

FISCAL MANAGEMENT IN GULF GOVERNMENTS

PAVING THE WAY TO SUSTAINABILITY

AUTHORS:
ANTONIO CARVALHO
JOEL GHOSN
JIMMY EL GEMAYEL



ABSTRACT

Gulf governments have been trying to regain control of their finances since 2014, after crude oil prices tumbled to below 40 USD/bbl. Governments' response focused on fiscal consolidation via spend reduction followed by revenue uplift measures. However, insufficient fiscal management – the mandatory requirement to balance finances in the short- and long-term – was the less obvious and highly pressing issue at hand.

The journey towards effective fiscal management in the Gulf is arduous and vital. Governments have a loose budget definition approach, are ineffective at managing their spend, lack medium-term fiscal foresight, and have inadequate systems and processes. Gulf governments must tackle these challenges head-on and develop a 360-degree view of their finances to improve fiscal agility, liquidity management, and budgeting. Not only can fiscal management help Gulf nations balance public finances more effectively, but it can also equip them with the processes, capabilities, and systems to spend more productively, better withstand future fiscal shocks, and manage finances to reinvigorate their planned economic transformation over the next 10 to 20 years.

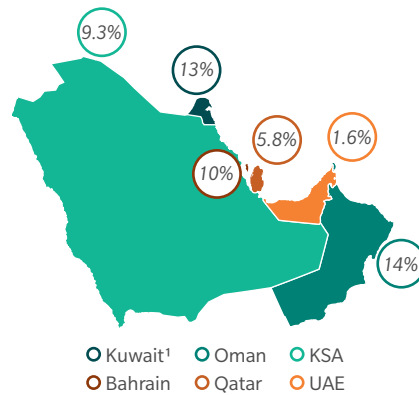
FISCAL IMBALANCE IN THE GULF

Gulf economies have been in fiscal deficit since 2014, following the oil price slump from around 110 USD/bbl to below 40 USD/bbl. The region's high reliance on hydrocarbon exports as a major revenue source triggered a sharp contraction in government income and a fiscal deficit that has not yet recovered (see Exhibit 1). Also, since oil prices are forecasted to remain around 60 to 80 USD/bbl in the medium term – driven mainly by risk of oversupply and global economic slowdown – oil revenue is unlikely to revert back to pre-2014 figures¹.

After the oil crisis, Gulf governments tried immediately to address the various drivers of fiscal deficit (see Exhibit 2). Countries took immediate cost cutting measures to reduce burden on national budgets. For example, most states halted various infrastructure projects and large procurement contracts, and countries such as Saudi Arabia and United Arab Emirates lifted numerous energy subsidies through liberalizing gasoline prices and increasing electricity tariffs.

Exhibit 1: Fiscal deficit share of GDP in Gulf nations

FISCAL BALANCE ACTUALS AND GDP IN 2017



1. Fiscal balance includes 10% transfer of government revenue to Kuwait Investment Authority's Future Generation Fund

Source: Gulf Ministries of Finance and Central Banks (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia), IMF Article IV (United Arab Emirates)

Exhibit 2: Direct drivers of fiscal deficit – high social contract and insufficient non-oil revenue



Bulging public wage bill: For nationals, Civil Service represents a preferred employment option largely due to the less demanding nature of the jobs – fewer working hours and less responsibility, safer and often better paid than private sector. Approximately 65% of the national workforce in the Gulf is employed in the public sector.



Generous subsidies: Energy subsidies, such as gasoline and electricity, and welfare subsidies, such as medical treatment abroad, scholarships, food, and living necessities are highly generous across the Gulf. Subsidies process loopholes have been identified and often result in misuse of funds – for example, GPA policy requirements can often be overlooked when awarding scholarships to study abroad.



Underdeveloped private sector with large governmental footprint: Gulf countries are perceived to have a weak private sector, from both a competitive and regulatory standpoint. Hence, governments are required to provide and bear the cost of a variety of services that are often privatized in advanced economies. For example, power generation, water desalination, maintenance services, and flour mills are businesses still operated by the public sector across various Gulf countries.



