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From: The Secretary

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF MAURITANIA

SELECTED ISSUES

November 27, 2019

Approved by
Middle East and Central Asia Department

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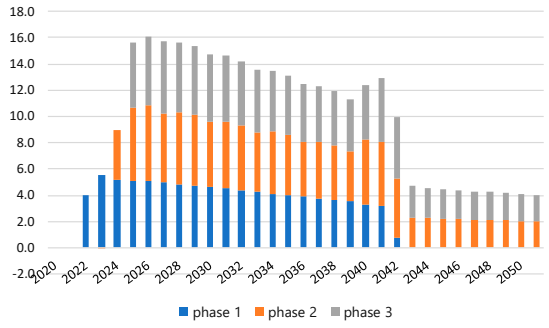
FISCAL FRAMEWORK FOR THE MANAGEMENT OF GAS REVENUE IN MAURITANIA

A. Introduction

1. Recent discoveries of offshore deep-sea natural gas are significant. They include the Greater Tortue/Ahmeyim (GTA) gas field shared equally between Mauritania with Senegal (with an estimated 15 trillion cubic feet of gas) and other important fields in Mauritanian waters. A number of international companies have secured exploration rights.

2. The investment decision by Mauritania, Senegal, BP, and Kosmos Energy for the first of three GTA phases was made in December of 2018. According to preliminary information, the first phase is projected to result in Liquefied Natural Gas (LNG) production (or equivalent) accruing to Mauritania of around 5 percent of its GDP per year as of 2022 for at least 10 years, based on flat price projections of US$60 per barrel. Phases 2 and 3, which could be launched in the next few years, could each generate additional output for Mauritania worth close to 5 percent of its GDP for around 15 years, starting in 2024 and 2025, respectively. After Phase 1 winds down in 2042, residual production would be around 4 percent of GDP annually for 10years starting.

GTA Gas Production—Accruing to Mauritania
(Percent of GDP)



Source: Mauritanian authorities; and staff estimates and projections.

3. Like all hydrocarbon exporting countries, Mauritania will be faced with the trade-off between using the additional revenue for immediate development spending or saving it for precautionary, stabilization, and/or inter-generational considerations. Scaling up public spending has potential benefits for social outcomes, long-term growth, and tax revenues. Saving the gas export proceeds would build financial assets for stabilization purposes, precautionary motives, and/or future generations.

- ***Development spending.*** There are important developmental upside benefits if gas revenues are spent efficiently: these include alleviation of income poverty, a rise in human capital, new infrastructure to facilitate private sector growth, and resources to manage adverse shocks. However, there are equally important downside risks if the additional resources are not managed adequately, such as inefficient spending on ill-prepared projects, a pro-cyclical expenditure policy leading to overheating of the economy, absence of buffers if commodity exports flounder, an appreciating real exchange rate, and a loss of competitiveness for the rest of the economy. However, Mauritania's relatively small economy and limited administrative capacity are important challenges.

- ***Saving for stabilization purposes.*** The accumulated savings can constitute additional resources to smooth budget revenues in case of fluctuations in gas revenues due to variations in international gas

prices or changes in production. The stabilization fund will typically accumulate assets when prices or revenues are "high" (exceeding a certain predetermined threshold) and pay out when prices or revenues are "low". The accumulation of assets may be subject to a cap based on an assessment of the magnitude of possible claims.

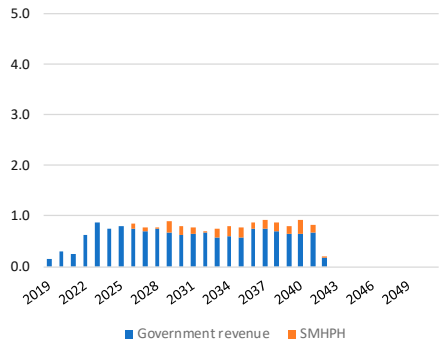
- ***Saving for precautionary purposes.*** Saving a portion of the gas revenues can help mitigate the impact of unexpected shocks (such as a draught, or floods). The capitalization of this contingency fund can follow the same principles as for the stabilization fund; however, the disbursement trigger would be different: disbursements would be predicated on an event beyond the control of the authorities, for example a natural catastrophe resulting in extraordinary expenditures or revenue losses exceeding a certain threshold.

- ***Saving for intergenerational purposes.*** The gas revenues can also be used to build up a savings fund tasked with safeguarding a portion of the monetized gas wealth of the country for future generations. The resulting endowment would generate a regular financing stream to supplement budget resources in the long run, to the benefit of this generation as well as the next generations. Considerations around its design are discussed in more detail in Section C below and illustrated with a modeling exercise.

