Natural Resource Governance Institute

Oil, gas and mining for development

Is Ghana's Approach to Petroleum Revenue Management Still Credible?

Mark Evans, Africa Economic Analyst, Natural Resource Governance Institute

Institute for Fiscal Studies and Natural Resource Governance Institute
2016 Budget Forum, Thursday 5th November, Accra

In 2011 Ghana adopted fiscal rules for the distribution of petroleum revenues to the Ghana National Petroleum Corporation, two newly created savings funds and the government budget. These efforts aimed to drive better budget outcomes and equip Ghana's public finances with the means to manage the fiscal challenges often associated with becoming a resource-rich country. Similar to resource revenue management approaches seen around the world, Ghana's Petroleum Revenue Management Act (Act 815) had multiple objectives[1]. It aimed to:

1. Encourage a careful scaling up of spending in line with absorptive capacity constraints[2]
2. Create a savings buffer to manage revenue volatility
3. Build an endowment for future generations
4. Use petroleum revenues to mobilise financing for development priorities

The PRMA has helped create vibrant public debate and oversight around the narrow use of petroleum revenues. Savings of these revenues have been accumulated and budget allocations made to 'priority areas'. However, these savings and allocations do not seem to have led to better budget outcomes and by extension development outcomes for Ghanaians.

In 2016 Ghana will reach the milestone of five years of the Petroleum Revenue Management Act. With the prospect of further growth in petroleum revenues over the medium-term, 2016 will be the year that Ghana will look to build on the reform efforts of the PRMA. The key lesson from the PRMA is that such approaches will offer few tangible benefits in the absence of commitments to careful management of the broader budget. This paper summarises some of the key questions to be asked of the law as we look to learning the lessons of recent years.

[1] http://www.resourcegovernance.org/sites/default/files/NRF_Ghana_Jan2013.pdf

[2] Absorptive capacity constraints refer to a country's ability to make good use of the additional revenues. The scale of resource revenue inflows in practice can cause difficulties.

1. Has the PRMA encouraged a careful scaling-up of spending?

The gradual scaling up of spending is an important challenge of resource revenue management. In theory, increases in spending should be managed in line with absorptive capacity constraints such as the capacity of the economy to manage Dutch Disease type pressures[3] and the capacity of public institutions to deliver public investments. This can be seen in the PRMA. As petroleum revenues begin rising, the Benchmark Revenue[4] calculation encourages spending to adjust up slowly, creating a surplus of revenues captured for the Stabilisation Fund and Heritage Fund[5].

While Ghana's rules have created a surplus that has been saved in the Ghana Petroleum Funds, this process has proved ineffective as a tool for controlling spending. There are two key reasons for this. Firstly, petroleum revenues remain a small proportion of total revenues therefore controlling petroleum revenues can only have a limited impact on the overall budget. Secondly, even if Ghana *only* received petroleum revenues, there are practical limits of using savings as a tool to encourage a careful scaling up of spending. This is because the government can offset the decision to save and limit the Annual Budget Funding Amount[6] by a decision to increase debt-financed spending. We saw this in Ghana with the rapid increase in debt financed spending from 2012 onwards[7].

A clear tension underpins resource revenue management approaches between the political pressures to spend petroleum revenues as they arrive or even in advance (through taking on debt) versus the purported benefits of deferring spending (saving). This is one of the key motivations for putting rules for saving in law and 'building consensus' around these benefits. Despite these efforts in Ghana, it is clear that the fundamental idea of deferring spending to the future never gained political traction, nor eased fundamental spending pressures. This was clear in the 2011 parliamentary debate on the PRMA when those against using petroleum revenues as collateral (in practice representing those in favour of a heavy frontloading of spending) were accused of being 'anti-development agents'[8]. These preexisting pressures to over-borrow were not altered by the introduction of a revenue management law.