Insufficient non-oil revenue: Since the oil price slump, governments have tried diversifying their revenue via various initiatives such as repricing of public services and introduction of taxation – Value-Added Tax (VAT) and excise tax. However, non-oil revenue has not increased sufficiently to curb government deficit.

¹ JPMorgan 2018 forecast

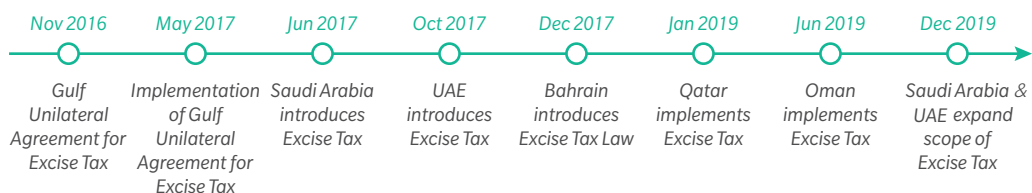
In parallel, Gulf countries tried to diversify their government revenue stream away from oil. One of the more noteworthy initiatives was the introduction of Value-Added Tax (VAT) and excise tax. In 2016, a unilateral agreement was signed to mandate the implementation of tax across Gulf nations, after which Saudi Arabia and United Arab Emirates were the first two to successfully implement taxation (see Exhibit 3).

However, Gulf countries tried not to disturb their tacit social contract, which in turn lessened the amount and extent of reforms implemented. Thus, these reforms have not curtailed their fiscal deficit sufficiently.

Exhibit 3: Excise tax implementation in Gulf nations

An excise tax on specific goods, to be launched across the Gulf states, was formalized in a unilateral agreement in 2016. Since then, all Gulf nations except Kuwait have implemented an excise tax on tobacco and Sugar Sweetened Beverages. In Saudi Arabia specifically, the excise tax has helped increase non-oil revenue by over USD 4 billion, equivalent to a rise of 7% of non-oil revenue. Other than fiscal benefits, excise tax can also provide health and social benefits such as potentially reducing obesity rates and smoking prevalence. It is often referred to as a “sin tax”, carrying popular positive sentiment.

EXCISE TAX IMPLEMENTATION TIMELINE



To reap maximum and lasting benefits from ongoing fiscal reforms, Gulf governments should improve their fiscal management approach – tightening control of public finances.

DEEP-ROOTED FISCAL CHALLENGES

A core fiscal challenge faced by Gulf governments is the lack of visibility and control of public finances. Gulf states have not been able to fully optimize their budget despite the immediate fiscal imperative. Efforts to slash spend were insufficient and did not contain budget growth, revenue diversification proved challenging and often fell short of targets due to lack of collection measures, and treasuries are still frequently riddled with out-of-budget obligations that are sizable and often considered high priority. This poor fiscal management can be linked to three root causes:

LOOSE AND UNSTRUCTURED BUDGET DEFINITION

Government entities typically set their budget by inflating the previous year budget by a certain percentage, a straightforward approach known as incremental budgeting. Even though this approach allows for easier and faster budget definition, it renders budget control and forecasting quite difficult due to its detachment from policy and performance metrics. Hence, incremental budgets often result in poor spending habits. Many entities exploit the budget ambiguity through a “spend it or lose it” mentality which can result in waste of government funds and consequently, a compounded budget misallocation in the subsequent year.

Clear repercussions from a loose budgeting approach can be observed across numerous budget dimensions such as:

Non-indicative revenue forecasts: Non-oil budget is defined via incremental budgeting, by inflating the historical revenue budgets. For some Gulf nations, this approach can often omit revenue targets and policies such as collection of accrued revenue, revenue from new fees and taxes, and changes in future revenue trends.

Spill-over across CapEx: Government infrastructure projects often exceed allocated budget, leading to frequent variations orders. This is commonly due to poor project planning and execution, which can breed habits of poor project management, both financial and operational management.

Unaccounted impact of reform policies: Government reforms aim to curb expenditure and increase revenue; however, if the fiscal impact of reforms is not adequately reflected in the budget, entities’ commitment towards reforms may be frail and policies cannot be properly enforced or measured.