B. Prospects for Public Revenue from GTA

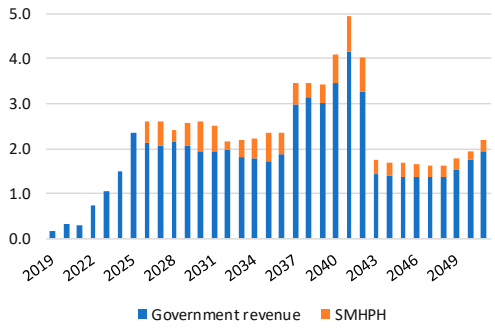
4. GTA will generate public revenue that will already be significant under Phase 1 but would more than double under the combined three phases. Under Phase 1, revenue could reach up to 1 percent of GDP per year, or around 5 percent of annual revenue. It would mostly accrue to the government in the form of taxes and royalties, with a smaller amount accruing as dividends to the SMHPH, the state-owned enterprise which holds a 14 percent stake in the Mauritanian portion of the GTA project on behalf of the state. Under the three combined phases, annual GTA revenue would be above 2 percent of GDP as of 2025 for over 25 years.

Mauritanian State Revenue from GTA—Phase 1
(Percent of GDP)



Sources: Mauritanian authorities; and staff estimates and projections.

Mauritanian State Revenue from GTA—Phases 1+2+3 (Percent of GDP)



Sources: Mauritanian authorities; and staff estimates and projections.

5. The impact of GTA under all three phases could prove transformative if managed under a well-designed natural resource management (NRM) framework. Public revenue from GTA under Phase 1, which would not amount to more than 5 percent of revenue per year (about one percent of GDP), could potentially be spent within the same year, with residual amounts accumulating in the existing National Hydrocarbon Revenue Fund (FNRH). This additional revenue could provide fiscal space for capital spending on much-needed public infrastructure. However, the much larger revenue projected under all three phases (10–25 percent of annual revenue for at least 20 years) would invite a discussion of the trade-offs between the uses of these monies, including the economic cost-benefits mentioned above in ¶3. Moreover, the advent of new natural resource (NR) production in other sectors (e.g. gold, iron ore) would only reinforce the need for a comprehensive NRM framework with which to manage all NR revenue and wealth.

C. Re-Architecting the Natural Resource Management Framework

Principles of Natural Resource Management

6. With the advent of possibly large gas revenues in the future, Mauritania will be confronted with the challenges of (i) investing its hydrocarbon wealth to generate returns while limiting risk; and (ii) spending its hydrocarbon investment proceeds, and possibly portions of the endowment, appropriately. International experience in the development of policy tools to guide the management of the financial wealth derived from NR, and of a fiscal framework with which to frame the key budget parameters, is diverse. However, some good practice principles can be discerned from past experience:[1]

i. **Transparency** – wide scrutiny by all constituencies will help ensure the legitimacy of the NRM framework;
ii. **Simplicity** – the NRM framework must be easy to explain, monitor and administer, given capacity constraints.
iii. **Incrementalism** – the NRM framework will need to fill important gaps (e.g. the design of both endowment constraint and fiscal rule), but it will also benefit from tapping proven arrangements in other countries and preserving functioning elements of the current NRM framework.
iv. **Robustness** – the NRM framework must be designed to withstand potential large and successive shocks.
v. **Resilience** – the NRM framework should aim at generating enough proceeds from the endowment and supporting steady expenditure levels that are not subject to economic cyclicality.
vi. **Flexibility** – the NRM framework will gain from a modular design to foresee and accommodate as much as possible necessary improvements to address Phases 2 and 3 of the GTA project—but also other projects currently at the exploration stage.
vii. **Sustainability** – the NRM framework will need to specify a time horizon by which NR will be exhausted, and beyond which fiscal deficit and debt levels are sustainable.

[1] IMF (2019).

7. Mauritania already has a basic functional NRM institutional setup, which was developed to administer once-promising oil revenue from a near-shore oil field. Revenues from hydrocarbons (production proceeds, explorations license fees, etc.) are deposited in full in a dedicated account in the name of the FNRH, a separate legal entity with its own statutes defined by law in 2008. The Central Bank manages the resulting endowment, which is invested abroad. The resources of the FNRH are used to finance the government budget through drawdowns decided every year in the annual budget law. In effect, it functions as a smoothing mechanism to help sustain expenditure levels. A financing gap to be financed by the endowment and its accrued revenue are identified at the time of budget preparation. The FNRH is drawn down accordingly as the budget is executed. The financial statements and net position of the FNRH are readily available to the principal (the Ministry of Finance) and are audited as part of the yearly BCM financial audit by a reputable international firm.

