GDP per capita.[36]

SACU revenue shares increased by an average of 30% per year between 2005/6 and 2009/10. Lesotho is highly dependent on this revenue; it comprises about half of total revenue and more than 60% of government expenditure. Until 2009/10, SACU revenue facilitated an annual average increase in recurrent expenditure of 19%, consistent fiscal and current account surpluses, and growth in government deposits and foreign reserves. The government of Lesotho became increasingly dependent on SACU revenues to fund its budget.

[36] *SACU (2017) Review of the Revenue Sharing agreement, www.sacu.int.*

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BOX 4

HOW CONTRACTION IN THE SOUTH AFRICAN MINING SECTOR AFFECTED LESOTHO

The contraction in South African mining activity and decline in gold and platinum prices led to the retrenchment of Basotho migrant workers; their numbers decreased from 55 112 in 2007 to 42 796 in 2010. Remittances, due to a compulsory remitting framework for mineworkers, which complements voluntary remittances, are an important source of inflows for the Lesotho economy. The reduction in employment led to a contraction in remittances from US$451 million in 2007 to US$439 million in 2008. Wages increased between 2007/8 and 2010/11, offsetting the decline in employment. However, the contraction in employment also increased pressure on the fiscus as the government of Lesotho had to increase its social spending.

Between 2009/10 and 2010/11, SACU revenue declined by about 50%, reducing the government's ability to fund its budget by about 25%. This was made worse by a 30% decline in textile exports due to a reduction in disposable income in and demand from the United States and countries within the Southern African Development Community. The fiscal and current account[37] balances deteriorated, and government deposits were depleted. The decline in economic activity in South Africa, Lesotho's largest trading partner, was instrumental in reducing SACU revenue shares and increasing fiscal pressure in Lesotho. Dependence on the South African economy is also evident in the large number of Basotho employed in South Africa (see Box 4).

SACU revenue has proven to be volatile. Customs duties comprise the greatest share of the revenue pool; they are difficult to forecast as they depend on developments in and demand from member and non-member countries. The pre-payment structure of the revenue-sharing agreement exacerbates the unpredictability. The agreement's structure implies that if actual customs and excise collections diverge from projections, an adjustment must be made in the financial year two years after the divergence. This increased pressure in 2010/11, when Lesotho was expected to reimburse extra revenue from 2008/9 to the SACU revenue pool.

Lesotho is also a member of the common monetary authority, which consists of all SACU members except for Botswana. Its currency is consequently pegged at parity with the South African currency, the rand. This means that decisions by the South African Reserve Bank significantly affect monetary conditions in Lesotho. Lesotho was therefore unable to make full use of monetary policy to address the effects of the financial crisis, while South Africa amended its monetary stance to limit its own challenges. The Lesotho loti's peg to the rand was maintained throughout the crisis at the expense of international reserves, which were depleted in the process. Between 2010/11 and 2011/12, international reserves, which act as a buffer against the volatility of SACU revenues, declined from the equivalent of six months of import cover to three and a half months of import cover.[38]

[37] *The current account balance reflected a deficit of 13.8% of GDP in 2010/11.*
[38] *IMF (2014) Kingdom of Lesotho Article IV Report.*

MINISTRY OF FINANCE'S RESPONSE: ATTEMPTS TO MAINTAIN MACROECONOMIC STABILITY

Like many developing countries, Lesotho was initially sheltered from the full impact of the international financial crisis.[39] However, early on, in 2008, the government of Lesotho recognised the potential for economic destabilisation associated with the crisis. It attempted to maintain macroeconomic stability and achieve broad-based economic growth, to protect the country from plunging into its own financial crisis. In 2010, when the effects of the crisis became more pronounced, the government signed a three-year Extended Credit Facility programme with the IMF. This programme enforced fiscal consolidation by containing expenditures within affordable levels and managing the international reserves at levels adequate for fiscal sustainability and macroeconomic stability.

The remainder of this case study considers how Lesotho's Ministry of Finance, given the limited margin to manoeuvre within the monetary policy space, adjusted fiscal policy to alleviate the pressures resulting from the reduction in SACU revenue.

Targeting core fiscal balance in the medium term

The international financial crisis highlighted the importance of reducing dependency on volatile, pro-cyclical SACU revenues. The government of Lesotho also acknowledged that SACU revenues are too unpredictable to anchor expenditure planning.

The Ministry of Finance therefore introduced the concept of a core fiscal balance to allow policymakers to distinguish between core or permanent and non-core or volatile SACU revenue, and thereby assess Lesotho's underlying fiscal position. By targeting the core-SACU fiscal balance, the ministry believed that a surplus would arise, consistent with maintaining an adequate level of international reserves.