[3] Dutch disease is often used to describe the negative impact of a large flow of foreign exchange on the non-resource sectors of the economy. The most common channels for this are thought to be a real appreciation of the exchange rate and/or an increase in the prices of labour and capital. The evidence for such a process remains largely inconclusive

[4] The use of moving averages in the First Schedule of the PRMA should ensure this.

[5] 70% of savings go to the Stabilization Fund (with withdrawals rules defined in Section 12 of the Act) and 30% to the Heritage Fund (withdrawal rules defined in Section 20)

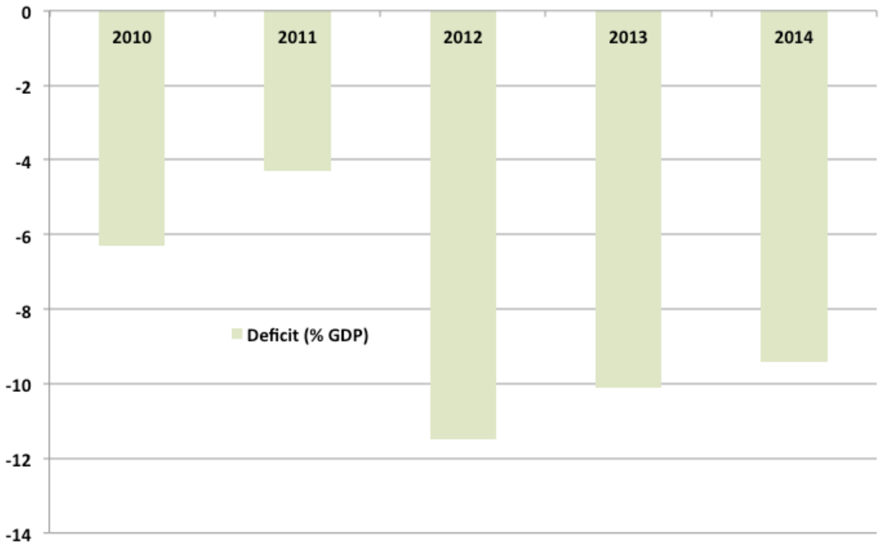
[6] The level of petroleum revenues allocated to the budget

[7] Those familiar with the long-standing debates about the rationale for Sovereign Wealth Funds will be reminded of the fungiblity of savings debates

8 http://www.effective-states.org/wp-content/uploads/working_papers/final-pdfs/esid_wp_49_mohan_asante.pdf

If Ghana is to create consensus around the benefits of saving and managing spending it will have to be a lot more explicit that this is an objective. Limiting overall spending growth and the size of the fiscal deficit can help do this[9].

Figure 1: Ghana's budget deficit (%GDP)



Source: Bank of Ghana 2015

2. How effective has the PRMA been at managing oil price volatility?

This recent fall in oil prices provides a clear motivation for Ghana's decision in 2011 to create the Stabilisaton Fund and collect savings to support spending when revenues unexpectedly fall. Unfortunately, in practice the Ghana Stabilisation Fund has been of limited effectiveness.

One reason for this is the impact of a decision to cap the Ghana Stabilisation Fund in response to Ghana's increasing debt-financing difficulties. Anything above this cap was withdrawn from the GSF to support debt repayment and for contingency purposes[10]. However, the decision more than halved the size of Ghana's savings buffer in the Stabilisation Fund. The cap also made the Budget more vulnerable to changes in the oil price. When the oil price fell, Ghana was left with two holes to fill: the hole in Annual Budget Funding Amount and the hole in debt financing plans left by the fact that revenues would not longer exceed the GSF cap[11]. The decision to use petroleum savings for debt repayment may have been warranted given the situation, however the process remains ill defined and continues to undermine the PRMA's core stabilisation objectives.