8. The FNRH as currently set up effectively serves as a source of ad hoc financing for the budget. While the FNRH's statutes may be adequate to manage limited hydrocarbon revenues, it will be insufficient to address significantly larger revenue inflows [explain why]. If the FNRH is expected to accumulate assets as a result of the sale of large gas or oil deposits, it will need to envisage short and long-term objectives, which in turn will require a more complex corporate governance structure to allow it to pursue various investment strategies; and facilitate auditing to support full disclosure and transparency toward Parliament. auditing to support full disclosure and transparency toward Parliament.

9. A strong public financial management (PFM) framework is required to effectively manage the large expected financial flows. Priority PFM reforms include: (i) the adoption and implementation of a comprehensive medium-term expenditure framework (MTEF) to plan for an augmented multi-year investment budget, especially if scaling up of spending is considered; (ii) the full implementation of the Treasury Single Account convention between the finance ministry and the central bank to ensure adequate tracking of financial resources; and (iii) an effective SOE supervision framework to prevent contingent liabilities and exercise oversight over large cashflows. These reforms are being implemented, including through the new organic budget law adopted in 2018.

Upgrading the Fiscal Framework for the Management of GTA Revenues

10. While the upcoming large gas revenues represent an opportunity to promote economic development, they may also pose some challenges to fiscal policy. The expected large gas receipts will create significant fiscal space that could be used primarily for two goals (i) increasing government spending towards achieving the authorities' development strategy and reaching the Sustainable Development Goals, (ii) saving part of the gas revenue for precautionary purposes, stabilization, and/or future generations. The objective of a future fiscal framework will be to strike a balance between government spending and savings while ensuring long term fiscal sustainability. Moreover, shielding the budget from procyclical spending and dealing with the uncertainty surrounding the estimation of gas revenues, stemming both from volatile international prices and uncertain assessment of gas reserves, further complicate fiscal management.

11. The spending-saving decision pertaining to gas revenue involves trade-offs. For example, spending large amounts quickly in social sectors and infrastructure may produce short-term results and

contribute to foster non-gas GDP growth; however, it may lead to inflationary pressures and current account deficits which may undermine macroeconomic stability, and could give rise to waste if administrative capacity is weak. In addition, a highly frontloaded spending profile would not allow the government to build savings buffers that could be used in case of a shortfall in gas revenue or to finance the budget in case of a shock or when gas production is exhausted. At the same time, saving gas revenue for the future or for precautionary reasons would require a strong consensus to fend off pressures to increase short-term spending.

12. Separating this decision into a two-step process may help. In the first step, the authorities would design a long-term fiscal strategy by deciding how much of the gas revenue to spend each year and how much to save, while ensuring a sound fiscal position when gas revenue fall off. In the second step, the authorities would design medium-term fiscal plans consistent with the long-term fiscal strategy by setting medium-term targets for expenditure and non-gas revenue. IMF (2012a) examines these issues and proposes new macroeconomic policy frameworks for resource-rich developing economies. (Box 1).

Box 1. Examples of Fiscal Frameworks in Resource-Rich Developing Countries

Several fiscal frameworks have been developed and implemented in resource rich countries over the years (IMF, 2012a and 2012b). The Balanced Budget rule implies spending all annual gas receipts, while keeping the government's overall financial position in balance. Although this fiscal policy would be sustainable in the short run, it would not benefit future generations and would also subject government spending to boom-bust cycles depending on developments in international gas prices. With the Bird-in-Hand approach, only the interest income accruing from already extracted resources is consumed. While this policy mostly avoids the boom-bust spending cycle of the previous rule, it results in low levels of public spending while the gas revenues are being accumulated during the production period. Also, there could be a high opportunity cost in terms of foregone social and infrastructure spending in the early years at the expense of future spending. In between these two extreme scenarios, several other fiscal rules have been used. These include constant expenditure rules; rules that target a specific gas price with any additional revenues in excess of the price threshold being saved; and rules that save a fixed percentage of gas revenues, among others. The gas windfall that is saved can be allocated to savings funds and/or to stabilization funds to smooth out fluctuations in annual budget spending.

13. There are several alternative approaches for assessing long-term sustainability benchmarks (IMF 2012a). The following approaches build on one another to achieve a long-term anchor set at a level that is consistent with sustainability in perpetuity.

