EVALUATION OF THE PRINCIPLE AND APPLICATION OF FISCAL CONVERGENCE IN THE WEST AFRICAN MONETARY ZONE

Ву

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INTRODUCTION

One of the most important revolutions in macroeconomics in the last two decades has been the shift of stance with respect to fiscal policy. From emphasis of Keynesian expansionary policies, since the 1950s, and fiscal effectiveness in accelerating growth, dampening of economic fluctuations and cutting unemployment, we have now turned to a more orthodox approach in which the long term costs of fiscal expansion and prolonged budget deficits are stressed. This change in attitude is important because it emphasizes efficient governments, lower taxes and market - friendly policies which are a priority for the private sector. Business is affected by fiscal policy in several ways and emphasis has been given since the 1990s to an approach that requires fiscal integrity and debt sustainability.

The viability of any economic integration programme depends on its ability to ensure economic and financial discipline, the consistency of the economic and financial policies defined by individual member countries of the zone with those of other members and guarantee sustained convergence of the member's economic performance. This is especially more pronounced in a monetary union in which the existence of a common monetary policy and common currency wield even more stringent constraints on national economic policies. In the envisaged WAMZ, an independent central bank is expected to take over the monetary policy for the Zone, thus, the ability to use the interest rate as an instrument would be limited. Consequently fiscal policy will assume prime importance in macroeconomic management. They must not only be coordinated but must be consistent with the

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maintenance of price stability. Lack of economic policy coordination can lead to negative externalities and consequently policy reversals in response to shocks that could endanger the common monetary policy.

This conceptual framework fully supports the inclusion of fiscal criteria in the WAMZ monetary zone convergence requirement as debt and its mode of financing is a risk factor for sound monetary policy. Budget deficit and its mode of financing determine the depth of the impact it will have on inflation and by extension other macroeconomic variables. Government borrowing from the Central Bank tantamounts to the creation of high-powered money. Creating money at a rate that exceeds demand at the current price level creates excess cash balances and eventually drives up the overall price level. In most of the WAMZ countries, high proportions of government deficits are monetised and are therefore the principal source of inflation.

The provisions that govern fiscal policies in the zone provide guidance to the national fiscal authorities (see ARTICLE 5.2 of the Revised WACB Statue). The budgetary provisions that limit the level of government deficits are considered key to achieving sound public finances. In addition, the WAMZ statutes introduced the goal of cordinating fiscal policy of member countries to ensure consistency with the objective of price stability. In this respect, member country's fiscal deficit/GDP ratio, excluding grants on commitment basis is not to exceed the 4 per cent. Furthermore, central bank financing of budget deficit of government is limited to 10 per cent of previous year's tax revenue. Other fiscal requirements include: prohibition of new domestic arrears and liquidation of existing arrears; tax revenue/GDP ratio to be at least 20 per cent; and wage bill/tax revenue ratio not to exceed 35 per cent.

On the face value, the framework is a sufficiently strong deterrent against unduly lax fiscal policies. However, the adherence to the framework since the zone's commencement has been challenging, raising the pertinent question of whether the attainment of the fiscal criteria in the WAMZ arrangement is feasible. The main objective of this paper is to assess the feasibility of the WAMZ countries meeting

the fiscal convergence within the stipulated time frame. The remaining part of the paper is arranged thus: part 11 discusses the theoretical issues, while part III examines the performance of the WAMZ countries with respect to fiscal convergence and part IVexamines outstanding issues and prospects.

II LITERATURE SURVEY OF SOME THEORETICALISSUES

11.1 Theoretical Basis

The drive for fiscal policy harmonization comes from the link between fiscal deficit, exchange rate and the external sector. The latter two in particular are the channels through which a country is linked with the rest of the world. Facilitating such link is crucial for successful monetary integration. Since major macroeconomic balances in general and the fiscal posture in particular have a direct bearing on the external sector, its harmonization is imperative for monetary integration efforts. As noted by Goldstein (1994), national policy action can have quantitatively significant spill over effects, or externalities. Thus national decision-making process should take into account zone-wide considerations. The justification for fiscal policy harmonization stems from the fact that centralized (or coordinated) organs than individual countries could better handle some developmental objectives. This is because they might have externalities or there could be the possibilities of exploiting scaled economies. As the experience in European Union shows, fiscal policy harmonization at the regional level could focus on correcting distortions or exploiting externalities that cannot be corrected or exploited by national fiscal policies. Externalities such as tax competitions or issues where regional level social returns exceed the national levels are cases in point. The latter two factors were the main impetus behind fiscal policy harmonization in the European Union (Masson 2000).