Increasing the deficit above the 3% benchmark in the short term

In 2009/10, when the pressures associated with the crisis were first felt, a countercyclical budget was proposed with a deficit of 10.6%. The government of Lesotho noted that it would remain within the 3% deficit guideline in the long term, but felt that immediate austerity in response to the revenue shortfall would squeeze investment (and recurrent expenditure), slowing down the economy's recovery.

However, after presenting the 2009/10 budget, updated forecasts indicating further economic contraction led the government to introduce expenditure cuts to the approved budget. This led to an actual deficit of 6.4% of GDP. The 2010/11 and 2011/12 budgets' planned expenditure was higher than previous budgets, proposing deficits of 12% and 15% of GDP respectively. In these years, fiscal performance was, however, better than expected, primarily due to payments of outstanding SACU adjustments in 2010/11, and improved domestic revenue collection; year-end deficits were 6.6% of GDP for 2010/11 and 10.3% for 2011/12. Fiscal consolidation in 2012/13, and recovery in SACU revenue, led to a substantial improvement in the fiscal performance and a surplus of 5%, far above the budgeted deficit of 0.9%.

[39] *In 2008/9, GDP grew by 4.4% and total revenue outturn was only 1.8% lower than projections. This was primarily a result of underestimating tax revenue, as grants were 2.7% lower than projected. Low capacity to implement projects meant that expenditure, however, was 9.9% lower than approved. This led to an actual surplus of 5.4% against the projected 2.8% deficit.*

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Government deposits and debt funded the deficit spending

To finance the fiscal deficit, Lesotho drew on its government deposits and introduced treasury bonds in 2010. Reductions in exports and SACU revenues meant shortfalls in foreign exchange earnings. Lesotho entered the Extended Credit Facility programme with the IMF to safeguard its reserves, which were rapidly declining due to the higher deficit.

The government introduced bonds in 2010 to limit a further decline in foreign reserves to below the limits required by the Common Monetary Area agreements; promote development of Lesotho's capital market; and raise alternative funds for public infrastructure development and investment.[40] This was timeous as, in addition to the decrease in SACU revenues, concessional loans declined steadily from 2011.

Building a domestic debt market is important for long-term sustainability; however, the reduction in concessional loans may ultimately increase Lesotho's debt burden due to higher interest rates. It may also displace efforts to promote private-sector investment. More than 80% of Lesotho's debt is foreign, making it vulnerable to exchange rate fluctuations. The increase in public debt from 2011 followed the depreciation of the loti against the US dollar, in which the debt is denominated. This may be regarded as another symptom of Lesotho's close ties with South Africa (it was the rand that depreciated against the US dollar). However, the loti may have fared worse, given Lesotho's low foreign reserves, reduced exports and high deficit, if it had not been pegged to the rand.

While the loti's depreciation after the crisis increased Lesotho's debt-service costs for its foreign-currency debt, the external component of the debt portfolio remains predominantly concessional. This suggests that debt-service repayments are unlikely to stifle growth, unless they become a substantially larger share of expenditure.

Reducing recurrent rather than capital expenditure

The government emphasised the long-term risk to growth of reducing capital expenditure and consequently focused on minimising increases in recurrent expenditure. This was achieved through cuts in international travel to 2007/8

> *“Immediate actions like rebalancing your debt portfolio, cutting non-essential spending and mopping up idle cash balances open fiscal space.”*

[40] *S Khoabane (2016) The financial cost of Lesotho's foreign and domestic debt.*

levels, and cuts to expenditure on training and workshops, office equipment, maintenance and transport. The economic recession and associated increase in inflation, as well as socio-political pressure, necessitated that the government increase public servant wages and salaries, even if only modestly so.[41] The 2010/11 budget proposed a 3.5% increase in public servant wages and salaries. The government also decided not to retrench workers, but implemented a hiring freeze. Social spending remained unaffected throughout the crisis, as the government sought to protect vulnerable sectors of society from the economic contraction.

Adequate infrastructure investment in roads, power, water and telecommunications are essential to economic growth independent of SACU revenues. Investment in industrial infrastructure was also identified as a means of diversifying production and exports. The importance of diversification was reiterated by the decline in the textile sector, on which the economy is heavily dependent, from 2009. Government identified tourism, agriculture and mining as key sectors for stimulating diversification.

Despite this recognition, in the years prior to the crisis, recurrent expenditure increased, while capital expenditure decreased. This was primarily due to under-execution of projects and a reduction in grants. In the 2011/12 budget, government also proposed an 18% increase in capital spending. However, the expected new infrastructure benefits of this investment did not ensue, as floods during the year damaged existing infrastructure.[42]

Developing the private sector through a strengthened financial system

The Lesotho government recognised that developing the country's weak private sector would facilitate diversification. It encouraged private-sector (particularly small, medium and micro-enterprise) investment and productivity through programmes that strengthened Lesotho's financial system and made it easier for local investors to borrow. It also introduced the Partial Credit Guarantee Fund, whereby government provided collateral and took 70% (while commercial banks took 30%) of the risk for lending to individual investors. This scheme also involves the government and banks closely monitoring business performance to detect problems early on and provide recommendations to prevent businesses from failing. However, the response to this programme has been slow and government has worked with commercial banks to address the challenges inhibiting the scheme's full potential.[43]

Enhancing domestic resource mobilisation

To encourage domestic resource mobilisation and reduce dependency on SACU revenues, methods of revenue collection were reviewed and restructuring was planned from 2008. The government proposed extending Lesotho's Revenue Authority's mandate to collect all revenue, rather than continuing to rely on the South African Revenue Service. It introduced measures to broaden the tax base, strengthen systems and improve institutional and human resource capacity.[44] Improvements in revenue collection were also seen as a means of improving transparency and ease of doing business. Government identified unexploited revenue sources and reviewed custom fees to allow for continued enhancement of domestic resource mobilisation.

[41] *Lesotho's public-sector wage bill relative to GDP is the highest in sub-Saharan Africa at 23% (and 50% of the recurrent budget).*
[42] *Minister of Finance Lesotho (2009) Budget Speech 2009/10; Minister of Finance Lesotho (2011) Budget Speech 2011/12.*
[43] *Minister of Finance Lesotho (2013) Budget Speech 2013/14.*
[44] *African Development Bank (2017) Lesotho Tax Modernisation Project.*

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LESSONS LEARNT: RAPID RESPONSE MAY PREVENT FULL-BLOWN CRISIS

The Lesotho government moved quickly to address the potential impact of the international crisis. Fiscal consolidation, building up foreign reserves, developing the private sector, and enhancing domestic revenue mobilisation prevented a full-blown economic crisis. By 2012, when many more-developed countries, including South Africa, were still reeling from the global crisis, Lesotho's economy recorded 6.5% growth and the fiscal account reflected a surplus (growth, however, stagnated in 2013). Lesotho's successes and challenges offer important lessons for peer countries.

SACU dependency: recognising Lesotho's vulnerability

While free-trade agreements and customs unions can increase fiscal space, the global crisis highlighted the potential for fiscal disruption associated with these arrangements. This is particularly relevant when economic power between parties is highly imbalanced, as is the case between South Africa and Lesotho.

SACU revenue has also been shown to be unpredictable, volatile and pro-cyclical, performing well during economic upturns and poorly in downturns. To reduce its dependence on external revenue sources vulnerable to shocks, Lesotho's Ministry of Finance focused on diversifying its economy and enhancing domestic revenue collection. Diversifying production and exports was even more critical in response to the contraction of the textile sector. Lesotho has, however, struggled to revitalise its agricultural and tourism sectors. Domestic tax and non-tax collection has improved, allowing Lesotho to achieve more fiscal balance.

During times of plenty, contain recurrent expenditure

The Ministry of Finance recognised that revenue during boom times, from both domestic and external sources, should be used to increase reserves and finance investment activities that promote growth. In 2008, Lesotho expressed its commitment to limiting growth in recurrent expenditure, particularly the wage bill. The Ministry of Finance also recommended that the non-core component of SACU revenues be directed only to capital expenditure. This was intended to protect government services funded by recurrent expenditures from future exposure to external shocks.

In the aftermath of the crisis, the Ministry of Finance used existing political structures, including Parliament, as the representative institution of the Basotho people, to communicate the importance of remaining within expenditure ceilings and cutting recurrent expenditure. This was emphasised as necessary for maintaining deposits at an adequate level and limiting the deficit. This strategy ensured that when revenue decreased, there was more acceptance of spending limits among the public and civil servants.

Despite these efforts, Lesotho's wage bill as a percentage of GDP remains the highest in sub-Saharan Africa. This highlights that plans to mitigate or respond to crises are often thwarted by socio-political pressures. While the government made a significant effort to negotiate and communicate, as noted by Motena Tsolo of the Ministry of Finance, addressing the wage bill has been particularly difficult.