- Under the ***Permanent Income Hypothesis (PIH),*** the benchmark corresponds to the sum of the real return on already accumulated net financial wealth and the implicit return on the net present value of future resource revenues. In other words, the country sustains a constant consumption flow equal to the implicit return on the present value of future natural resource revenues. The drawback of the PIH is that it considers a trade-off between financial wealth and consumption; therefore, this approach fails to account for alternative uses of the NR revenues such as investment in physical or human capital, the large short-term social needs, and the economy's absorptive capacity; moreover,

it does not discount expenditure into the future. As a result, a pure PIH approach leads to relatively low levels of primary expenditure.

- The ***Modified Permanent Income Hypothesis (MPIH)*** takes investment into consideration and incorporates the possibility of scaling it up during an initial period, relaxing the fiscal balance accordingly before stabilizing it in the medium term. However, this approach also faces shortcomings: it does not include the effects of higher investment on growth and non-resource revenues.

- The ***Fiscal Sustainability Framework (FSF)*** is the more complete approach which incorporates such effects and therefore adds an insight into the trade-offs between saving in financial assets versus investing in public infrastructure.

14. The fiscal framework is implemented through a fiscal policy anchor which depends on the expected number of years gas revenues. A common threshold for classifying countries as having a long reserve horizon is over 30–35 years (IMF, 2012a). In such countries, the focus could be on smoothing out revenue volatility, justifying the use of a structural balance rule as fiscal anchor.[2] In countries with relatively shorter resource horizons like Mauritania (20–25 years of gas production), the fiscal anchor should focus on safeguarding long-term fiscal sustainability.

15. In the case of Mauritania, a non-resource primary balance (NRPB) would normally be recommended as the fiscal anchor. Since the overall fiscal balance will be distorted by the volatility of commodity prices, the NRPB provides a better indicator of the underlying fiscal stance and its impact on aggregate demand. Adopting a fiscal framework based on an NRPB rule mitigates short-run volatility since resource revenues are fully excluded from the target path. Also, if the overall balance was to be used as an anchor, spending would need to be adjusted abruptly when resource revenues are exhausted, with disruptive effects on economic activity and public service delivery.

16. The sizable gaps in human and physical capital in Mauritania would justify using part of gas revenues to scale up public investment. Several indicators suggest that physical and human capital is much lower than in comparable countries, which undermines long-term growth prospects. For instance, Mauritania's infrastructure gap is estimated at 26 percent of GDP relative to the average in Sub-Saharan Africa.[3] Health and education spending are also very low compared to the average in SSA and low-income countries. In this context, using gas revenue to upgrade infrastructure and invest in human and physical capital would help boost the productive capacity.

17. However, a key issue is how much additional spending the economy can absorb without generating inflationary pressures and the symptoms of "Dutch disease." In presence of supply bottlenecks, boosting public spending may adversely impact the economy if the increase in domestic

[2]A fiscal anchor based based on a structural balance corrects for both the economic and commodity cycles. This approach is especially relevant to countries in which the business cycle can be assessed with some confidence, which is not the case in Mauritania given data limitations.

[3] The infrastructure stock is estimated at 93 percent of GDP in Mauritania against an average of 119 percent in SSA. Source: IMF Expenditure Assessment Tool, IMF, "Making Public Investment More Efficient," 2015.

demand puts pressure on the price of non-traded goods (IMF, 2012a). In this context, gradually scaling up investment would give time to improve both the economy's absorptive capacity and the efficiency of public investment while strengthening fiscal buffers and keeping public debt dynamics sustainable to prevent a disruption to investment in case of a negative shock. The magnitude and duration of the investment scaling-up would need to be consistent with the authorities' medium-term development strategy.

Illustrative Simulations of Fiscal Frameworks

18. This paper uses the Fiscal Sustainability Framework to derive long-term benchmarks for Mauritania, consistent with an initial scaling-up of public investment. The intuition behind this framework is that instead of accumulating higher financial savings, Mauritania would accumulate physical assets that would also provide a fiscal return. The FSF approach allows for a stabilization of financial wealth at lower levels than the PIH or MPIH approaches, as higher investment is assumed to have a positive impact on growth (with a magnitude depending on the size of fiscal multipliers). However, such investment scaling-up is likely to be associated with higher operation and maintenance expenditures. Since financial wealth is allowed to decrease in this framework, the implicit adjustment path of fiscal variables can be smoother than with either the PIH or the MPIH frameworks.