Another motivation for fiscal policy harmonization comes form its link with monetary policy. Masson and Pattillo (2001) opine that instead of trying to meet a very short deadline for monetary union, the countries of the region need to focus on

convergence on low inflation, sustainable fiscal and structural policies necessary for strong growth. They noted that, if the role of France in the monetary union of West Africa is discounted, the need for fiscal policy harmonization will be much more critical. For instance, pursuing open trade policy requires harmonization of exchange rate. The latter is linked, among other things, to inflation differential. One of the needed instruments to harmonize inflation differential apart from monetary policy that would be formulated and implemented centrally by the common central bank, is fiscal policy harmonization.

Another rationale for fiscal policy harmonization comes from the 'optimum currency area' literature that is usually discussed in the context of a monetary union, which is one major objective of regional integration schemes. In this context, fiscal policy harmonization is imperative because it is one of the important preconditions for optimum currency area formulation.

In the long run, as the debt-GDP ratio increases due to continuous fiscal imbalances, countries start to pay a 'debt penalty': their governments borrow in order to pay interest on previous debt. As the interest burden grows over time, the deficit becomes a source of structural distortion. Eventually, fiscal deficits become unsustainable and taxes start to rise in order to service the debt. This will have a depressing effect on investment and growth. Fiscal imbalances can lead to structural distortions. Also, a rising debt-GDP ratio provokes fears that a government will not be able to pay back its debt without creating inflation. The financial markets will demand a higher interest on government bonds to compensate for the higher risk. Thus, the interest payment will increase further worsening the debt-GDP ratio and calling more vigorously for a stop in borrowing. Unless expenditure can be curbed, the only alternative is a rise in taxes.

Reversing the argument, fiscal integrity can create a positive spiral in the economy, particularly for countries that are heavily indebted, a phenomenon suggesting that fiscal contraction can be expansionary. If a country with a large deficit makes a commitment to reduce its deficit and provided that its government is fully credible,

the risk premium in long-term interest rates will decline, thus having expansionary effects on investment and consumption. Furthermore, the burden of interest repayment on previous debt will be reduced, making the implementation of budget commitments for the government even easier.

It is pertinent to add that fiscal discipline does not necessarily imply lower taxes. A low level of deficit can be attained either by reducing public spending or increasing taxes. However, the general belief is that the former is the most effective and efficient way of achieving fiscal targets. Taxation, if it gets too high, discourages industry and encourages tax avoidance and/or evasion, while low spending leads to low interest rates: this is a self-reinforcing mechanism which improves business expectations and confidence in the future.

In theory, it is possible to manage fiscal policy in a way that budget deficits in recession are followed by budget surpluses in boom, keeping an overall stability in the public debt burden. Empirical evidence, including (Wilcox, 1989) does not support the theory that the debt-GDP ratio tends to rise in periods of recession but does not fall in periods of expansion. Two main reasons can be highlighted. First, budget deficits are more popular than budget surpluses. A government asking for austerity in a boom period to reduce the public deficit is not politically popular; until recently, people were less concerned about the long term and future costs of borrowing. Second, discretionary management of fiscal policy is motivated more by political rather than economic considerations. Governments tend to exhibit fiscal activism before elections and fiscal consolidation after elections. Therefore, fiscal activism risk becomes pro-cyclical rather than counter-cyclical leading to economic instability. This has serious consequences when the size of the government sector reaches 50 percent of the GDP as in most WAMZ countries.

Limiting the discretionary power of politicians over fiscal policy would have the positive effect of eliminating (or diminishing) the election induced expenditure cycle mentioned above. A constitutional amendment that would forbid governments

from using fiscal policy in order to gain their political survival can be strengthened within the context of a zone-wide harmonized fiscal policy management framework. Another positive effect would be on the government's credibility: financial markets will reward consolidation policies when they are trustworthy, and such a constitutional amendment would be a sign of strong credibility. Through a decrease in interest rates and expectations of lower taxes in the future, this would create an expansionary effect on the economy. Regrettably, there is also a drawback. When external disturbances or domestic shocks happen, fiscal expansion can be the cushion to avoid dramatic costs in terms of unemployment, although the fiscal instrument is now less effective than in the past (mainly for small countries and for single countries initiatives).

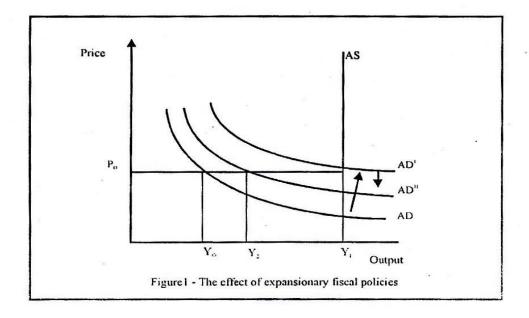
The rationale behind the fiscal convergence proposal is represented in figure 1 and responds to the Keynesian idea of fiscal policy management. A decrease in taxes augments disposable income of households: more money is available and is spent on consumption and investment goods, stimulating the economy and cutting unemployment. In Keynesian terms, the aggregate supply curve is horizontal until the point of full employment. A decrease in taxes implies a shift outwards of the AD curve, increasing output and employment through the fiscal multiplier (see figure 1, AD moves to AD' increasing output from Y_o to Y_i).

