2017 CABRI Conference
MANAGING BUDGETARY PRESSURES
7-9 March 2017
Ouagadougou, Burkina Faso

2017 CABRI CONFERENCE

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

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CABRI would like to thank the participants of the 2017 CABRI Conference, for their time and inputs, which made this work possible.

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FOREWORD

Budget managers are frequently confronted with changing circumstances during a fiscal year that disrupt 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.

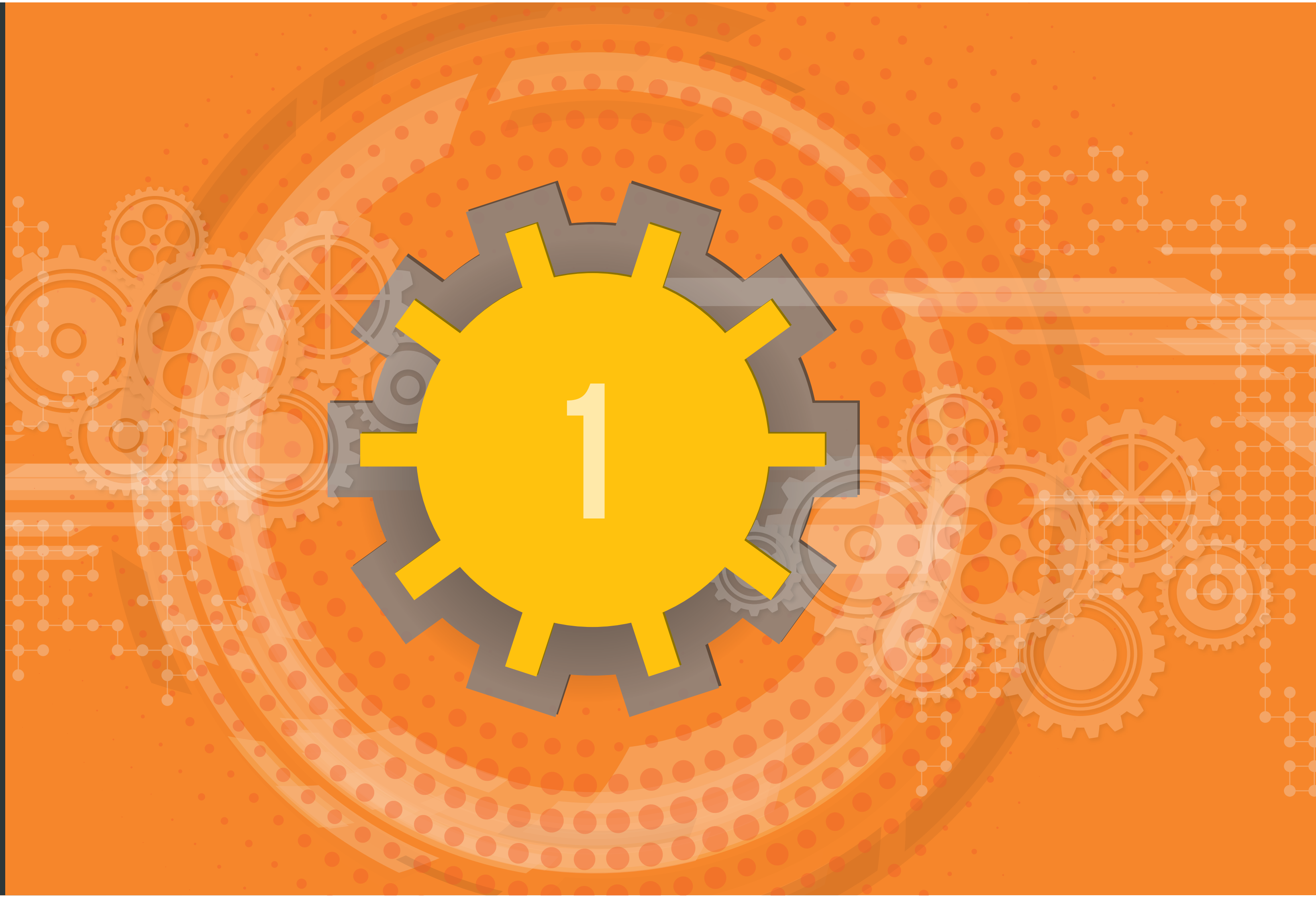
At the time of the hosting of the CABRI Conference in Ouagadougou in March 2017, several African countries were emerging from natural disasters and health emergencies. The best known of these is the Ebola epidemic that affected Liberia, Guinea and Sierra Leone, claiming over 11 000 lives and resulting in a significant contraction in gross domestic product (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 their experiences of various budgetary pressures: how they managed in the midst of the crisis, what strategies were applied, and what they would 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



1: MANAGING BUDGETARY PRESSURES – THE 2017 CABRI CONFERENCE

THE 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.