INEFFECTIVE SPEND MANAGEMENT

Inflated expenditure is also due to inefficient spending habits across government. Inadequacies in monitoring spend patterns can result in lack of control, over-spend, and forecasting difficulties across most spend areas, such as:

Spend heavily concentrated in fourth quarter: Expenditure in public sector is often higher in the fourth quarter due to spend related to payment terms for capital projects, service contracts, and salary bonuses. However, across Gulf governments, fourth quarter spend is disproportionately larger, caused by lack of budget abundance and poor bookkeeping practices, e.g. late reporting of spend throughout the year.

Lack of CapEx project performance visibility: Ministries of Finance have limited oversight of infrastructure projects' progress throughout the year and lack the processes and systems to periodically review their financial and operational status. Consequently, project funds can be disbursed without a link to project performance metrics, service level compliance, and/or overall progress.

Frequent budget adjustments: As a result of loose and inaccurate government budgeting, entities tend to reach their yearly budget before the end of the fiscal year across various spend items. To avoid impeding their operations, entities resort to budget adjustments and request funds to be reallocated from one budget item to another. If done frequently, budget adjustments can significantly increase financial disorder and drain potential budget savings.

Insufficient checks and balances: Cash disbursement to entities on a monthly basis should often be based on proof-of-payment, such as third-party invoices and service contracts. However, government entities can receive cash that is not immediately spent and remains idle in the entities' account for many months, or even years. Due to lack of central transparency and checks and balances, an opportunity cost and liquidity management complications are incurred on Gulf governments from having idle and scattered cash across the various entities' accounts.

INSUFFICIENT FISCAL FORESIGHT

Gulf nation budgeting is for a one fiscal year horizon. Hence, the impact of policies and visibility of the budget in the medium term are often uncharted. Moreover, fiscal forecasts are hindered by various unknown revenue and expenditure items impacting long-term budget visibility. For example, state income is highly oil dependent and varies amply with market swings. Also, government expenditure is frequently riddled with out-of-budget spend derived from national development plans, expenditure that is often justified as high-priority and poses significant contingent liabilities on the government. For example, in 2008 – around the time of the Global Financial Crisis – the government of Dubai in United Arab Emirates was victim of insufficient foresight of liabilities. Dubai development plans, government financial commitments, and debt

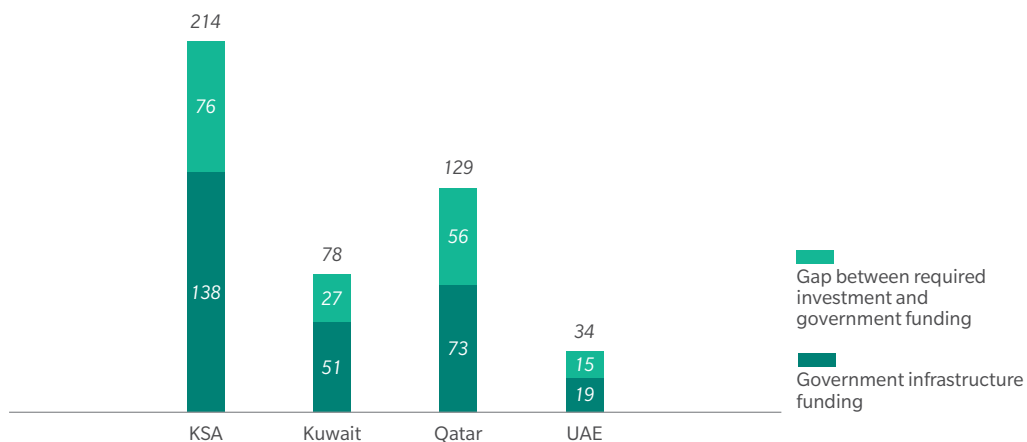
exceeded USD 80 billion, which crippled the Emirate after the international real estate market collapse. Only after a USD 10 billion bailout from Abu Dhabi and USD 21 billion liquidity facilities from the UAE Central Bank did Dubai manage to regain control over these oversized liabilities. This is testament that, without adequate planning, governments are at risk of heightened exposure to market shocks due to large government-backed development plans. Over the past 5 years, more costly national development plans across Gulf economies have raised concern due to their uncharted and sizable contingent liabilities (see Exhibit 4).