19. Simulations indicate that the NRPB deficit consistent with the fiscal sustainability framework would be -0.4 percent of non-extractive GDP (NEGDP) in the long run.[4] The simulations assume that all three GTA phases are completed and that a portion of these resources is used to gradually increase public investment (starting by 1 percent of NEGDP in 2022 followed by a gradual increase to reach 3 percent in 2029). The exercise is first conducted by considering gas wealth in isolation from other assets and debts. Under the key assumptions presented in Box 2, the NRPB would deteriorate in the first 8 years with the frontloading of public investment (reaching -3 percent of NEGDP in 2029) before stabilizing at -0.3 percent in the long run (Panel I). The generated fiscal path is sustainable and consistent with a lower level of financial wealth (36 percent of NEGDP by 2051) compared to the PIH benchmark (55 percent of NEGDP). Even if net financial wealth is lower in the FSF, the level of primary expenditure could be the same or even higher depending on the additional growth impact of public investment and the investment multiplier, given that higher growth will result in larger non-resource revenues.

[4] In this paper, the non-resource primary balance NRPB is defined as the primary balance excluding GTA revenues.

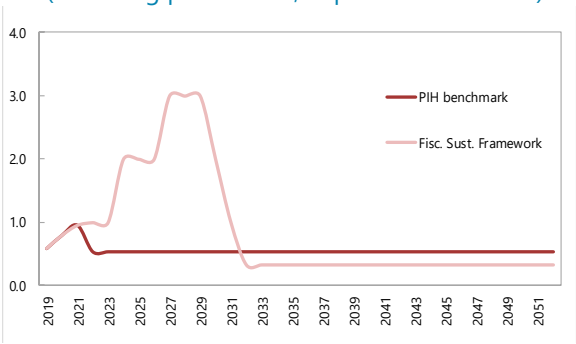
Box 2. Assumptions

The economic impact analysis for the baseline scenario is based on the macroeconomic framework for the 2019 Article IV consultation, which reflects phase 1 of the GTA project. Project-specific assumptions are as follows: the annual production volume is broadly constant at 40 million-barrel equivalent feet per year; the price of LNG is the one used for WEO projections; and government revenue is up to 1 percent of GDP for 20 years starting in 2022. Broader economic assumptions include a long-term non-extractive real growth rate of around 5 percent, inflation of around 3 percent, and an allocation of GTA revenue that is evenly split between savings in the existing hydrocarbon fund and spending on investment. There is no programmed drawdown of the FNRH.

The economic impact analysis for the full (3 phases) GTA project uses price projections from the WEO through 2024 and is also based on the macroeconomic framework of the 2019 Article IV consultation. Several key assumptions underpin the simulations: (i) non-extractive sector grows at a constant growth rate of 5 percent in real terms per year; (ii) the oil revenue share accruing to the government remains constant at about 18 percent; (iii) inflation stabilize at 3 percent per year, while the average real rate of return on financial assets is 1 percentage point above the non-oil growth rate. Mauritania is assumed to continue to contract debt on concessional terms. Regarding the impact of public investment on growth, a capital spending multiplier of 1.1 is assumed following Cerisola and al. (2015). Finally, the model foresees that an amount equivalent to 10 percent of yearly gas revenues is set aside in a fund set up for precautionary purposes. The simulations compute fiscal sustainability benchmarks and enable a comparison of the paths for the non-oil primary deficit, financial wealth, primary expenditure, and non-oil revenue for three alternative approaches: FSF, MPIH, and PIH.

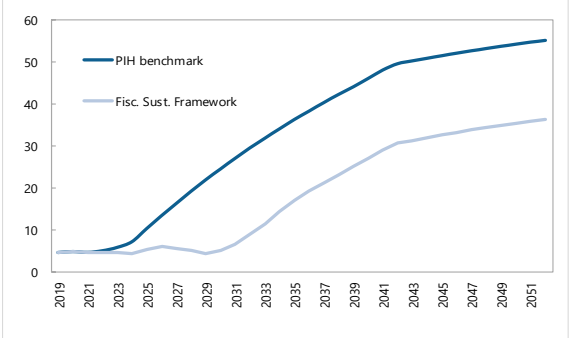
Panel I

NR Primary Deficit: PIH rule vs, FSF
(Excluding public debt, in percent of NEGDP)



Source: IMF staff estimates.

Net Financial Wealth: PIH rule vs. FSF
(Excluding public debt, in percent of NEGDP)



Source: IMF staff estimates.

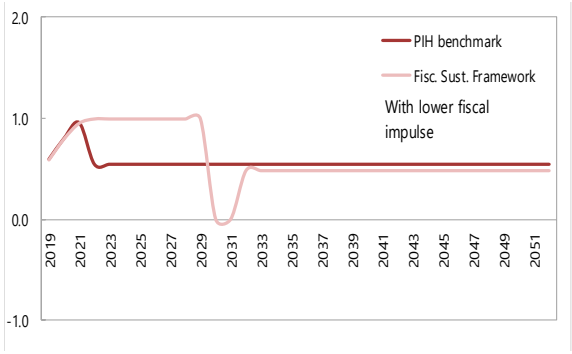
20. These findings are sensitive to assumptions on the impact of higher public investment on growth. Panel II presents the NRPB benchmarks under alternative assumptions regarding the size of fiscal multipliers and of additional GTA revenue to finance the NRPB deficit (the "fiscal impulses"). The alternative simulations consider (i) a lower capital spending multiplier (0.6 instead of 1.1) and (ii) a more prudent investment scaling up where capital expenditure is increased by only 1 percent of NEGDP per year for 8 years[5] . The results show that if the expansion of public investment has a more limited impact on growth, the NRPB would need to be stabilized at -0.3 percent of NEGDP (which corresponds to a lower nominal level of primary deficit given the lower level of NEGDP under the alternative scenario). If a

[5] A cumulative increase of 8 percent of GDP between 2022 and 2029 compared to the baseline scenario of 16 percent of GDP.

more prudent investment scaling up is followed, NEGDP would increase more slowly than in the baseline scenario but the government will accumulate more financial wealth. The NRPB benchmark would be broadly similar to the PIH benchmark given the lower fiscal impulse.

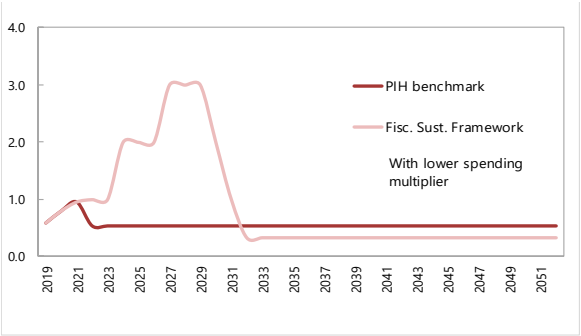
Panel II

NR Primary Deficit: PIH rule vs. FSF with lower fiscal impulse (excluding public debt, in percent of NEGDP)



Source: IMF staff estimates.

NR Primary Deficit: PIH rule vs. FSF with lower spending multiplier (excluding public debt, in percent of NEGDP)

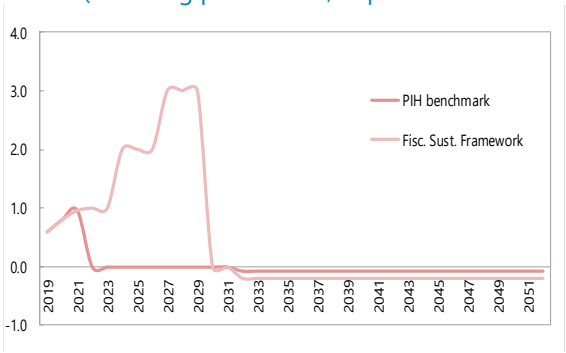


Source: IMF staff estimates.

21. When public debt is included in the calculation of total wealth, the FSF would call for a larger NRPB surplus of 0.2 percent of NEGDP in the long run following the initial period of investment scaling up (Panel III). The benchmark NRPB to be maintained in the long run is higher than when the gas wealth is taken in isolation as the lower level of net financial wealth (when debt liabilities are considered) implies lower financial returns to finance a perpetual deficit following the period of initial investment scaling-up. However, a higher deficit could be maintained if the government is able to mobilize more non-resource revenue, for example through tax reforms. Besides, the government may also opt to pay down public debt faster rather than accumulating financial assets. Such a strategy can be justified not only on purely financial grounds but, also to reduce the country's interest premium (if Mauritania were to start borrowing on international markets) and thereby foster private sector growth (IMF, 2012a).

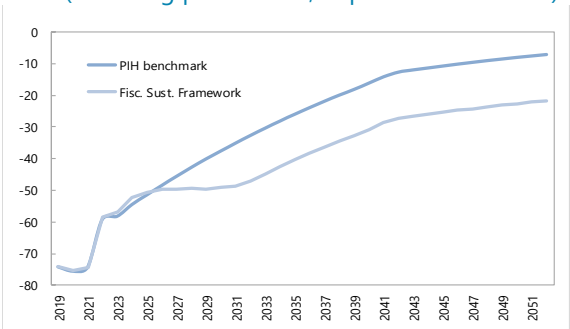
Panel III

NR Primary Deficit: PIH rule vs. FSF (Including public debt, in percent of NEGDP)



Source: IMF staff estimates.