1: MANAGING BUDGETARY PRESSURES – THE 2017 CABRI CONFERENCE

ABOUT THE CONFERENCE PUBLICATIONS

2017 CABRI Conference

MANAGING BUDGETARY PRESSURES

7–9 March 2017
Ouagadougou, Burkina Faso

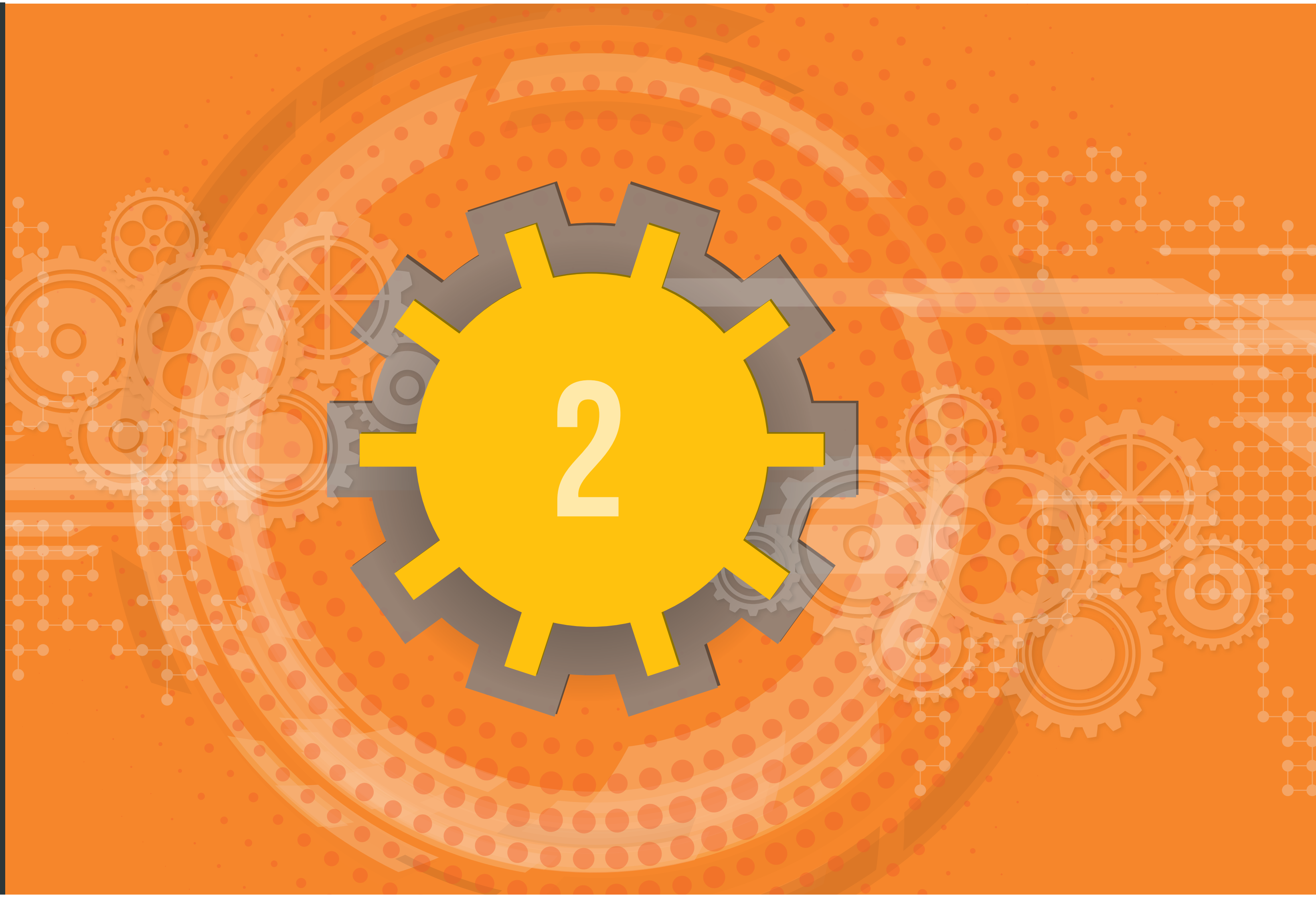
CABRI has produced four publications based on the 2017 conference. The main report, *2017 CABRI Conference: Managing budgetary pressures*, reflects on the conference discussions and conclusions. It is structured around three country case studies, each focused on a different category of pressure. For ease of use, these three case studies are also presented in separate, summarised publications.