To subdue fiscal pressure exerted by imbalanced public finances and poor fiscal management, governments must maintain momentum of structural reforms aimed at maximizing government non-oil revenue and optimizing government expenditure. More importantly, governments should instate fiscal management by keeping a state-wide 360° view of all government obligations and by establishing good financial practices, such as fiscal planning, to shield the state from potential economic risks.

Exhibit 4: Gulf infrastructure funding gap

Over the past few years, Gulf states have devised national development plans to stimulate their economies by investing in infrastructure. These plans aim to diversify the economy away from oil and gas and into sectors such as alternative energy, transportation, healthcare, and education, while also trying to improve the quality of infrastructure. However, these ambitious development agendas carry aggressive financing requirements. With the fiscal headwinds currently faced by Gulf governments, these plans cannot be fully government funded, thus risking the creation of a funding gap that exceeds 40% in the medium term.

GULF INFRASTRUCTURE FUNDING GAP, 2018–2023
USD BN



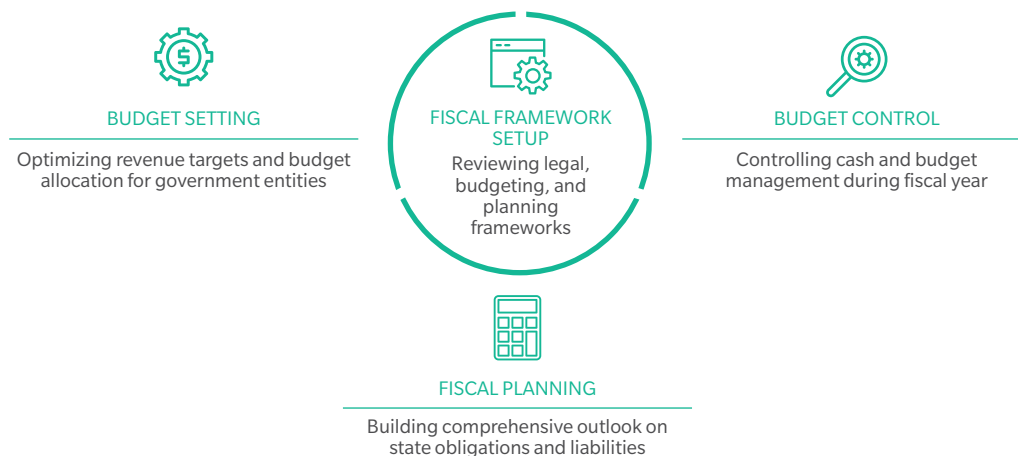
Source: National transformation plans of KSA, Kuwait, Qatar and UAE, Oliver Wyman analysis.

ACHIEVING FISCAL SUSTAINABILITY THROUGH END-TO-END FISCAL MANAGEMENT

Fiscal management is the cornerstone of fiscal consolidation. It allows for strategic fund allocation across nation development and economic diversification plans, promotes productive and efficient expenditure, optimizes control over revenue, helps governments improve planning capability, and ensures fiscal transparency across government entities.

Drawing from its extensive experience helping Gulf governments manage their fiscal agendas and liquidity, Oliver Wyman has developed a comprehensive approach for end-to-end fiscal management and for achieving a 360° view of government finances. This approach covers four key dimensions: budget setting, budget control, fiscal planning, and fiscal framework setup (see Exhibit 5).

Exhibit 5: 360° view of government finances – end-to-end fiscal management framework



Source: Oliver Wyman analysis

End-to-end fiscal management is a comprehensive solution that is based on policy-driven budget setting. Gulf governments struggling due to imbalanced finances and inefficient spend management need to integrate strategic priorities, performance metrics, policy targets, and Key Performance Indicators (KPIs) as budget inputs. These policies should hold public entities accountable to fiscal targets, thereby increasing overall efficiency, reducing expenditure, and boosting revenue.

Budget control is another key component of the fiscal management process. The adherence of the public sector entities to a defined budget – i.e. monitoring how public funds are spent, and revenue generated – is key to optimizing fiscal efficacy in day-to-day operations. Recouping accrued revenue, streamlining adjustments, and revamping cash disbursement processes are levers that can help government entities improve fiscal management.