Net Financial Wealth: PIH rule vs. FSF (Including public debt, in percent of NEGDP)



Source: IMF staff estimates.

Additional Options for Prudent Gas Revenue Management

22. Investment scaling-up should only start when actual gas revenues start accruing, not before. In principle, large increases in expenditure based on forecasts of future incomes should be avoided because both production volumes and price projections are subject to considerable uncertainty. Instead, given Mauritania's moderate performance in various investment efficiency surveys,[6] the authorities should use the pre-production phase to upgrade the public investment management framework so that new investment projects are better appraised, selected, and implemented.

23. An expenditure growth rule would help limit excessive increases in government spending, given absorption constraints, and shield spending from the volatility of gas revenues. By restricting the annual growth of expenditure, the rule functions as a secondary check on the NRPB to manage macroeconomic demand. The rule constrains total expenditure growth to a rate consistent with the economy's capacity to absorb additional spending without triggering a surge in inflation or an overshooting of the real exchange rate. With this additional rule, the increase in spending would be more gradual, and buffers would be built to address volatile and uncertain gas revenues. The rule would also reduce the procyclicality of fiscal policy and support macroeconomic stability (IMF, 2015b). The rule could be formulated to limit the growth of public expenditure in nominal or real terms, or as a percentage of GDP excluding natural resources.

D. Operational Aspects of a Natural Resource Management Framework: Institutions and Procedures

A Fiscal Responsibility Law as Overarching NRM Framework

24. The medium-term reform agenda for a NRM framework could be undertaken under the broad umbrella of a fiscal responsibility law (FRL). Once in place, a FRL could help natural resource management within a rule-based, stable, and sustainable NRM framework. The FRL is a legal device adopted by many countries, both advanced and developing, that could help map out and formalize the fiscal arrangements needed to adjust to the GTA; it would help stir a broad national discussion with which to manage expectations of GTA resources and its uses; it would encourage public scrutiny and accountability; and it would help ensure the cross-compatibility of various legal texts. An FRL need not have all of its components in place at the same time; it can be implemented and expanded gradually. In practice, the FRL would integrate many of the existing institutions and processes involved in budget preparation, execution, reporting, auditing, and the existing basic NRM framework; and it would specify the missing elements, and their timeline and sequencing to completion.

25. FRLs are characterized by procedural rules, the fiscal frameworks discussed above, transparency standards, and surveillance and enforcement mechanisms. As discussed above, fiscal rules and related anchors set targets which guide key fiscal aggregates over the medium term. Fiscal rules have become common in recent years as a response to debt sustainability concerns. Procedural rules regulate the budget process, including preparation, execution, reporting, and audit. They can also

[6] See 2019 Global Competitiveness Report (http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf) and FAD Expenditure Assessment Tool.

include medium-term budget planning. Transparency standards within FRLs generally go beyond reporting of the budget by requiring generation of timely, reliable, and comprehensive information on the public sector, including SOEs. Surveillance and enforcement mechanisms assign the responsibility to assess compliance to an agency and/or branch of government and set out sanctions and/or corrective actions for non-compliance. Those can be judicial in nature (e.g. compensation and damages in the case of misappropriations), or fiscal (e.g. automatic expenditure cuts), although an escape clause is advisable in the case of exceptional circumstances.

Reform Strategy

26. The introduction of an FRL requires a comprehensive reform strategy. Aspects of the reform strategy are presented below:

- ***A well-functioning, credibility FRL will require robust PFM arrangements*** to facilitate real-time, transparent scrutiny of the use of NR proceeds. While the development of an FRL may in itself be a catalyst for PFM reform, the components of a sound PFM system described in Paragraph 8 should be viewed as initial conditions.

- ***Introduction of an FRL can proceed gradually as its key components are developed and operationalized.*** This approach can help identify and correct potential implementation issues, and thus strengthen the credibility of the FRL when it becomes law. Given the sequencing of the GTA project in three phases, and the first phase's relatively limited impact on the economy and public finances, this gradual approach could be adopted in Mauritania.

- ***Communication will be key.*** Successful communication typically includes broad consultation with key stakeholders, outreach to the identified target audience, and dissemination of simple messages.

Institutions and Procedures for Sovereign Wealth Funds [7]

27. A future sovereign wealth fund (SWF) should be enshrined in a robust legal framework to promote strong governance arrangements for effective wealth management. As the upcoming gas revenues are accumulated into the existing FNRH, the latter's legal and operational framework should evolve into a SWF, following best international practices. The legal framework should achieve the following purposes: (i) provide clearly for the legal form and structure of the endowment and its relationship with other state bodies (including the ministry of finance and central bank); (ii) be consistent with the broader legal framework governing budgetary processes; (iii) lay out its organs and processes to for effective operation and achievement of its financial and economic policy objective(s); and (iv) promote effective governance, based on transparency and accountability. While the FNRH's current legal framework is broadly consistent with the first two points, it is largely silent on the more complex operating rules and governance arrangements that need to be addressed with the advent of gas on a larger scale.

[7] See IMF (2013).

28. In practice, there is a variety of legal frameworks for SWFs. Generally, SWFs are established either (i) as separate legal entities under the law with legal identities and full capacity to act; or (ii) as a pool of assets owned by the state or the central bank, without a separate legal identity, as is currently the case with Mauritania. Both of these forms are compatible with recognized practices and principles but differ with regard to their tax exposure and the sovereign immunity of their investments. Investments through central banks will generally be less costly to run, will normally be protected by sovereign immunity, and may also enjoy tax privileges in recipient countries. However, if the endowment is projected to grow significantly, features of a SWF as a separate legal entity become more relevant: (i) statutes, policies and transactions of the SWF are documented, with a view to promoting accountability; (ii) the distinct legal incorporation adds a degree of separation from the state, and could help safeguard resources; (iii) controlling participations in some investments may be better managed with inhouse expertise; and (iv) the added complexity of the pursuit of more than one policy objective (e.g. revenue smoothing, rainy day insurance, intergenerational transfers) may be better served by a dedicated structure.

29. Governance and institutional arrangements for the endowment need to be specified, and commensurate with the objectives, nature, and risks of its investments. Under either legal form, it will be useful to establish a governance structure that differentiates between three governing bodies: the owner, the board, and the operational management. Moreover, each governing body should benefit from being matched to a supervisory body whose role it is to verify that it is acting in accordance with the regulations set by the governing body above it:

- an internal audit unit or a compliance unit to supervise management;
- an external, ex-post supervisor (i.e. a reputable international audit firm or state audit agency) to supervise the board of the SWF; and
- the Parliament, seconded by the Court of Accounts, to supervise the Government.

30. The SWF must consider two high-level decisions that: how to invest its resources, and how to distribute revenue and/or draw down its resources. In doing so, a clear division of roles and responsibilities, with as little overlap as possible, will help establish an effective incentive system, accountability, and legal certainty.

- **Investment Strategy.** The investment strategy would come into its own, with clear objectives for yield, maturities and risk tolerance, and a simple but operational institutional setup to carry it out. A sound investment strategy is comprised of two sets of decisions. The owner of the SWF first articulates SWF objectives, time horizon(s) and risk tolerance. The SWF through its board or CEO, defines an investment policy consistent with those inputs, and management will implement it after its approval by the Board. The policy is the result of an analysis of economic circumstances and financial markets and encompasses a "strategic asset allocation" reflecting classes of assets of certain risk/return profiles. The degree of delegation in the implementation of the investment policy will depend on the investment strategy: an aggressive strategy relying on active asset management in financial markets will require a high degree of delegation to highly skilled asset managers. A more

passive investment strategy can be managed inhouse (i.e. within the SWF), and for particular investments[8] can involve the head of the SWF or its board.

- **Distribution Strategy.** Financial transfers to the State (e.g. dividends and the transfers mandated by the fiscal rule and/or FRL) should be guided by the statutory purpose of the SWF and will normally be the prerogative of the board. Such transfers to the budget also take stock of the financial performance and preservation of the endowment, and its ability to pursue the SWF's objectives. An escape clause allowing an exceptionally high or low distribution should exist to address exceptional circumstances – under the control of the governing body at the next higher level: the cabinet or Parliament.

- **Other Decision Rules.** In addition, because of the prospective size of the SWF relative to the economy, some general rules to strengthen incentives for sound fiduciary management and enhance accountability should be affirmed in the statutes, such as:

  - All revenues generated by natural resource extraction should be held by the SWF. These include royalties and taxes paid to the state by GTA, but also dividends transferred to the state from SMPH.

  - The SWF, which is owned by the state, should only receive revenue (other than from its investments) channeled through the state (i.e. not directly from the production consortium), and can only distribute dividends to the state.

  - To contain the risk of contingent liabilities, the SWF should not be allowed to borrow.

  - Domestic public investments should be made through other investment vehicles, namely the government budget. Instead, and to help avoid the risk of duplication with the government's budget, the SWF can only use its endowment to invest abroad.

[8] Investments that convey some control over the firm that is invested into, or that may breach some investment policy parameter, such as asset concentration.

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