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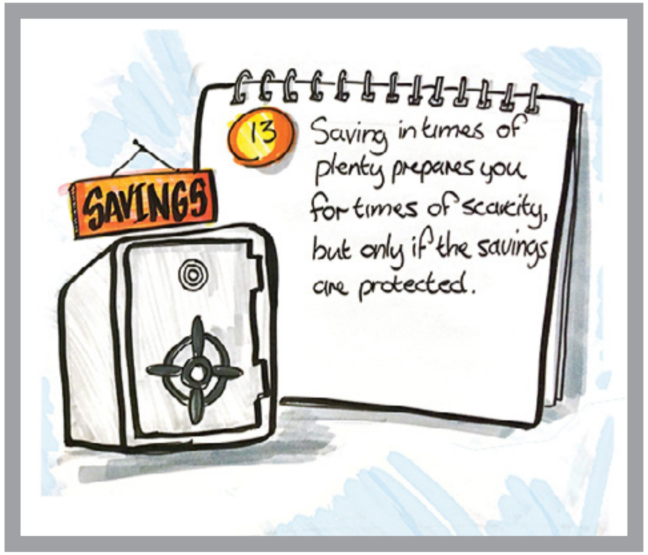

Utilise revenue windfalls to build reserves

The crisis highlighted the importance of maintaining adequate levels of international reserves, import cover and buffers. Countries with high reserves were less affected by the financial crisis and faced fewer balance of payment problems.

Since the crisis, Lesotho has built substantial reserves to maintain macroeconomic stability and mitigate against future revenue crises. Lesotho recorded 6.1 months of import cover in 2013, compared to 4.7 months in 2012. This increase was supported by growth in SACU revenue and a decrease in government expenditure. These reserves, together with fiscal buffers, will allow for adjustment to longer-term shocks, including sustained contraction of SACU revenues.

Reform is a continuous process

The importance of reducing SACU dependency remains – SACU revenues continue to decline. While the SACU revenue formula provides Botswana, Lesotho, Namibia and Swaziland with more revenue than they are technically due, it has resulted in a volatile, unpredictable and dependent relationship between these countries and South Africa. It is critical that Lesotho continues to strengthen independent sources of revenue and its fiscal systems.

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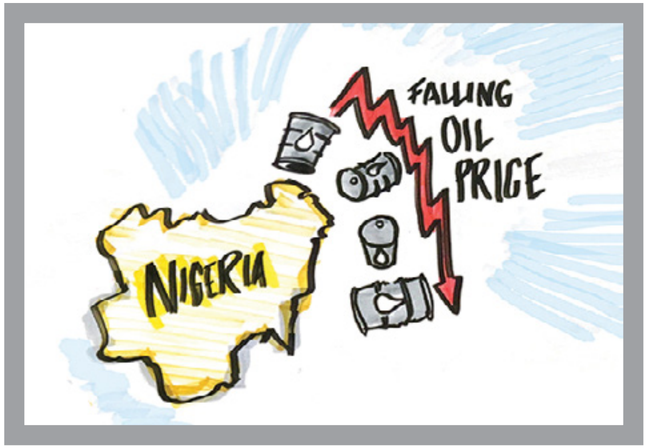
MANAGING NIGERIA'S BUDGET WOES DUE TO THE FALLING OIL PRICE

> *"A combination of lower production volumes caused by disturbances in oil production and a significant decline in international oil prices created a substantial shock for the country, which had always depended on oil revenues."*
>
> *– Ben Akabueze, Director General of the Budget Office for the Federal Republic of Nigeria*



THE COMMODITY CRASH: REDUCTION IN NIGERIA'S FISCAL SPACE

Resource-dependent countries are particularly vulnerable to macroeconomic shocks, most notably those resulting from fluctuations in commodity prices. The Federal Republic of Nigeria, with a maximum crude oil production capacity of 2.5 million barrels per day, ranks as Africa's largest producer of oil and the sixth largest oil-producing country in the world. The Nigerian economy is heavily dependent on oil revenue, and fluctuations in the production and price of oil have placed significant pressure on the fiscus.

The FGN's oil revenues decreased in 2015 and 2016 because of a sharp decline in the oil price and concurrent decrease in oil production.

The global price of oil fell from US$110 per barrel in January 2014 to US$29 per barrel in January 2016. This dramatic decrease in price was the result of excess oil supply associated with an economic slowdown in emerging markets and a reduction in US oil imports.

As seen in figure 1, from a peak of 2.5 million barrels per day in 2013, Nigerian oil production declined to 1.4 million barrels per day during 2016. This was due not to the international market situation, but to pipeline vandalism and oil theft by the militant Niger Delta Avengers.