Fiscal planning is also key since it helps Ministries of Finance establish foresight of government fiscal trends and challenges and effectively link them to policies and targets. Accordingly, governments should initially develop an understanding of their current finances – a 360° view. Via thorough asset and liabilities management, Gulf governments can manage their fiscal exposure and accurately estimate fiscal outlook and risk in the short to medium term.

Finally, present and future fiscal management initiatives should be mounted on a functional fiscal framework. Governments should set in place the right organization, tools, and systems for Ministries of Finance to increase control of their budget and state finances. We have summarized the main end-to-end fiscal management initiatives in Exhibit 6.

Exhibit 6: End-to-end fiscal management initiatives

	<p>Pursue performance-based/policy-driven budgeting that combines a top-down and bottom-up budget comparison, aligning spend to the strategic objectives of the state and linking fiscal policy and reform targets to government budget</p>
<p>BUDGET SETTING</p>	<p>Scrutinize spend effectiveness and accuracy by comparing yearly closing accounts with set budget to highlight variances and risks across spend items and to incorporate key learning in future budget definition and forecasts</p> <p>Introduce mid-year budget reforecasting with a “3+9” or “6+6” budget cycle that allows Ministries of Finance to revise budget three months or six months after its initial approval at the beginning of the fiscal year and to reforecast including new fiscal and national priorities for higher budget accuracy</p>
	<p>Monitor revenue collection via a dedicated and specialized unit which is responsible for managing all revenue-generating entities and flagging accrued and uncollected items vis-a-vis budget policies and targets</p>
<p>BUDGET CONTROL</p>	<p>Streamline expenditure adjustment revision and approval processes to minimize the frequency and amount of budget reallocations, discourage variation orders for capital projects, capitalize on budget savings throughout the year, and address cash mismanagement across government entities</p> <p>Standardize cyclical payments policies and processes to help ensure liquidity transparency between Ministries of Finance and all other government entities and to increase efficiency and control over cash management and planning activities</p>
	<p>Define a 360° state fiscal view, an all-inclusive map of state assets and funds, fiscal obligations, and implicit and explicit liabilities to assess the financial situation and measure financial risk and fiscal exposure of the state</p>
<p>FISCAL PLANNING</p>	<p>Investigate liquidity evolution and scenarios for the state, considering possible short-term financial obligations and risks, and develop mitigation plans to remediate challenges and potential scenario outcomes</p>
	<p>Define medium-term budget framework for a rolling three-year cycle that integrates current and expected budget policies, fiscal guidelines, future expenditure obligations and budget risks</p>
<p>FISCAL FRAMEWORK SETUP</p>	<p>Revamp budget law to equip Ministries of Finance with optimal governance, policies, enforcement tools, processes, and reporting structures to deliver on their role and responsibilities</p> <p>Develop adequate and standardized systems and tools by improving digitization and information sharing across government entities, expediting deployment of IT system upgrades, breaking information silos and standardizing reporting across functions, to provide Ministries of Finance with adequate inputs and visibility to set, monitor and plan budget and spend</p>