The third of these case studies, presented here, focuses on managing the budgetary impact of macro-fiscal shocks. It reflects on 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.

The other two country case study publications focus on chronic pressures and fiscal response to disasters respectively (both available on the CABRI Publications page).

SECTION 2

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



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

INTRODUCTION

By Danielle Serebro[1]

International macroeconomics reveals that each successive wave of crises exposes possibilities for crisis that were overlooked in earlier analysis.[2]

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

[1] *Danielle Serebro is a public debt management officer in the CABRI Secretariat, responsible for public debt and bond markets.*
[2] *P Krugman (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*

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

> *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.[3]

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

[3] *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.*

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 INCREASED 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.[4]

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.

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

BOX 1

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[5] 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 1).

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.[6]

[5] *The current account balance reflected a deficit of 13.8% of GDP in 2010/11.*
[6] *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.[7] 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 International Monetary Fund (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%.

[7] *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.[8] 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."*

[8] *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.[9] 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.[10]

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.[11]

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.[12] 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.

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

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.

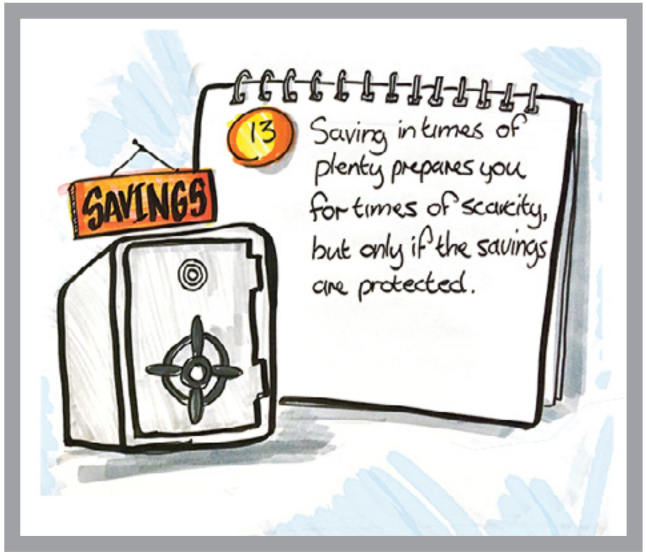
SACU revenue has also been shown to be unpredictable, volatile and pro-cyclical, performing well during economic upturns and poorly in downturns. To reduce its dependence on external revenue sources vulnerable to shocks, Lesotho's Ministry of Finance focused on diversifying its economy and enhancing 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.



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.

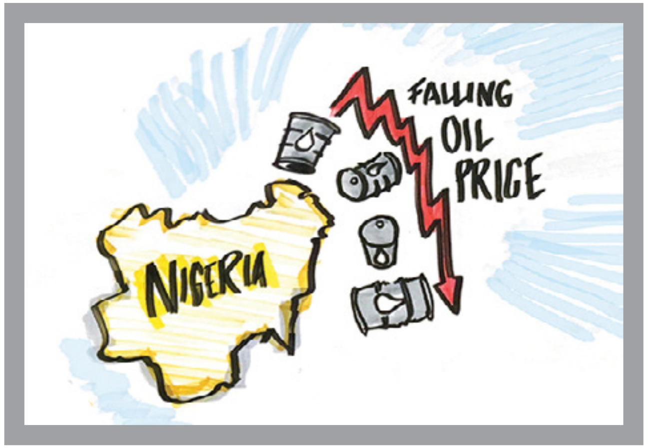
Since the crisis, Lesotho has built substantial reserves to maintain macroeconomic stability and mitigate against future revenue crises. Lesotho recorded 6.1 months of import cover in 2013, compared to 4.7 months in 2012. This increase was supported by growth in SACU revenue and a decrease in government 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.

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.

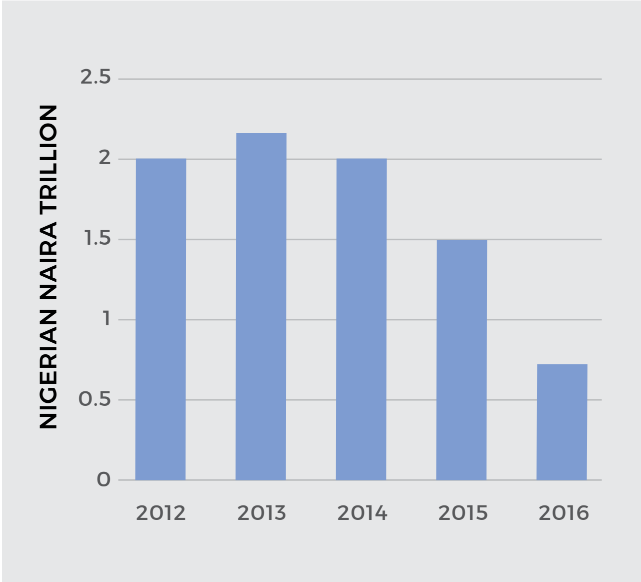
As seen in figure 1, from a peak of 2.5 million barrels per day in 2013, Nigerian oil production declined to 1.4 million barrels per day during 2016. This was due not to the international market situation, but to pipeline vandalism and oil theft by the militant Niger Delta Avengers.

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

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.[13] 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.

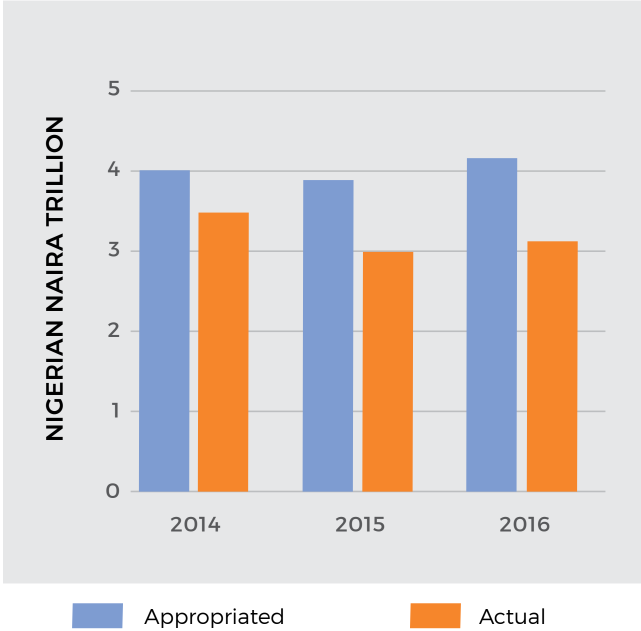
As seen in figure 2, the economic slowdown also negatively affected revenue collection, and actual revenue has fallen short of projected revenue since 2014. In September 2016, revenue was 25% less than pro-rated projections.

FIGURE 1: NIGERIA'S OIL REVENUE



Source: Budget Office of the Federation

FIGURE 2: FGN BUDGET REVENUE 2014–2016



Source: Budget Office of the Federation

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

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 2), 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[14] 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.[15]

BOX 2

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

[14] *This remains within the 3% of GDP threshold stipulated in the Fiscal Responsibility Act, 2007.*
[15] *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 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.

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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.[16]

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*

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

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.[17]

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.[18]

[17] *Minister of Finance (2017) Budget Speech 2017.*
[18] *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 reduction in revenue becomes the country's new normal, prioritising short-term solutions may simply result in further regression.

Nigeria, like Chad (see Box 3), 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.

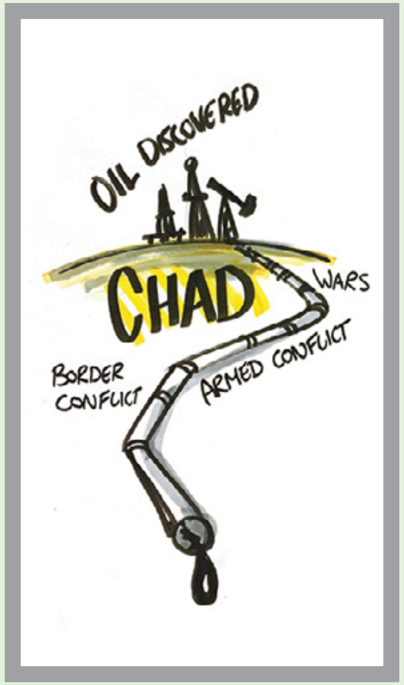
BOX 3

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 is 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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