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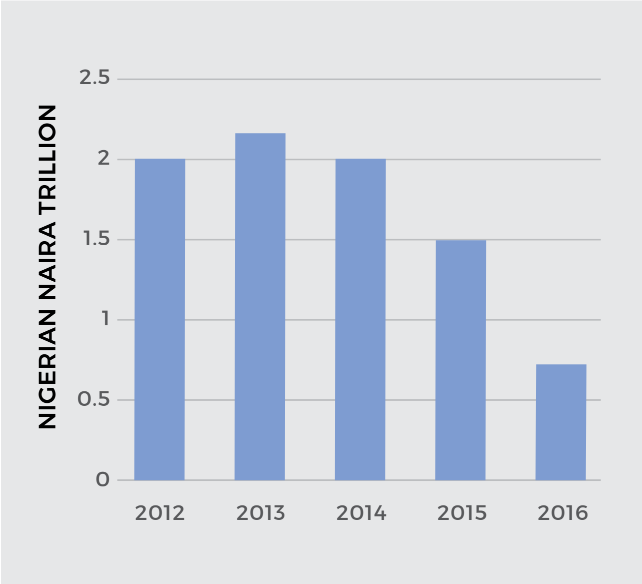
The concurrent reductions in oil price and production led to a 63% decline in oil revenue in Nigeria between 2014 and 2016 in naira (this decline is even more notable when one accounts for the naira's devaluation). Despite the increase in non-oil tax revenue over this period, this has had a significant impact on the Nigerian economy: in the decade up to 2014, oil revenue accounted for 70% of total revenues for the FGN.[45] The decline in oil revenue, shortage of foreign exchange, and restriction on imported inputs for manufacturing and agro-industry have contributed to a dramatic decrease in Nigeria's GDP. The Nigerian economy, which grew at an annual average rate of 7% between 2004 and 2014, grew 3% in 2015 and contracted by 1.5% in 2016.

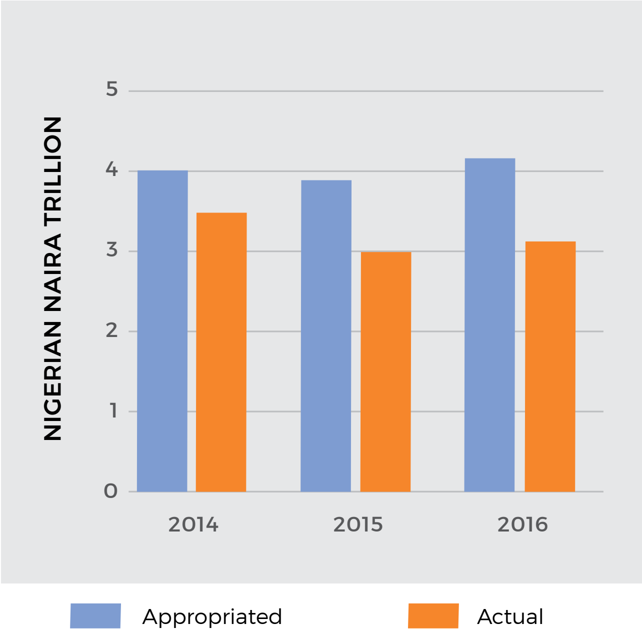
As seen in figure 2, the economic slowdown also negatively affected revenue collection, and actual revenue has fallen short of projected revenue since 2014. In September 2016, revenue was 25% less than pro-rated projections.

FIGURE 1: NIGERIA OIL REVENUE



Source: Budget Office of the Federation

FIGURE 2: FGN BUDGET REVENUE 2014–2016



Source: Budget Office of the Federation

[45] *This dependency is even more marked in terms of foreign exchange earnings, as oil accounts for about 95% of foreign exchange.*

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The impact of the crisis may have been less severe if the FGN had been able to draw on its stabilisation fund. Nigeria maintains this fund to protect the economy from fluctuations in oil price and production. In 2009, when the price of oil declined, Nigeria had US$20 billion in its excess crude account (see Box 5), which holds surplus earnings from oil. The FGN was consequently able to draw on this stabilisation fund through the decline in oil revenue. In 2014, at the beginning of the current crisis, the fiscal buffer was far smaller, with only US$4.11 billion in the account. Without this buffer, the revenue contraction associated with the oil crisis resulted in an increase in the fiscal deficit to 2.5% of GDP[46] in 2016. The reduction in oil revenue also led the authorities to reduce transfers to this account by 93% in 2015, missing the opportunity to smooth the impact over the period of decline.[47]

BOX 5

STABILISATION FUNDS

Sovereign wealth funds serve as a fiscal buffer against economic shocks, such as a decline in the oil price. Oil-dependent economies finance their sovereign wealth funds from taxes on sales of oil and gas. This provides long-term economic stability and allows for the diversification of resources.

Nigeria has struggled to increase its sovereign wealth fund, with state governors citing the lack of legal justification for existing savings mechanisms, including the excess crude account and sovereign wealth funds.

Source: BudgIT (2014) Falling oil prices: An opportunity for reforms

[46] *This remains within the 3% of GDP threshold stipulated in the Fiscal Responsibility Act, 2007.*
[47] *Ibid.*

> *A coherent and credible package of sustainable economic measures is needed for economic turnaround.*
>
> *– Ben Akabueze, Director General of the Budget Office for the Federal Republic of Nigeria*

FGN'S RESPONSE: LOOKING INWARDS AND ONWARDS

The FGN's response to the decreased oil revenue has been inward-looking and centred on local actions. It has implemented expenditure controls and bold structural reforms for infrastructure and public services. It has also focused on improving management of resources and identifying new revenue sources to narrow the fiscal deficit and increase reserves

Expenditure cuts and increases

Significant pressure on the Nigerian fiscus forced the FGN to implement a series of short-term expenditure cuts, particularly in capital allocations, in 2014. In preparing the 2015 Budget, the FGN's plan was to limit the growth in recurrent expenditure as specified in the 2015–2017 Fiscal Framework and Fiscal Strategy Paper. The oil crisis and perennial demands for wage increases limited these efforts, and recurrent expenditure rose at the expense of capital expenditure.

The 2016 Budget, the first under President Muhammadu Buhari, differed substantially from the 2015 Budget in its distribution of recurrent and capital expenditure. It embraced a countercyclical expenditure model, cutting recurrent expenditure to make provision for higher levels of capital expenditure. Between June and October 2016, 753.6 billion Nigerian naira was released for capital expenditure, one of the highest capital releases in the nation's recent history. Transportation; works, power

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and housing; agriculture; and defence were the largest beneficiaries of this higher capital allocation.

The 2016 Budget also attempted to contain recurrent costs by restricting travel costs, reducing board members' allowances, and eliminating thousands of ghost employees. These efforts are predicted to result in annual savings of almost 180 billion Nigerian naira, which will be diverted to priority areas, such as health, defence and education.

Expenditure and cash controls to promote spending efficiency

An Efficiency Unit has been set up within the Federal Ministry of Finance to review the FGN's expenditure profile and pattern. The unit is tasked with working with ministries, departments and agencies to introduce processes and procedures that will ensure that the government's revenues are efficiently deployed, resulting in value for money and savings.

This initiative is complemented by sustained use of the treasury single account to monitor the financial activities of Nigeria's 900 ministries, departments and agencies. The treasury single account, which provides a consolidated view of government's accounts, has been implemented at the federal level since 2015 and is currently being rolled out to states. Its proponents regard it as effective in promoting transparency and providing insight into government's liquidity, which may limit unnecessary borrowing. Treasury single accounts are, however, not risk-free. While they can reduce in-year borrowing needs, they do not eliminate corruption and may serve to increase bureaucracy and delay disbursements of funds.

Improved management of revenue collection

In response to the oil shock, the FGN has acknowledged the importance of diversifying its resources and reducing revenue leakages. It is committed to increasing revenue from the non-oil sectors.

This will be achieved by improving tax compliance through conducting audits of taxpayers' returns to identify under-filing, engagement with non-compliant taxpayers, and enforcement of tax rules. Broadening the tax base will be achieved by increasing registration of informal and formal businesses and creating an enabling environment for small and medium enterprises. Consideration will be given to increasing value-added tax rates and increasing the coverage of vatable products.

The FGN will reduce revenue leakages by tackling trade mis-invoicing for customs, and introducing a single window to drive customs efficiency. The adoption of a single window will make Nigeria's ports competitive in the international trade network and reduce corruption.

The FGN has also been targeting independently generated revenues (receipts collected by government entities). It has sustained an upward trajectory in receipts for independently generated revenues despite continued leakages and incidences of non-remittance of funds.

Expanding energy infrastructure and stabilising oil production

The FGN is working towards expanding power-sector infrastructure and capabilities. This will be central to increasing oil production which, relative to the externally determined price of oil, is within the control of the authorities.

President Buhari's regime was initially against negotiating with the Niger Delta Avengers, who are responsible for much of the instability in the country's oil production. The FGN has since committed to working with the Niger Delta region to limit infrastructure damage and stabilise oil production.

This will be achieved through incentive schemes, jobs and investment. President Buhari has agreed to sustain the Presidential Amnesty Programme for the Niger Delta region, whereby government provides vocational training and stipends to former militants.[48]

The government has targeted refining petroleum products locally to encourage self-sufficiency. Plans were put in place to reduce petroleum product imports by 60% by the end of 2018. The FGN intends to establish more modular refineries – refineries consisting of easily fabricated and moveable parts – to increase local capacity, reduce imports and employ those involved in illegal refining. Incentives have been implemented for those looking to engage in local refining. These include less stringent requirements than conventional licensing, independence to sell products to the market at market-determined prices, and lack of government interference in day-to-day operations.

The fuel subsidy was removed in 2016 to alleviate fuel shortages and reduce corruption, allowing savings to be directed to priority sectors. It was also seen as another incentive to investors to build oil refineries in Nigeria. An attempt in 2012 to remove the subsidy led to violent protests across the country and the subsidy's restoration. The removal of the subsidy in 2016 remained controversial due to the subsidy's pro-poor implications. However, during the latest oil crisis, there was more acceptance that removing the subsidy was necessary for alleviating fuel shortages.

The 2017 Budget also ruled out joint-venture cash calls in the oil and gas industries. Joint ventures between the FGN, represented by the Nigerian National Petroleum Corporation, and private operators have allowed the FGN to share exploration and financial risks and costs. However, when the operators have asked the FGN for cash, it has not been forthcoming. This has limited growth in the country's oil and gas industries and led to a build-up of arrears and increasing debt-service costs. Part of the arrangement ruling out joint-venture cash calls is that arrears will be paid within five years through incremental production revenues. This arrangement should allow for cost recovery as the Nigerian National Petroleum Corporation will continue receiving royalties, taxes and profits from its share of joint-venture oil production.

> *"Promote national prosperity and an efficient, dynamic and self-reliant economy to secure the maximum welfare, freedom and happiness of every citizen on the basis of social justice and equality of status and opportunity."*
>
> *– Ben Akabueze,*
> *Director General of the Budget Office for the Federal Republic of Nigeria*

[48] *A Mustapha (2016) "Oiling Amnesty Programme: Stamping out any form of unrest in the Niger Delta", Vanguard, https://www.vanguardngr.com.*

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Diversifying the Nigerian economy

The Nigerian government is committed to diversifying the economy to promote recovery and build a dynamic, self-reliant economy that continues to grow without oil revenue. Diversification efforts will also be important for creating jobs outside the oil and gas industry.

The Economic Recovery and Growth Plan and Made in Nigeria campaigns have been initiated to advance agriculture and industry and develop local and small business enterprises. Along with the National Industrial Revolution Plan, these campaigns attempt to redirect production and consumption away from imported goods and services to locally manufactured ones. These efforts will be complemented by the Presidential Enabling Business Council, chaired by the Vice President, which has been mandated to make doing business in Nigeria easier and more attractive.[49]

The 2016 Budget included several other initiatives to diversify the economy, including revitalising and expanding agro-processing; stimulating investment in the solid-minerals sector; increasing private-sector investment in tourism, entertainment and sports; and creating high-technology innovation hubs to support growth in the digital and technology sector.

> *Pursue economic growth in all sectors with focus on activities that have greater multiplier effects.*
>
> *– Ben Akabueze, Director General of the Budget Office for the Federal Republic of Nigeria*

Increasing borrowing, but with greater efficiency

Revenue has yet to recover to pre-2014 levels. Nigeria's commitment to countercyclical expenditure and infrastructure investment thus necessitates that its borrowing requirement increase. With a debt-to-GDP ratio of 13.2%, Nigeria has adequate space to increase its borrowing to cover the fiscal deficit.

Under the Federal Ministry of Finance's debt management strategy for 2016–2019, domestic and foreign debt was set to increase. This debt strategy intends to rebalance the public debt portfolio with more external borrowing and by issuing bonds for contractor arrears. External sources will include multilateral agencies, export credit agencies and, potentially, the Eurobond market. The FGN believes that external borrowing is cheaper and avoids the risk of crowding out the private sector; however, the volatility of the naira indicates that debt-service costs may be subject to currency risk.

The debt management office also intends to introduce products to diversify its investor base for government bonds, resulting in cheaper borrowing costs and financial inclusion. The new debt instruments include retail bonds, inflation-linked bonds and domestic Sukuk (Islamic bonds).

Stabilising subnational government finances is another key element of the FGN's plans to stimulate the economy. In June 2016, a conditional budget support programme was introduced, which offered state governments 566 billion Nigerian naira to address their funding shortfalls. To participate, state governments had to subscribe to certain fiscal reforms centred around transparency, accountability and efficiency. Thirty states had received bailouts as of May 2016, while 35 had applied for the Excess Crude Account-backed loans.[50]

[49] *Minister of Finance (2017) Budget Speech 2017.*
[50] *Ibid.*

LESSONS FOR NIGERIA'S COMMODITY-DEPENDENT PEERS

Nigeria's fiscus has yet to recover from the oil crisis; it is consequently difficult to assess the impact of all response measures. This section does, however, reflect on key features of Nigeria's response to the crisis, as discussed at the CABRI Conference. It offers emerging lessons from these responses that may prove helpful for countries facing similar pressures. It includes a brief discussion of Chad's response to falling oil revenues to identify common lessons.

Trade-off between short-term and long-term priorities

The FGN's immediate response to the crisis was to cut capital expenditure. This reflects the short-term versus long-term trade-offs that governments must consider when responding to a fiscal pressure. While it was necessary to cut spending in the short term, the FGN recognised that cutting capital expenditure would worsen the country's prospects for both short- and long-term recovery. The 2016 Budget consequently allocated a greater portion to capital expenditure; however, the shortfall was financed by increased borrowing.

It is critical that governments recognise that commodities, including oil, may not recover to previous levels and that this reduction in revenue may become permanent. Once the

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reduction in revenue becomes the country's new normal, prioritising short-term solutions may simply result in further regression.

Nigeria, like Chad (see Box 6), implemented short-term recurrent expenditure cuts and a series of measures to ensure efficient expenditure. While such measures will have a beneficial effect in the medium term, short-term cuts could carry great costs, including worsening the plight of the poor and destabilising economies.

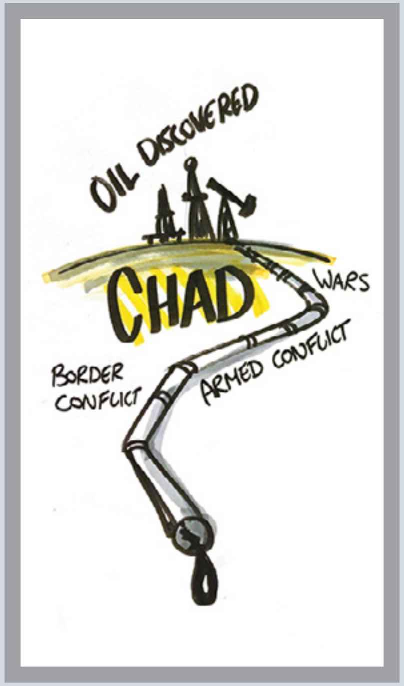
BOX 6

IMPACT OF THE OIL SHOCK ON CHAD'S FISCAL SPACE

Chad began producing oil in 2003, contributing to a more than 100% increase in the country's per capita income over the subsequent decade.

Chad built up significant public resources from its oil operations, which laid the ground for development efforts and initiation of stabilisation funds and funds for future generations. Civil conflict in 2005 and 2008 led authorities to create a new armed division using these reserve funds. The fall in the oil price in 2014 and regional security threats have destabilised Chad's economy and increased budgetary pressure. GDP growth slowed to 1.8% in 2015 (compared to 6.9% growth in 2014), with sectors dependent on public expenditure most affected.

In response to these external macroeconomic shocks, the government initiated significant expenditure cuts, leading to an increase in socio-political tensions. These have included: reducing civil servants' allowances by 50%; auditing state agents, payment systems and projects; cutting the state's car fleet; restructuring regional delegations; and limiting the size of the organisational charts of ministries and institutions.



To further rationalise expenditure, supplementary budgets were proposed in 2016 to group all current expenditure under the Ministry of Finance and capital expenditure under municipalities. This was unsuccessful. An attempt to introduce a savings fund was also unsuccessful due to revenue being lower than expected. The authorities have redoubled efforts to diversify the economy and have increased domestic and concessional financing.

To increase tax revenue, the authorities are considering increasing the non-oil tax rate above 9% (the current rate, at 8%, is far lower than the Central African Economic and Monetary Community standard of 18%). Revenue authorities have also proposed actions to improve tax collection, including: updating the General Tax Code to improve the transparency of taxation and increase productivity; improving control, recovery and the operationalisation of value-added tax refunds and control over transactions related to value-added tax; gradually reducing tax exemptions; and systematically recovering tax arrears.

Communication between central government and political and economic actors is critical to the success of response strategies

Political support for the stabilisation fund in Nigeria has diminished, inhibiting the FGN's ability to use countercyclical policies to limit the fiscal impact of crises. In Nigeria, a continuing imperative will be to stress the importance of mitigation measures and sensitise ministries, departments, agencies and state authorities to the extent of the central government's fiscal constraints.

A successful strategy to address any fiscal pressure requires central government to clearly communicate to the public and economic players the long-term risks of not having mitigation measures in place and not responding in a unified way.

Importance of diversifying revenue sources

Nigeria's longstanding dependence on oil exports worsened the fiscal impact of the international oil crisis. Consequently, the FGN is committed to diversifying the economy through advanced industrialisation and increasing productivity of and investment in the agricultural and solid-minerals sectors. The FGN believes that foreign and domestic investment are critical to achieving diversification and has begun a targeted campaign to attract investors and boost market confidence. The success of these diversification efforts are likely to determine when the economy recovers and how future oil shocks are weathered.

Diversification, through developing industry, has also been pursued through more protectionist policies. It is unclear whether this strategy has been effective in reducing fiscal pressure. Import restrictions on medicine, furniture and food have been met with internal resistance. Manufacturers have argued that these policies limit their access to raw materials and stifle productivity.

In addition to addressing the effects of the commodity price shock, it is necessary for countries to understand whether their interventions are effectively addressing the underlying weaknesses that made them vulnerable to the crisis. Response strategies must be subject to live policy making and adjustments, as one learns what worked and where unintended effects have resulted. While protectionist policies have many downsides, economic diversification across resource-dependent countries will be essential if the decline in commodity prices becomes the new normal.

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