Highlighted initiatives are detailed in exhibits 7 to 10

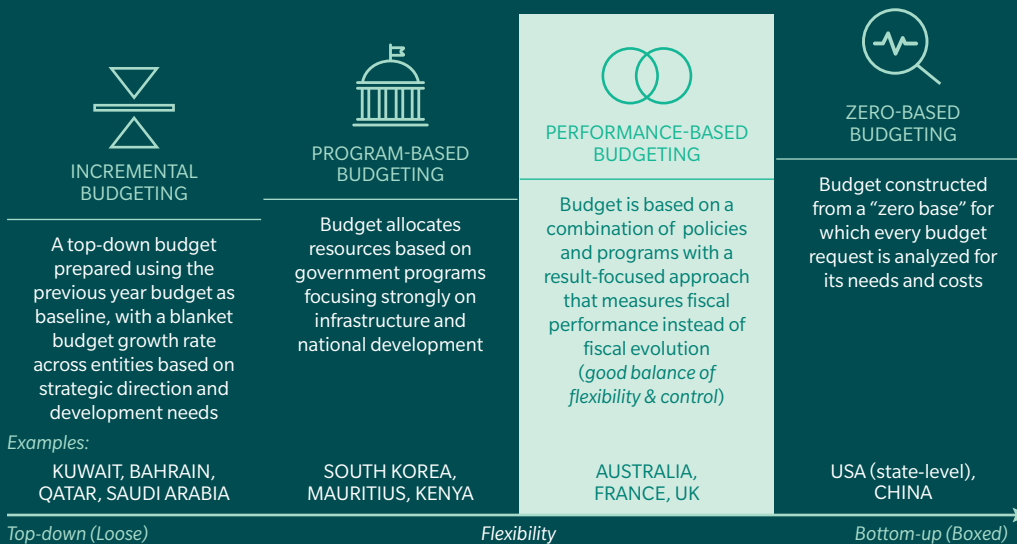


BUDGET SETTING

Exhibit 7: Towards a performance-based budgeting method

Incremental budgeting is a loose and crude method of budgeting that is used mostly in countries with less sophisticated fiscal capabilities. As capabilities evolve, a government can start defining its budget in a more comprehensive manner, by embedding more policies and performance metrics into its definition and execution. Unlike Zero-Based Budgeting (ZBB), which is a bottom-up, highly detailed and resource-intensive budgeting method, Performance-Based Budgeting (PBB) provides the appropriate balance of complexity and control. It allows governments to track fiscal performance, improve overall transparency, and be more result-focused, while still defining budget with a top-down and forward-looking strategic outlook.

Key government budgeting mechanisms



A proper PBB framework is underpinned by a set of fiscal fundamental requirements; if these requirements are not met, the upsides of the PBB method are undermined.

Program-based budgeting that is based on costs and benefits of programs for budget definition and performance tracking

Defined performance indicators linked to funding result targets, policies and objectives to quantitatively track budgeting and spending performance

Performance incentives to encourage entities to overperform by rewarding them financially – or to penalize them if underachieving

Justified financing where cash is provided as a function of results – outputs or outcomes

Note: Non-exhaustive; Source: World Bank, International Monetary Fund – Robinson 2007, Oliver Wyman analysis



BUDGET CONTROL

Exhibit 8: Dedicated unit to monitor and optimize revenue across government

Gulf governments' aspiration to grow non-oil revenue is hindered by various roadblocks such as lack of internal capability and a non-unified revenue responsibility – the obligation to manage revenue is often scattered across various entities, Interior, Energy, Customs, Ports and Commerce.

By investigating Ministries of Finance of leading benchmarks (Australia, Denmark, France, Norway, USA, UK), we observe that they have a central function to oversee all major revenue streams. Moreover, the larger the revenue amount, the higher the degree of MoF involvement – for example, policies for speeding fines in the UK are set by the Ministry of Transport with minimal oversight from HM Treasury whereas income tax policies require close involvement from HM Treasury with a dedicated team to oversee collection. Hence, to effectively manage revenue, governments can opt to centralize responsibility in a central revenue unit with the appropriate oversight, activities, priorities, structure, and capacity.

Revenue function across global Ministry of Finance benchmarks

	DIMENSIONS	KEY TAKEAWAYS FROM BENCHMARKS
OVERSIGHT	What strategic oversight do other MoFs have over public revenue?	MoF should have oversight of all major revenue streams, unifying finance function
ACTIVITIES	Which are the key activities undertaken by MoFs and/or outsourced?	Even though MoFs provide strategic oversight, revenue collection and specific policy development functions can be carried out by arms-length entities
PRIORITISATION	How are revenue oversight and policy development distributed?	Degree of MoF oversight is typically closely correlated to the value of the revenue stream
STRUCTURE	How are other MoFs structured?	A coordinating body in MoF oversees all revenue generation activities and manages sub-teams within MoF that supervise other entities' revenue-raising activities and policies
RESOURCING	What are the size and capabilities of revenue-focused teams in various MoFs?	Light review and challenge coordination focused team, teams in MoF can have up to 20 experienced employees

Source: Australia, Denmark, France, Norway, USA, UK and Gulf Ministries of Finance, Oliver Wyman analysis



FISCAL PLANNING

Exhibit 9: Managing government assets and liabilities

Governments worldwide have optimized their fiscal strategies by implementing a sovereign asset and liability management framework to manage their balance sheet. By defining clear fiscal objectives, policies and risk, governments have gathered a comprehensive and dynamic view of their assets and liabilities, and built a clear understanding of the country's liquidity position in the medium term. Accordingly, this has allowed governments to define a more effective liquidity and reserve allocation strategy debt, structure and reform prioritization at state level.