---

[9] Fiscal Rules in practice may only be part of the solution. In practice this must be combined with institutional reforms to manage spending pressures

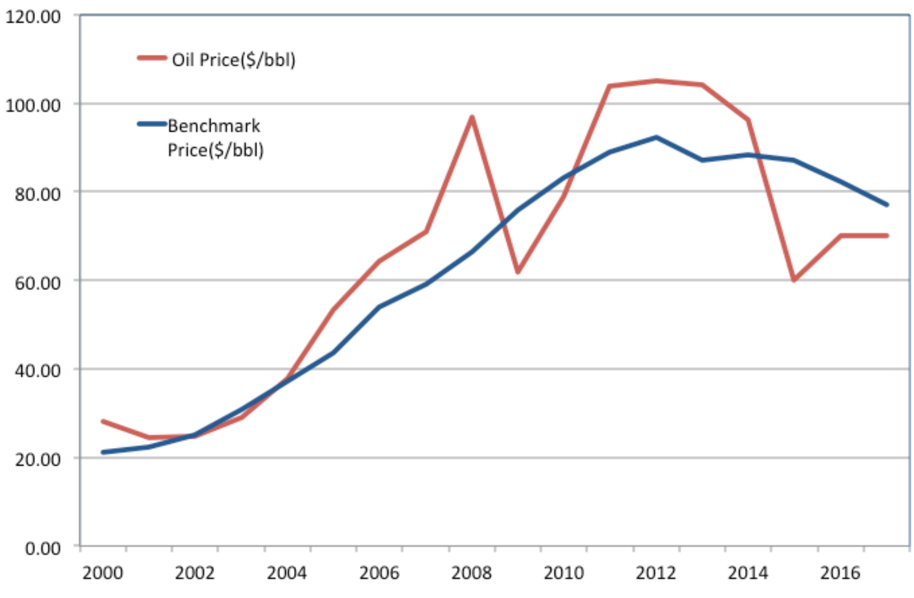
[10] Anything exceeding the cap is transferred to the Contingency Fund, created under 1992 Constitution for meet urgent or unforeseen expenditure needs and a Sinking Fund, created in the 2014 Budget initially to start paying down "Bullet Loans".

[11] We might also add a third way the budget was made more vulnerable to oil price. Given Ghana committed future oil sales to pay back the China Development Bank Loan agreement at a reported $85, the fall in oil prices also made it impossible to continue with the loan facility and its associated projects

Ghana has also faced some of the more familiar practical difficulties of stabilisation. Stabilisation is particularly challenging when trying to distinguish between temporary or permanent changes in prices or production. Rules that don't take into account the possibility of permanent changes can quickly run into challenges. This was seen in Ghana. Ghana's rules create stability around a seven-year average of prices[12] that, as of September 2014, was $99. By the time the 2015 Budget was tabled later in the year, the Benchmark Price of $99 compared to an actual price of around USD$50. This gives the government the option to rely heavily on the Stabilisation Fund

While the PRMA explicitly sets out the calculation to be used for Benchmark Price, the approach is better suited to managing volatility around a stable trend in prices (if prices had rebounded the approach would have looked more credible). Instead, the recent fall in oil prices was a marked change in the trend in oil prices (a structural break). As a result, the Benchmark Price will only adjust down slowly to the new level. This may not be practical or palatable. In these kinds of situations stabilisation becomes more of an art than a science and the rules should be used with care. In this new price environment Ghana should carefully reassess the Benchmark Price calculation and its implementation. At the same time the process of capping the GSF needs to be reconsidered to avoid undermining the Stabilisation Fund's only objective.

Figure 2: Benchmark Prices and actual prices (USD$)



Source: World Bank Data and NRGI staff calculations

3. What is Ghana leaving for future generations?

The desire to save for future generations is often a motivation for revenue management laws. If leaving something for future generations is a policy objective, countries have a few options: they can invest in long-term savings, reduce the debt burden or spend on capital or development expenditures. All of these things point to the accumulation of different kinds of

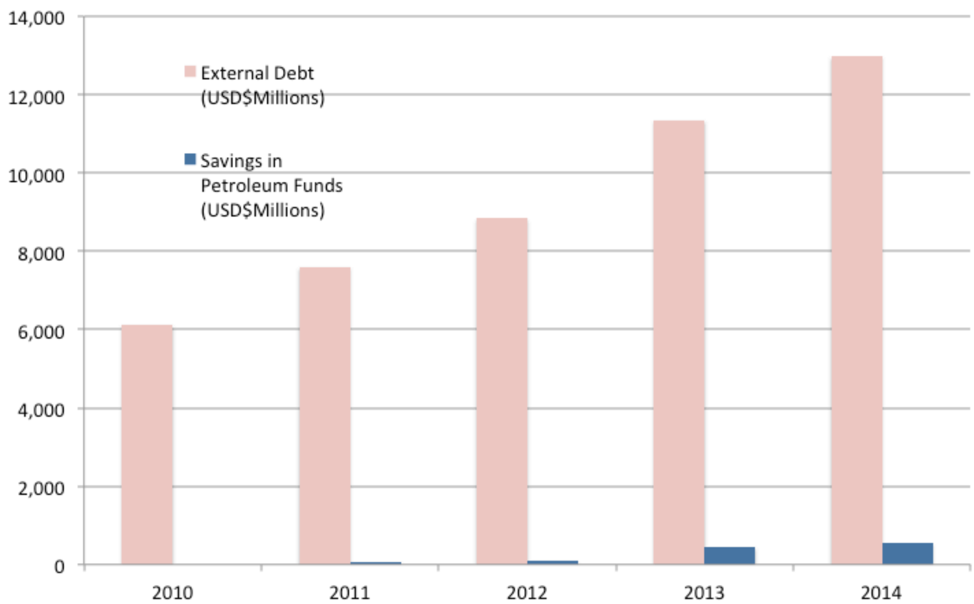
[12] Set out in the First Schedule of the Act 815

assets. The decision to save a proportion of revenues, rather than spend entirely on capital spending, usually reflects an assessment of institutional and economic absorptive capacity constraints and the desire to create a savings buffer to manage the volatility and exhaustibility of petroleum revenues.

If we consider the PRMA narrowly it has delivered savings for future generations and the petroleum revenues used in the budget have supported public investment. However, if we consider things more broadly in the context of the whole budget, future generations have overwhelmingly been saddled with liabilities. Over the last five years long-term savings in the Heritage Fund have been modest, reaching about $250 million, while debt accumulation has been very large. External debt increased rapidly from of $6 billion in 2011 to more than $14 billion[13] in 2014. As we will see in the next section, this debt is increasingly financing a budget focused on recurrent expenditures.

Ghana has seen the petroleum revenue savings overshadowed by much larger increases in debt since 2011. It has also seen petroleum revenue spending to public investment overshadowed by a much bigger shift in the government budget to recurrent expenditures. Once again this implies a divergence between the strategy for the use of petroleum revenues and the rest of the budget.

Figure 3: External debt and Savings of Petroleum Revenues (USD$)



Source: Ministry of Finance

[13] Ghana has also seen a four-fold increase in domestic debt over the same period

4. Has earmarking petroleum revenues for priority areas helped deliver development priorities?

In practice there is no evidence that priority areas have received a greater share of overall revenues. Being defined as a 'priority area' in the PRMA implies a desire to mobilise additional financing from petroleum revenues for these areas. Despite this, the overall share of revenues going to these areas has not increased. This can be seen most clearly in the falls in capital expenditure as a proportion of revenues every year since 2011 (despite 70% of petroleum revenues being directed to public investment). This implies that while petroleum revenues have been directed towards priority areas, non-petroleum revenue sources have been directed elsewhere[14].

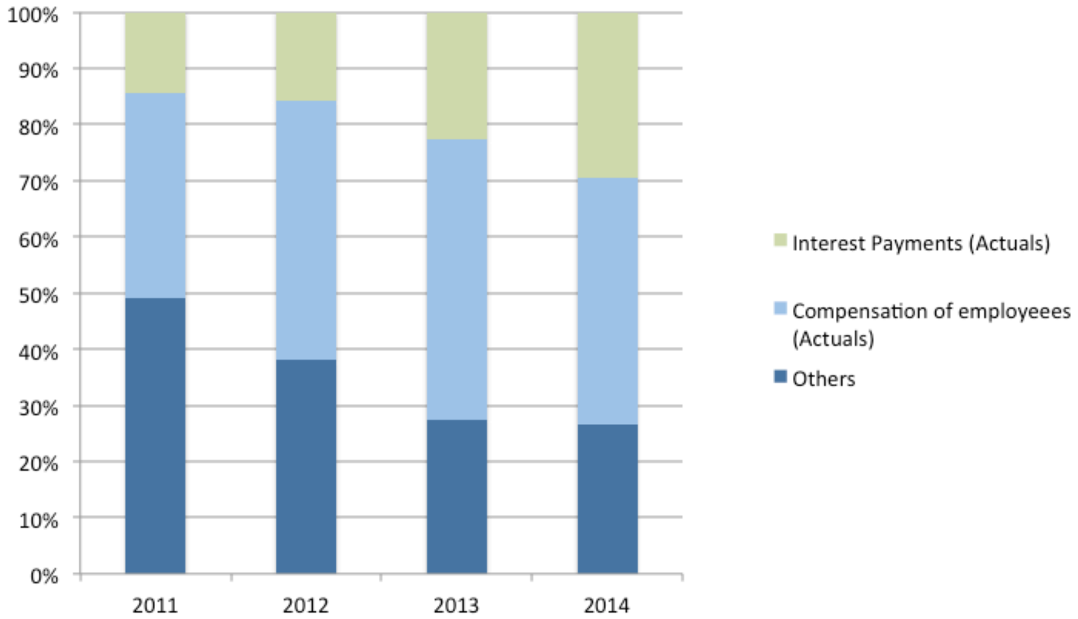
This problem does not reflect a strategic decision to shift revenues to other competing areas. Instead, once again this is a symptom of the lack of control of recurrent expenditures over recent years. Over 2011-2014 budget allocations to capital expenditure has been overestimated in every budget by an average GH650 million. In contrast, budget allocations for interest payments and compensation of employees have been underestimated on average by GHS1.7 billion per year. Ghana regularly plans to spend its revenues on public investments but when the revenues arrive they pay disproportionately for wages and salaries and interest payments.

Over the last five years the use of petroleum revenues has been overshadowed by much larger and fundamental shifts in overall spending patterns in the Budget. This makes the aims of allocating petroleum revenues to priority areas look more like a reporting exercise than a meaningful way of mobilising financing.

Between 2011 and 2015 the combination of salaries and interest payments as a percentage of domestic revenue has grown from just under 50% to over 75%. This means that by the end of 2014 for every one cedi of domestic revenue, the government has just 25 pesewas to deliver investment and services (this compares to 50 in 2011). The shrinking space in the budget for the core work of government helps creates a reliance on grants and, as we have seen, reinforces the need for debt.

[14] Once again, this is a problem of fungibility of revenues

Figure 4: Percentage of domestic revenue consumed by interest payments and compensation of employees



Source: Ghana Budgets 2011-2015; NRGI Calculations

5. How transparent is the PRMA?

The Petroleum Revenue Management Act put in place a range of important transparency provisions that put Ghana amongst some of the world's most transparent countries in terms of the use of resource revenues. The government should also be commended for the gradual integration of reporting on the use of petroleum revenues and spending into most levels of budget reporting. These strides in transparency are helping to build a much more comprehensive picture of the planning and use of petroleum revenues.

Unfortunately there remains a huge gap in transparency in the PRMA. The Benchmark Revenue, Price and Output[15] calculations are the core of the saving rule in the law but details of this are never made publically available. The outcome from this calculation will ultimately dictate the level of savings that the government will be forced to make however it remains unclear whether the calculation remains appropriate or whether the government is making appropriate assumptions. Until this calculation is made transparent, stakeholders will continue to question the validity of the overall split between saving and spending and the PRMA will continue to lack credibility.

On top of the lack of transparency around the core calculations, over recent years petroleum revenues have increasingly been disbursed to new funds that lack the level of transparency and

15 Benchmark Revenue provides the basis for the allocations of revenues to the budget (known as the Annual Budget Funding Amount). The level of Benchmark Revenue will ultimately determine the level of savings a government is required to make in a given year. It is calculated as the sum of Benchmark Price and Benchmark Output, which are defined in the First Schedule of the PRMA.

reporting of the rest of the PRMA. In particular, recent years have seen petroleum revenues directed to the Contingency Fund[16], Sinking Fund[17] and the Ghana Investment Infrastructure Fund[18]. The petroleum revenues directed to these areas are not subject to the same level of oversight as those revenues transferred to the Ghana Petroleum Funds or the Consolidated Fund. This adds to a lack of transparency around the loans that use petroleum revenues as collateral. As the distribution of petroleum revenues reaches further, the PRMA's transparency should follow.

6. Was it a mistake for the PRMA to focus purely on petroleum revenues?

In the lead up to Ghana's last election a rapid and unplanned expansion in wages and salaries led to a doubling in the size of the budget deficit. This ultimately put Ghana on an unsustainable path of debt accumulation and forced a return to the IMF for support. This unsustainable increase in spending and debt has come at a significant cost to the delivery of Ghana's public services and investment and has harmed Ghana's broader economic prospects[19].

While some argue that the management of debt and overall spending is beyond the scope of the PRMA, there are important reasons why it is difficult draw such a clear line. We have seen how the PRMA cannot meet its core objectives without careful management of overall spending growth and debt accumulation. The cap placed on the Ghana Stabilisaton Fund is the clearest example of how debt pressures have directly hindered the implementation of the PRMA. However, more broadly, the aspirations of a careful scaling up of spending have been undermined by the rapid expansion in debt-financed spending; savings has been overshadowed by increases in debt; and the allocation of petroleum revenues to development priorities offset by a much bigger share of allocations going to interest payments and wages and salaries.

The decision in 2011 avoid placing regulatory limits on spending growth, the size of the fiscal deficit and on borrowing (while allowing collateralization of future petroleum revenues[20]) as other resource-rich countries do was ultimately costly for Ghana. It also undermined the spirit of the Petroleum Revenue Management Act.

Looking ahead

As petroleum revenues continue to grow over the medium-term Ghana's approach to management of petroleum revenues will become increasingly important. Having almost reached five years of oil production, Ghana should use this time to take stock of the lessons

[16] Created under 1992 Constitution for meet urgent or unforeseen expenditure needs

[17] Created in the 2014 Budget to start paying down "Bullet Loans".

[18] Created through the Ghana Infrastructure Fund Act (2014)

[19] http://www.imf.org/external/pubs/cat/longres.aspx?sk=43243.0

[20] The PRMA does not provide limits on how much the Minister of Finance can borrow against future petroleum revenues. In 2011 the IMF supported the lifting of Ghana's commercial borrowing ceiling from $800 million to $3.4 billion, which allowed a significant frontloading of petroleum revenues in the form $3 billion loan agreement with China Development Bank. The subsequent difficulties in managing this loan demonstrate the risks of such an approach

from the PRMA and shape reform efforts to support good fiscal management. Over the last five years there is little evidence to suggest that Ghana's creation of a Sovereign Wealth Fund and revenue management law has led to better outcomes. This should be a key motivation for reforms to the PRMA going forward.

The challenges Ghana faces reflect fundamental problems often associated with these revenue management approaches. Careful saving and allocation of petroleum revenues is of little practical benefit unless the rest of the budget is supporting the same objectives. This requires a more comprehensive approach to budget management than the PRMA currently offers. The PRMA's rules will lack credibility in the absence of rules, commitments and reform efforts that place limits on overall expenditure growth, the size of the fiscal deficit, and realign spending patterns to development priorities.