This positive effect is counterbalanced by other negative effects: if the reduction in taxes is financed by borrowing, the excess of money demand leads to an increase in the interest rate with the effect of thrashing investment and consumption. In other words AD, because of the reduction in investment and consumption, moves leftwards. According to Keynesian economics, this *crowding out* in private expenditure is only partial (AD' moves to AD" and the final equilibrium is in Y₂) but it is complete according to classical economics (AD' moves back to AD and the equilibrium remains in Y₂), thus rendering fiscal expansion policies ineffective.

While this analysis refers mainly to the short term, more important is the final effect

of fiscal expansion in the long term, which is linked to the issue of sustainability of fiscal deficits. While Keynesian economics seems to work in the short and in the medium-long term, its analysis of affordability is not applicable in the long run. Keynesians thought that fiscal expansion could be financed largely, and perhaps entirely, through an increase in tax revenue obtained from higher output.

Empirical evidence reveals instead that, because of continuous borrowing, the burden of public debt has grown. In the long run, the unsustainability of the debt creates further costs. The loss of credibility in the ability of a country to reduce the debt leads to a rise in the interest rate: the interest repayment becomes the most important part of a country's deficit and the government has to borrow just to pay interest on previous debt. The solution to this spiral is twofold: either tax has to be raised in order to achieve a balance in public accounts, or expenditure has to be curbed. Both instruments imply a movement inwards of the AD curve, crowding out the previous gains from expansionary policies. However, these contractionary policies can be expansionary if better expectations on the future level of the interest rate stimulate private spending.



The final outcome of expansionary and contractionary fiscal policies is far from being clear and further complications, also in the short run, are explained by the Ricardian equivalence. According to the Ricardian equivalence, an expansionary fiscal policy financed by borrowing can be ineffective also in the short term. The reason lies in the rational expectations of economic agents. They know that borrowing cannot be sustained for a long time and that, sooner or later, it has to be financed by a rise in taxes.

They expect this and, in anticipation of higher future taxes, they increase saving now, in the period of fiscal expansion. This contraction of private spending offsets most if not all the beneficial effects of increased public spending. The empirical evidence of Ricardian equivalence theory is mixed and its limits can be listed as following: Taxpayers could decide 'rationally' to pass the burden of the debt to future generations, if public debt can be rolled over for very long periods. Imperfections in the capital markets could prevent economic agents from behaving rationally. Reactions appear to be sensitive to the debt size. Ricardian equivalence may apply only when the debt has reached a certain threshold. Although the strict application of the Richardian and/or Keynesian theories may not apply to the WAMZ countries due to the prevalence of excess capacity especially the level of unemployment, other factors that create rigidities include political instability and weak institutional framework and lack of adaptation of modern technology.

11.2 BUDGET FINANCING AND RISKS

Conventional analyses of sustained budget deficits demonstrate the negative effects of deficits on long-term economic growth. Under the conventional view, ongoing budget deficits decrease national saving, which reduces domestic investment and increases borrowing from abroad². Interest rates play a key role in how the economy adjusts. The reduction in national saving raises domestic interest rates, which dampens investment and attracts capital from abroad ³. The external borrowing that

The conventional view assumes that in the long term, the economy operates at, or near, full employment.

The increase in interest rates may also exert a negative influence on aggregate demand through several channels. First, the increase in interest rates reduces investment, which is a component of aggregate demand. Second, the increase in interest rates may directly reduce interest-sensitive consumption, such as on credit-financed durable goods. Third, the increase in interest rates may indirectly reduce consumption, by reducing asset values and therefore household net wealth.

helps to finance the budget deficit is reflected in a larger current account deficit, creating a linkage between the budget deficit and the current account deficit. The reduction in domestic investment (which lowers productivity growth) and the increase in the current account deficit (which requires that more of the returns from the domestic capital stock accrue to foreigners) both reduce future national income, with the loss in income steadily growing over time. Under the conventional view, the costs imposed by sustained deficits tend to build gradually over time, rather than occurring suddenly.

The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than traditional analysis suggests, however. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The unfavourable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment with deficits that are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficit, financial markets, and the real economy:

The government has several ways to finance budget deficits and each of those could lead, in certain circumstances, to inflation, namely, borrowing from private sector, borrowing from the central bank, external borrowing, accumulation of payment arrears and raising tax. If the budget deficit is financed through borrowing, and if the deficits persist, potential output will be reached and inflation may be initiated. If the central bank decides to accommodate fiscal deficits by purchasing government bonds, it releases new money in the economy. The effect of an increase in money supply on inflation is straightforward, as the quantity theory of money shows. Hence, inflation becomes a tax that authorities raise to pay the public debt. Budget deficits could be financed, alternatively, through a rise in taxation. In this case, the effect on inflation is less direct. Business could be tempted to raise prices to maintain their mark-up, eroded by higher taxes. Moreover, an increase in taxation is often

perceived as postponed adjustment. In such circumstance, financial markets will react through an increase in the interest rates, thus an inflationary spiral could thus be started.

The financing of budget deficit through external borrowing though an option is bedevilled with several difficulties. The dependence on external financing induces a greater threat to macroeconomic stability than domestic financial obligations as it makes the economy increasingly vulnerable to changes in perceived creditworthiness, the external debt payment stream is subject to the risk of: currency depreciation which increases the debt burdens, a shift in market sentiment, which informs the lenders to require higher interest rates to extend new credit for rolling over the existing debt; and a negative impact of external financial crisis.

When planned revenue is not met, the government is prone to accumulate expenditure arrears. Arrears appear to be the most prominent and persistent sources of financing the budget deficit (calculated on commitment basis). The cost of this liability is low in money terms, although the social impact is disastrous. A large share of population depends crucially on wages, pensions and other benefits paid by the state; thus, the accumulation of arrears pushes these persons into poverty. Moreover, economic decisions are biased, since arrears distort the expected real returns on various economic activities. Arrears also undermine the credibility of the state, making economic agents more reluctant to meet their tax obligations towards the budget.

It has been argued (See Verhoeven, 1998; Onwioduokit, 1999; Adam and Bevan, 2003 and Baldacci etal 2003) that if budget deficit exceeds a certain threshold, it might lead to a contractionary budget having a stimulating effect on aggregate demand (expansionary fiscal contraction). The core of the problem, here, is to understand the role of expectations on future policy actions and interest rates. Since a high public debt is regarded as dangerous for the economy (because it can be a source of instability, inflation, high interest rates and high taxes), policies aimed to reduce it

through fiscal contraction give encouragement to economic agents and financial markets. If a government of a highly indebted country makes a firm commitment to reduce its debt and, if the government is stable and credible, the contractionary policy is seen as a guarantee of price and financial stability.

This reduction has positive effects both on investment (lower cost of borrowing money) and on consumption (particularly of durable goods). Furthermore, the lower interest rate helps the government in reducing the cost of debt allowing either a cut in taxes or giving room to an expansion of primary balance. These expansionary effects might outweigh the traditional negative short-term impulse derived from fiscal restriction, thus creating a sort of 'crowding in' effect. Contraction through spending cuts is more effective than through increase in taxes: high taxes worsen competitiveness and can give to the markets a signal of postponed adjustment.

There is some empirical evidence of this expansionary fiscal contraction in EU countries, transition economies and developing countries, particularly in countries where the debt is so high that is considered unsustainable by financial markets (IMF, 1995). However, balanced budget is not, in all circumstances, a sign of good economic management. In this situation, the government ought to use a mix of expansionary fiscal and monetary policies. The government should expand fiscal policy through public consumption and investment. These policies would support aggregate demand, replacing private expenditure and sustaining employment and income. The central bank should avoid restricting money supply. Deflation can be as dangerous as inflation in some cases. Falling prices have deteriorating effects on consumption and investment.

Fiscal policy effectiveness depends on a sequence of considerations: expectations of the financial markets, level of confidence in the economy, level of unemployment, level of inflation, fiscal budget and trade balance. Not only might optimal policies vary between normal and extraordinary times, but also in normal times their effectiveness depends on operators' expectations. While the case for fiscal activism

has been heavily qualified by the new economic consensus, fiscal policy can play a 'coarse-tuning' role when the objective is the avoidance of major deviations from potential output. A stable macroeconomic environment is attained when inflation is low or prices are stable, (in the less developed economies this is usually taken to mean single digit inflation), public accounts are under control, interest rates are low (generally the emphasis here is on positive real interest rates) and market-friendly policies are implemented.

Indeed, fiscal policy plays a critical role in shaping overall economic development. In concert with monetary and exchange rate policies, fiscal policy influences the balance of payments, the debt profile, and the rates of inflation as well as economic growth. Policies that deal with taxation, public spending, and borrowing impinge on the behaviour of producers and consumers and sway the distribution of income and wealth in the economy. Often, large macroeconomic imbalances, both internal and external, could be attributed to a fiscal imbalance that policy has failed to correct. Fiscal policy unfailingly affects an economy's use of collective resources and level of aggregate demand.

The theoretical justification notwithstanding, Dornbusch (1996) argued that the inclusion of fiscal convergence criteria in the pre conditions for monetary union is unnecessary for two reasons. First, the provisions for the European Union for instance go all the way in assuring that the institution is independent, cannot solicit or accept guidance, and cannot finance governments. In addition, the provision of no bailouts of public debts eliminates an immediate spill over effect of poor public finance to the central bank or country's budgets. Thus, there is no basis for insistence on debt provisions, while the concern for fiscal probity is not justifiable by the need for sound monetary policy. But Eichengreen and Wyplosz (1998) contend that the main justification for explicit fiscal restraints is that prohibition against bailouts in some form is never ironclad especially for countries with weak monetary and fiscal institutions that also lack strong public support for low inflation. Consequently, formal rules are in danger of being set aside. Large fiscal deficits make it more likely

that the point would be reached that the central bank, despite its formal statutes, might yield to pressures for bailout. This could come either in form of monetary financing, or through lowering interest rates, thus lowering government's interest cost and ultimately inflating away the real value of the debt.

Masson (1996) maintains that the latter channel would be especially difficult to rule out by statute, since there could be other plausible arguments for loosing monetary policy (or not tightening it in the face of inflationary pressures). Furthermore, he argued that a country in a monetary union with an overhang of debt would be vulnerable to adverse shocks, even if it's fiscal deficits were currently under control. An unsustainable level of debt would raise the dilemma for the central bank of choosing between allowing a government to default and bailing it out. In addition, fiscal criteria signal the country's willingness to adhere to the constraints of monetary union. Inability to satisfy the criteria would indicate that the country was unlikely to maintain policies necessary to remain in the monetary union in the face of unfavourable shocks.

The experience of the WAMZ countries in the last four years has clearly shown that there exists a high level of correlation between fiscal deficit and the attainment of other convergence criteria. The data show that countries that financed deficits by borrowing mainly from the central banks experienced high inflation and negative real interest rates as well as exchange rate instability (WAMI, 2003). Finally the antecedents of large budget deficits and inability to service external debt suggest that it will be important to apply the criteria for membership of the monetary union in the WAMZ.

III FISCAL CONVERGENCE IN THE WAMZ: Apraisal of WAMZ Experience

Like most developing countries, expenditure that exceeded revenue characterizes WAMZ members. Consequently, all members recorded a deficit. There was also a

sizable gap between deficit including and excluding grants - indicating the significance of grants in financing deficit. Foreign financing of the deficit varies across members. In some countries it reached as high as 60 percent of total expenditure while in others it is insignificant. Tax revenue is an important source of government revenue in the WAMZ. In what follows attempt is made to assess the fiscal performance of the WAMZ with respect to the convergence criteria.

(i) Budget Deficit/GDP Ratio

This criterion requires members' budget deficit (excluding grants)/GDP ratio to be limited to 5 percent by 2000 to 2001 and 4 percent from 2002. Analysis of countries efforts under this criterion from 2000 to 2003 shows a deteriorating performance. The Gambia and Nigeria satisfied this criterion in 2000. In 2001 and 2002 none of the WAMZ member countries conformed to the requirement of this criterion. In The Gambia, the ratio deteriorated from 3.6 percent in 2000 to 9.8 percent in 2001, and 9.4 percent in 2002, but improved marginally to 8.1 per cent in 2003. Nigeria's performance trailed the same pattern, from 2.5 percent in 2000 to 5.4 percent in 2001 and 2002, before improving to 2.9 per cent in 2003. In Ghana, the ratio nudged from 10.1 percent in 2000 to 13.1 percent in 2001, but decelerated to 7.9 and 7.7 percent in 2002 and 2003, respectively. Guinea's performance was not impressive. From 5.2 per cent in 2000, the ratio worsened to 7.8, 8.3 and 9.6 per cent in 2001, 2002 and 2003, respectively. Sierra Leone's compliance with the criterion has been problematic from 17.3 percent in 2000 to 16.7 percent in 2001, and thereafter rose to 19.7 percent, but decelerated to 16.7 per cent the highest level in the WAMZ. The most worrisome aspect of the emerging scenario is that some countries projections as contained in the national economic agenda/programmes with other development partners, including the IMF seems to ignore the agreed bench marks regarding the convergence performance with respect to this criterion, thus compounding the prospects of satisfying the criterion.

(ii) Central Bank Financing of Budget Deficit

This criterion requires central bank financing of government deficits to be limited to 10 per cent of previous year's tax revenue. With respect to central bank financing of the government budget deficits, only The Gambia and Nigeria continually fulfilled the criterion between 2000 and 2001. By 2002, only Nigeria and Sierra Leone satisfied this criterion. In 2003, country performance plummeted substantially as only Ghana met the criterion while the performances of most countries deteriorated to the lowest level since the commencement of the convergence process. The trend showed 63.0 per cent for the Gambia, 25.4 per cent for Sierra Leone, 18.9 per cent for Guinea and 10.3 per cent for Nigeria. It is instructive to note that Nigeria slipped on the criterion for the first time in 2003. What is clear from the data presented in Table 1 is the lack of consistency in meeting and sustaining this convergence requirement. A distressing feature of country performance under this criterion is that the ability for attaining other convergence criteria is concurrent to country feat on this criterion.

(iii) Tax Revenue/GDP Ratio

The requirement of the convergence criterion regarding the ratio of tax revenue to Gross Domestic Product (GDP) is that the ratio should be at least 20 per cent. Throughout the period 2000-2003, it was only The Gambia, Nigeria and Ghana that met this criterion only once. The Gambia satisfied the criterion in 2000 while Nigeria and Ghana met the criterion only in 2003. A country-by-country assessment of performance under this criterion reveals that The Gambia and Nigeria recorded mixed trend. In the Gambia the ratio dropped from 24.2 per cent in 2000 to 13.9 and 14.6 per cent, in 2001 and 2002, respectively, but nudged somewhat to 17.9 per cent in 2003. In Ghana, the ratio improved consistently, from 16.3 percent in 2000 to 17.2 per cent in 2002, 18.2 percent in 2002 and 20.2 per cent in 2003. The Guinean performance with regards to this criterion also exhibited an improving trend from 10.2 percent in 2000 to 11.1 per cent in 2002, and thereafter dropped to 9.8 per cent in 2003. Nigeria's performance showed a mixed trend. From 16.7 per cent in 2000 to 19.5 percent in 2001, but declined to 13.2 per cent in 2002, before peaking at 36.5 per

cent in 2003. The performance of Sierra Leone followed a similar trend from 10.8 per cent in 2000 to 13.4 per cent in 2001 and 14.5 per cent in 2002 and 14.4 per cent in 2003.

(IV) Wage Bill/Tax Revenue Ratio

Under this criterion member countries are expected to limit wage bill as a ratio of tax revenue to at most 35 percent. The outcome of member countries performance under this criterion has been mixed not just among the countries but also across the years. In the Gambia, the ratio stood at 30.6 per cent in 2000, rose to 39.1 per cent in 2001, but declined to 31.6 per cent in 2003. Thus, The Gambia only met the criterion in 2000. Ghana did not meet the criterion during the review period. Ghana's wage bill/tax revenue ratio ranged from 52.1 per cent in 2000 to 57.2 per cent in 2002 and 49.6 per cent in 2003. Guinea met the criterion in 2002, when the ratio stood at 34.2 per cent. In 2000 and 2001, the ratios were 38.2 and 35.3 per cent, respectively, while the outcome for 2003 was 36.7 per cent. Nigeria met the criterion in the 2000 and ·2001 but failed to meet the criterion in 2002, when the ratio of wage bill to tax revenue deteriorated to 47.2 per cent. However in 2003 there was a marked improvement when the ratio was reduced substantially to 14.6 per cent. For Sierra Leone, the ratio declined from 62.0 per cent in 2000 to 55.0 per cent in 2001 and deteriorated further to 63.2 per cent in 2002, but improved marginally to 59.7 per cent in 2003. The main issue with the attainment of this criterion is the large size of government with very low tax base in the WAMZ countries.

(V) Domestically Financed Public Investment/Total Revenue

Under this criterion member countries are expected to attain a ratio of at least 20 per cent of domestic financing of public investment. With the exception of Nigeria that has consistently met this criterion between 2000 and 2002, and Ghana that met it only in 2000 and 2003, none of the other WAMZ member countries of the zone met this criterion during the review period.

IV ANALYSIS OF PROBLEMS AND PROSPECTS.

There are several outstanding issues regarding fiscal convergence in the WAMZ. The principal issues discussed here include: low tax base, high level of tax evasion, corruption, inefficient tax administration, election cycles, external shocks and over-dependence on external budgetary supports.

LOW REVENUE BASE

The revenue base across the countries is weak due mainly to over dependence on limited revenue sources as well as the sluggish economic growth. Another major cause of the weakness is that the tax administration allows for numerous exemptions and zero rating. Most of the exemptions apply to indirect taxes (excise duties, import duties and sale tax). Exemptions also in some cases, extend to direct taxes. Zero rating is one form of exemptions in the WAMZ. In the case of sale, it applies to basic foods. The aim is to improve the distribution of tax and help to minimize the cascading in the processed food industry. Furthermore, zero rating is also applied to certain industrial inputs and mechinery. The major flaw of this approach is that some goods which were exempted because they are productive inputs, can also be legally used for other purposes. Consequently, there is loss of revenue while the benefits of such exemptions spill over to unintended beneficiaries.

HIGH LEVEL OF TAX EVASION/CORRUPTION

Tax is widely regarded as an essential component of a fair and efficient society. A fundamental principle underpinning tax collection is the liberal social obligation on companies and individuals to pay tax proportionately to their income so as to aid the provision of public goods and enhance social welfare. However, the analogous processes of trade and investment liberalisation and the rise of tax havens have allowed several multinational corporations and wealthy individuals to avoid their

tax liabilities. The internationally integrated nature of these corporations allows them to switch between locations according to the different tax regimes or other benefits on offer. More importantly they can artificially attribute the ownership of assets or the locations of transactions to paper subsidiaries in convenient jurisdictions or havens. This enables them to minimise taxation of business profits at source, and defer home country taxation on retained earnings.

Liberalisation has led an increasing number of countries to engage in a battle to attract foreign investment through offering lower tax rates on capital. This has led to a widespread reduction in tax rates for foreign owned subsidiaries and affiliates of multinational corporations. Corporate tax rates for overseas affiliates operating in the WAMZ countries dropped significantly over the years. This has principally been influenced by the threat to stay away from countries that doesn't propose the right tax incentives. Pressures such as these seriously diminish the capacity of countries to raise adequate taxes through this avenue.

Tax evasion usually involves withholding knowledge of the transactions or of the income from the tax collector. The methods of achieving this are limited only by the ingenuity of the citizen and his accountant on the one hand and the sophistication and efficiency of the tax collector on the other hand. Irrespective however of the sophistication or the ingenuity which makes tax evasion possible, it creates innumerable moral problems, which affect both the individual and, to the degree that tax evasion becomes a norm, the whole of society. In order to minimize one's income and evade the tax, it is necessary to create a large number of subterfuges, to lie consistently, and to keep false records. As often as not, these require collaboration between workers and employees, between suppliers and consumers, indeed between all the factors in the economic world. At the same time, the taxpayer has a problem of what to do with the money; any legitimate use will arouse the suspicion of the tax collector as to the source of this income. Here, too, immoral considerations come into play. Sometimes it is necessary to illegally extradite the money from the economy in which one is operating, and to retain it in secret numbered accounts in

countries set up as tax havens. Sometimes, the money is used in wasteful consumption of articles and of services that the tax collector cannot reach. On the other hand, tax planning also intends to reduce the cost to the firm or to the individual of sharing in the expenses of society. Here, however, nothing illegal is done, rather the ingenuity of the tax payer and his financial associates is geared to finding loopholes in the law or methods of minimizing income within the limits of the fiscal legislation. Tax planning, like tax evasion, enables the citizens to escape their moral obligations of paying for the social costs of the community.

Empirical evidence of large underground economy develops which is funded by the proceeds of tax evasion. It would seem, therefore, that to the degree that it is the high tax rates that produce the evasion, a tax cut should be made for moral reasons. The moral damage of not doing so may be greater than the social damage resulting from a decline in the public sector income. Also, when citizens feel that the tax burden is not distributed fairly and at the same time the public sector authorities waste the tax money through junkets, white elephants, catering to special interest groups, etc., the objection to paying taxes grows, as do the ways of tax planning and tax evasion.

INEFFICIENT TAX ADMINISTRATION

The efficiency of tax administration has a direct link with the size of the tax revenue from tax. That is to state that more efficient tax administration should produce higher tax revenue. The experience in the WAMZ countries clearly reveal that the administration of tax is inefficient. This is further exacerbated by multiple tax authorities and beureacratic redtapism which encourages wastages and perpetuate corruption.

ELECTION CYCLES

One of the outstanding issues here is that in periods preceding elections, high borrowing from the central bank to finance the election usually derail the fiscal framework for the fiscal year. The case is true for all countries of the WAMZ.

OVER - DEPENDENCE ON EXTERNAL BUDGETARY SUPPORTS.

In the last three years fiscal deficits characterize WAMZ members. Indeed for most of the period 2000-2003, all members recorded a deficit (with and without grants). The only exception is Nigeria where surplus was recorded in one of the years, due mainly to oil revenue windfalls. There was also a sizable gap between deficit including and excluding grants - indicating the significance of grants in financing deficit. Foreign financing of the deficit varies across members. In some countries it reached as high as 22 percent of GDP.

The deterioration of the budgetary outlook was basically caused by over dependence on few commodities as the major sources of revenue as well as non-optimasation of tax revenue sources due principally to inadequate tax reforms. In addition, wastefull and/or sub-optimal expenditure due to non or insufficient adherence to the due process in fiscal management on the expenditure side accounted for the observed level of sllipages.

V. THE WAY FORWARD FOR OVERCOMING SOME OF THE PROBLEMS

As indicated earlier, the main obstacle to the move of member states to satisfy the WAMZ convergence criteria is in the compliance with the fiscal criteria, listed above. Most countries have been facing serious difficulties in fulfilling the fiscal criteria since the commencement of the WAMZ programme in 2001 and the outcome in the final year of assessment before accession in 2005 may not be too different.

In order to achieve fiscal convergence and overall sustainability of government revenue, fiscal policy plan should aim at harnessing all direct and indirect tax revenue sources, especially against the background of evidence that most WAMZ countries have not fully exploited their taxable capacity (WAMI, 2003). It is

desirable that tax administration should be efficient, apply simple and codified rules, ensure fairness, and embody progress. Tax administration agencies need to be made functional through employment of qualified personal, staff training, provision of equipment and necessary facilities and overall conducive working environment.

On the expenditure side, it is clear that public expenditure has the potential to contribute significantly to economic growth and development. This is particularly true for the WAMZ countries where the private sector is not yet very well equipped to take the initiatives for growth and development and the government commands the greater part of national resources. However, for public expenditure to contribute meaningfully to growth and development, it has to be prudently managed. Most WAMZ countries expenditure management has not been quite impressive. The present economic crisis, with the attendant problems of high inflationary pressures, exchange rate distortions, debt over long, adverse balance of payments and high unemployment, to mention a few, has been attributed largely to reckless and poor management of public expenditure, complied with widespread corruption in the countries. It is on this note that the current efforts of governments across the Zone in fighting corruption and other related malpractices should be sustained. There is need for government to ensure that the usual gap between policy pronouncements and implementation is bridged. This among the other things calls for good governance as well as transparency and accountability in the use of public resources.

All things considered the prospect of all the countries meeting the fiscal convergence criteria within the stipulated time frame is very challenging. However, as shown in the 2003 performance, when some countries improved on their level of performances in the previous years, it is not impossible. What is important therefore is the sustained commitment to push through the reforms needed to achieve the desired results.

TABLE 1: STATUS OF COUNTRIES' COMPLIANCE WITH THE PRIMARYCONVERGENCE CRITERIA IN 2000-2003

							ota
	771	2003	0,4	4.0	1.8	6.9	6:1
ives Imports)	% i.	2002	5.5	23	2.1	6'6	3.1
Gross Reserves (in months of imports)	71 €	2001	7.3	112	2.8	11.3	23
ā	% i	2000	7.5	8.0	77	13.6	2.8
ŧ.,	×015	2003	63.0	-5.0	98.	10.3	25.4
ng of Bud IX Reven	%0 [>	2002	22.0	. 77	23.9	0.0	6:1
estral Bank Financing of Budg. Deficit Prev. Yr. Tax Revenue	%0I>	2001	0.0	0.0	0.0	0.0	6.0
Central Bank Financing of Budget Deficit Prev. Yr. Tax Revenue	%01S	2000	0.0	57.9	17.6	0.0	32.7
	207	2003	17.6	23.6	14.8	23.8	=3
ion Rate (%01>	2602	13.0	15.2	1.9	12.2	-3.1
Price Inflation Rate (End Period)	<10%	2001	2	21.3	=	16.4	34
Consumer I	<10%	2000	07	40.5	7.2	14.5	-2.00
a	35,	2002	∞	E.7	9.6	23	16.7
d gra	71	2002	9.4	67	2	5.4	19.7
Budget Deficit (excl. grants)	10%	2001	9.8	13.1	8:	5.4	16.7
Budget	\$	2000	3.6	10.1	2.2	2.5	17.3
Primary Criteria	Target		The Gambia	Ghana	Oninea	Nigeria	Sierra Leone

Source: WAMI and Authorities in WAMZ member countries

STATUS OF COUNTRIES' COMPLIANCE WITH THE SECONDARY CONVERGENCE CRITERIA, 2000, 2001, 2002 AND JUNE 2003 TABLE 2

Target ≥20%	Tax Revenue AGDP	e /GDP		Wage	Mill/Tax	Wage bill / Tax Revenue	-	Domestically Financed Public Real Interest Rate (avg savings Investment/Tax Revenue rate - end period inflation)	ally Fina	somestically Financed Publi Investment/ Tax Revenue	ablic R	eal Interest Rate (avg saving rate - end period inflation)	est Rate	d inflati	vings on)	Nomi	nal Exch ciation (Nominal Exchange rate depreciation (Luc/USS)	2
	>20% 3	>20% >20% >20%		<35%	~35% ~35%	43%	35%	435% 435% 435% 220% 220% 220% 220%	7 %02 7 %02	. 7 %0		0 <	9 <	0 <	0 <	> 0 +4.15% +	×15%	*517* +/12% +/12%	757
2000	2000 2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002 2003	2003 e	2000	2001	2002	200
The Gambia 24.2	13.9	14.6	17.9	30.6	40.1	38.0	31.6	4.9	62	8.	32	60	0.1	-5.0	-5.1	28,9	12.1	27.6	32.
Ghana 16.3	3 17.2	18.2	20.2	52.1	52.9	57.2	49.6	23.5	16.4	13.2	43.4	1.5	9.9	-2.2	-13.9	49.2	5.4	13.9	55
Juinea 10.2	2 10.8	=	9.83	38.2	35.3	34.2	36.7	1.1	5.5	10.3	12.1	0.7	2.8	1.3	-8.36	14.6	2.8	0.1	Η.
Nigeria 16.7	7 19.5	132	36.5	34.5	26.4	47.2	14.6	29.3	40.3	30.7	9.6	-1.5	4.0	9:1	-20.6	11.8	3.1	11.9	7.7
Sierra Leone 10.8	8 13.4	14.5	4.4	62.0	55.0	63.2	59.7	4.4	9.9	6.9	10.6	9.3	₹ .	9.0	4	15.4	23.2	=	14.9

Source: WAMI and Authorities in WAMZ member countries

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