Asset and liability management across benchmarks

	FOCUS	OVERVIEW
AUSTRALIA	Broader economic priorities	Asset allocation between alternative portfolios and funds based on government's macro priorities and objectives Not specifically focused on balance sheet risks
DENMARK	Interest rate risk	Interest-rate risk managed on a consolidated basis Common in countries where government funds (e.g. pension funds) hold primarily government bonds
FINLAND	Balance sheet risks	Integrated management of the net position on government debt and cash reserves Objectives and risk constraints defined by these balance sheet items only
TURKEY	International reserves	Currency composition of international reserves based on maturity structure and currency composition of the government foreign exchange liabilities, including off-balance sheet foreign exchange cash flows

Source: Australia, Denmark, Finland and Turkey Ministries of Finance, Oliver Wyman analysis



FISCAL FRAMEWORK SETUP

Exhibit 10: Increasing fiscal medium-term foresight

To increase foresight and control over public sector expenditure, most well-established governments abide by a Medium-Term Budget (MTB). MTB is a top-down estimation and bottom-up validation of spend in the medium term (often 3 years) which integrates expected government spend, current and expected policy changes, and potential fiscal risk. MTB quantifies the cost of different plans and policy options for government leaders and decision makers, to ensure that decisions always abide by a healthy fiscal envelope. However, before implementation, governments should confirm that adequate preconditions are in place:

Policy-driven budgeting: Overhauled budgeting method geared towards performance- and policy-based instead of incremental budgeting

Budgetary abidance and discipline: Satisfactory budget definition, classification, and timely management

Macroeconomic reliability: Linking of macroeconomic environment and its projection to state fiscal targets

Governance and support: Adequate political and stakeholder support to ensure fiscal management discipline

For example, in Bulgaria, MTB was introduced in 2006 and obligated the Ministry of Finance to define a three-year macroeconomic and budget forecast that was presented alongside the proposed budget for the next year and had to be approved by the National Assembly. MTB is updated annually and is only binding in the first year (the other two years are directional). Yet, decision makers can still leverage MTB as a useful tool to measure the impact of fiscal policies, development plans, and other fiscal contingents in the medium term.

THE ROAD AHEAD: A FISCAL EVOLUTION

End-to-end fiscal management is crucial for governments to improve their grasp over their public finances. However, revamping fiscal management in the Gulf is a challenging task that is muddled by various obstacles:

Shift in paradigm: Change impetus can be lost if the economic situation shifts; for example, if the economic outlook improves due to a rise in oil price, interest in evolving fiscal management can be dimmed.

Popular resistance: Public pushback, disarray, and confrontation can surface whenever addressing the topic of public funds; this must be managed through cautious communication and complete transparency.

Lengthy implementation: Fully reshaping a government's approach to fiscal management in a country is a highly bureaucratic process, often accompanied by various gates of approval and hurdles. Hence, it can take time for the fiscal impact to become apparent, especially for more contentious initiatives.

Stakeholder management: The involvement of multiple stakeholders increases the complexity of an end-to-end fiscal management revamp. Therefore, on top of the complexities of managing government stakeholders, Ministries of Finance should also be ready to manage the complexities and interactions with local population, international stakeholders and private sector.

Many Gulf nations have already recognized the importance of fiscal management and are ready to take control of their finances. By implementing a functioning end-to-end fiscal management framework, which will result in more efficient processes, capabilities and systems, Gulf nations will be able to manage their public finances by spending productively, investing efficiently in their economy, and tackling looming fiscal challenges with more agility and precision in the future.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS

+1 212 541 8100

EMEA

+44 20 7333 8333

ASIA PACIFIC

+65 6510 9700

www.oliverwyman.com

Copyright © 2019 Oliver Wyman

All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman.