FISCAL SPACE FOR STRENGTHENED SOCIAL PROTECTION   **WEST AND CENTRAL AFRICA**

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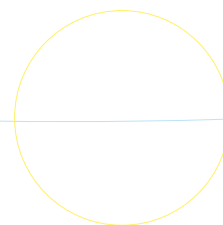# FISCAL SPACE FOR STRENGTHENED SOCIAL PROTECTION WEST AND CENTRAL AFRICA

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LIST OF ACRONYMS

1P	Proven Reserves (of hydrocarbons)
2P	Proven Plus Possible Reserves (of hydrocarbons)
ADF	African Development Fund
AFRREO	Africa Regional Economic Outlook (IMF)
AIDS	Acquired Immune Deficiency Syndrome
BEAC	Bank of Central African States
CEMAC	Economic and Monetary Community of Central Africa
CFA	African Financial Community
CGD	Centre for Global Development
CMDT	Mali Textile Development Company
CPIA	Country Policy and Institutional Assessment (World Bank)
DFID	UK Department for International Development
DSF	Debt Sustainability Framework (IMF)
EITI	Extractive Industries Transparency Initiative
ECOWAS	Economic Community of West African States
FCFA	African Financial Community Franc[1]
FFG	Fund for Future Generations (Equatorial Guinea)
GDP	Gross Domestic Product
HIV	Human Immunodeficiency Virus
HIPC	Heavily Indebted Poor Countries Initiative
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
ILO	International Labour Organization
IMF	International Monetary Fund
IRAI	IDA Resource Allocation Index
LEAP	Livelihood Empowerment Against Poverty (Ghana)
M2	Broad Money
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MTEF	Medium-term Expenditure Framework
NHIS	National Health Insurance Scheme (Ghana)
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
OVC	Orphans and Vulnerable Children
PEFA	Public Expenditure and Financial Accountability
PEM	Public Expenditure Management
PFM	Public Finance Management
SCB	Selective Child Benefit
TCB	Targeted Child Benefit
TCBpt	Targeted Child Benefit with Perfect Targeting
UCB	Universal Child Benefit
UN	United Nations
UNICEF	UN Children's Fund
VAT	Value-added Tax
WAEMU	West African Economic and Monetary Union
WAMZ	West African Monetary Zone
WCARO	West and Central Africa Regional Office (UNICEF)
WDI	World Development Indicators (World Bank)
WEO	World Economic Outlook (IMF)

[1] The CFA franc has a fixed exchange rate with the Euro: FCFA 100 = 0.152449.

PREFACE AND ACKNOWLEDGEMENTS

This is one of a series of reports produced by a regional study on social protection and children in West and Central Africa, commissioned by the United Nations Children's Fund (UNICEF) West and Central Africa Regional Office (WCARO) and carried out by the Overseas Development Institute (ODI) in London between November 2007 and November 2008, in partnership with local researchers in the region.

Social protection is now widely seen as an important component of poverty reduction strategies and efforts to reduce vulnerability to economic, social, natural and other shocks and stresses. It is particularly important for children, in view of their heightened vulnerability relative to adults, and the role that social protection can play in ensuring adequate nutrition, utilisation of basic services (education, health, water and sanitation) and access to social services by the poorest. It is understood not only as being protective (by, for example, protecting a household's level of income and/or consumption), but also as providing a means of preventing households from resorting to negative coping strategies that are harmful to children (such as pulling them out of school), as well as a way of promoting household productivity, increasing household income and supporting children's development (through investments in their schooling and health), which can help break the cycle of poverty and contribute to growth.

The study's objective was to provide UNICEF with an improved understanding of existing social protection mechanisms in the region and the opportunities and challenges in developing more effective social protection programmes that reach the poorest and most vulnerable. The ultimate aim was to strengthen UNICEF's capacity to contribute to policy and programme development in this important field. More generally, however, the study has generated a body of knowledge that we are hopeful will be of wide interest to policymakers, programme practitioners and researchers, both in West and Central Africa and internationally.

Specifically, the study was intended to provide:

- A situation analysis of the current situation of social protection systems and programmes in West and Central Africa and their impact on children;
- An assessment of the priority needs for strengthening social protection systems to reduce poverty and vulnerability among children in the region;
- Preliminary recommendations to inform UNICEF's strategy development in the region.

The study combined a broad desk review of available literature, official documents and data covering the region as a whole on five key dimensions of social protection systems, with in-depth case studies in five countries, resulting in 11 reports produced overall. These are as follows[2]:

Five regional thematic reports:

- R. Holmes and T. Braunholtz-Speight (2009) 'Strengthening Social Protection for Children in West and Central Africa';
- G. Handley (2009) 'Fiscal Space for Strengthened Social Protection in West and Central Africa';

[2] Full titles are listed in the references.

- R. Holmes and A. Barrientos (2009) ' Child Poverty: A role for cash transfers?';
- C. Walsh, with N. Jones (2009) 'Maternal and Child Health: the Social Protection Dividend'; and
- N. Jones (2009) 'Promoting synergies between Child Protection and Social Protection'.

Five country case study reports:

- E. Villar and B. Makosso with R. Holmes, N. Jones and P. Pereznieto (2009) 'Social Protection and Children in West and Central Africa: Case Study Republic of Congo';
- R. Holmes and E. Villar (2009) 'Social Protection and Children in West and Central Africa: Case Study Equatorial Guinea';
- N. Jones, W. Ahadzie and D. Doh (2009) 'Social Protection and Children in West and Central Africa: Opportunities and Challenges in Ghana';
- P. Pereznieto and V. Diallo (2009) 'Social Protection and Children in West and Central Africa: Case Study Mali'; and
- P. Pereznieto and A. Fall (2009) 'Social Protection and Children in West and Central Africa: Case Study Senegal'.

A final synthesis report:

- R. Holmes and N. Jones (2009) 'Child-sensitive Social Protection in West and Central Africa: Opportunities and Challenges'.

EXECUTIVE SUMMARY

This report examines the current situation in five countries in West and Central Africa with regard to fiscal space, with a view to identifying scope for the sustainable financing of additional spending on social protection. It starts from the premise that, although such programmes may be desirable from the point of view of poverty reduction and politically and institutionally possible at sector level, spending decisions need to be taken from a 'whole of government' perspective, explicitly taking into account the need to maintain fiscal and macroeconomic stability.

The definition of fiscal space adopted in this analysis is 'room in a government's budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy' (Heller, 2005). The basic rationale is that such space needs to exist or be created in order for governments to increase spending on national priority areas, which may include social protection, in a sustainable manner. The sustainability of government's financial position (i.e. 'fiscal sustainability') refers to whether current fiscal policy can be continued into the future without threatening government solvency.

Different types of expenditures will have different impacts on the available fiscal space in the medium to long term through their impact on fiscal sustainability. Some expenditures – investments in economic infrastructure, for example – may well boost economic growth, contributing to fiscal sustainability by generating future revenue and perhaps even paying for themselves. On the other hand, some recurrent expenditures may well create entitlements that are politically very difficult to revoke once provided and therefore require fiscal space in future years. Social protection payments may contribute to economic growth by enabling the poor to invest in productive assets and human capital (through investments in their children). However, they may also create costly entitlements that represent a significant contingent liability for the state, particularly if poorly administered so as to undermine their growth impact.

Fiscal space is typically allocated to specific expenditures through the national budget process (Schick, 2008). This has a number of implications for how easily and quickly simple affordability in terms of macroeconomic and fiscal aggregates can be converted into budgetary resources, as appropriated by parliament. This fundamental link between fiscal space and public budgets means that fiscal space is a forward-looking, dynamic concept, reflecting the incremental increases in resources available for allocation among competing priorities through future budgets. Further, most budgeting is inherently incremental and only a very small percentage of the budget is reallocated to new policy initiatives (such as a new social protection scheme) from year to year: the government's annual 'margin of manoeuvre' is typically no more than 5% of total budgeted expenditure. The central question for most countries in the region, except for a few oil-rich countries in the Gulf of Guinea, is not whether they have surplus funds available today, but whether they have the capacity to build that space gradually, perhaps finding around 1-2% of GDP over the next five to 10 years.

It is important to note the central importance of politics in the allocation of fiscal space. Good practice rightly emphasises the central role of domestic political processes in deciding where public funds are spent – and ideally these trade-offs should be formalised within a policy-based budget process. New social protection programmes therefore require 'political space' as well as fiscal space. Moreover, the 'politics' of public finance management in many developing countries is such that the formal budget process often bears an imperfect relation to the reality of budgetary decision making and expenditure allocation. These political considerations mean that, even where prospective fiscal space is identified, there may not be corresponding political commitment within the executive to pursue reallocation, or that available funds may be used for political or clientelist purposes rather

than for developmental ends. Purely technocratic calculations of fiscal space disregard the political dimension of decision making around the budget. These issues are explored further in the in-depth case studies (on the Republic of Congo, Equatorial Guinea, Ghana, Mali and Senegal) that form part of this larger research initiative.

In this regional overview, an indicative framework is provided that highlights key macroeconomic and fiscal factors that should be taken into account in identifying potential fiscal space, with a backward look at recent trends among the five case study countries[3]. The framework includes six principal mechanisms for the creation of fiscal space: (i) **increasing revenue** through two main channels: increased economic activity, i.e. real growth in gross domestic product (GDP) and increases in the average tax yield as a proportion of GDP; (ii) **reallocating spending** from lesser to higher priorities and from lesser to more effective and productive programmes; (iii) **reducing debt** by writing off all or part of a country's debt stock with a view to freeing up resources that would otherwise be spent on meeting government's future debt service obligations; (iv) **increasing borrowing** from either external or domestic sources; (v) **increasing aid** in the form of grants and concessional loans; and (vi) **seignorage**, or generating revenue by money creation.

However, although fiscal space can be created relatively easily over the short term, the real challenge lies in **sustaining** it – i.e. creating fiscal space that lasts. This is particularly important in the context of social protection, which requires governments to enter into long-term recurrent commitments that are politically very difficult to revoke. The nature of these commitments demands prudent choices in means of generating fiscal space. Of the six mechanisms highlighted above, **increasing revenue and reallocating spending** would appear to offer the best options for national government policymakers seeking to build lasting fiscal space for social protection. The analysis here therefore focuses on these two mechanisms in particular. In addition, we follow Heller (2005) in complementing the analysis of possible avenues for the creation of fiscal space with an examination of prospects that additional spending can be properly managed and that the macroeconomic framework can withstand the increases in demand pressures that increased public spending is likely to stimulate.

Applying this framework to the five case study countries and taking into account the results of quantified simulations of the cost of alternative social protection programme options in these countries, the following tentative conclusions can be drawn regarding fiscal space for social protection (although they should be read in conjunction with the more detailed analysis provided by the country case studies, which are crucial to understanding the deeper political and institutional determinants):

- **Congo:** Headline figures suggest that Congo shows significant potential fiscal space. It has seen sustained economic and revenue growth as a result of an oil boom, but with a very low non-oil tax to GDP ratio of 5.3% in 2005. Total expenditure averaged 30.6% of GDP over the period 1997-2008, although this has fallen in recent years and in 2008 was projected to be the lowest of the five case study countries, at 22.7% of GDP. In 2005, non-discretionary expenditures were relatively high, at around 9.1% of GDP. The key macroeconomic and fiscal aggregates suggest that a universal child benefit would be affordable, costing 2.0% of GDP compared with an overall fiscal surplus of 11.1% of GDP in 2007. However, the very low levels of health and education spending (2.2% and 1.2% of GDP, respectively) suggest weak government commitment to converting oil wealth into fiscal space for improved social service provision, and poor performance on measures of institutional quality imply that managing social protection expenditures and programme delivery may prove challenging.

[3] For a more 'forward-looking' approach that makes projections regarding future fiscal space in Mali, see IMF (2006b).

- **Equatorial Guinea:** This is by far the strongest candidate country for the affordability of social protection provision, benefiting as it does from vast oil wealth. The economy is now 20 times larger than in the mid-1990s, although the non-oil tax revenue to GDP ratio is extremely low, at 1.6% of GDP in 2005. Despite having the highest non-oil deficit in sub-Saharan Africa, there is clearly potential for additional expenditures, particularly those that enhance the productivity of the non-oil economy (as social protection may well do). Indeed, the estimated costs of social protection are relatively low for Equatorial Guinea when expressed as a proportion of GDP – both a universal child benefit and universal social pension could be provided for a combined cost of around 1% of GDP, while the overall fiscal surplus in 2007 exceeded 22% of GDP. However, although social protection is clearly affordable in simple aggregate terms, it is not immediately clear whether sufficient organisational capacity exists to develop and administer social protection programmes in light of the country's very low government effectiveness scores (of the case study countries, Equatorial Guinea scored lowest on government effectiveness in 2005). Overall, social protection is certainly affordable for Equatorial Guinea, but the feasibility of undertaking the associated institutional reform required to deliver social transfer programmes requires further investigation.

- **Ghana:** In the short term, the government of Ghana is probably the least able to afford additional spending on social protection among the case study countries, notwithstanding possible future growth and revenues associated with the exploitation of recently discovered oil reserves. Revenue is already high as a proportion of GDP, as is total expenditure, which averaged 30.6% of GDP over 1997-2008. In terms of the composition of expenditures, a relatively large share is taken by non-discretionary expenditures (10.8% of GDP), partly as a result of rapid growth in wages and salaries in recent years. Wages and salaries constituted around 28% of total expenditure in 2005 and there is strong political resistance to reducing this share. However, Ghana has already shown willingness to spend on social protection: the addition of 2.5% to the value-added tax (VAT) rate in 2004 to finance the new national health insurance scheme (NHIS) and relatively high scores on institutional quality measures suggest that, were Ghana to create fiscal space, it would be spent relatively well (although there would be a number of competing policy options, such as the need to address infrastructure bottlenecks). A child benefit, even if targeted to children in households below the poverty line, would be difficult to afford, as would a social pension (at an estimated cost of around 14% of recurrent expenditure and 3% of GDP per year). An alternative option might be to consider an expansion of the recently launched Livelihood Empowerment Against Poverty (LEAP) cash transfer programme to cover all extreme poor households – at present it is planned to reach only one-sixth of extreme poor households within five years, based on a very narrow form of categorical targeting.

- **Mali:** Economic and revenue performance in recent years has been good, with a 4.6% rate of real economic growth over the period 2000-2007 and average revenue growth of 12.2% per year over the period 2002-2005. The revenue yield (tax revenue to GDP ratio) was 15.8% in 2005, suggesting some room for an increase when compared with levels in Ghana and Senegal. Total expenditure as a percentage of GDP averaged 23.5% over the period 1997-2008, and was projected to reach 26.9% in 2008, second only to Ghana among the case study countries. Within total expenditure, non-discretionary expenditures comprise a relatively small share (equivalent to 5.5% of GDP in 2005, compared with discretionary expenditure at 19.7% of GDP), which suggests there may be some scope for reallocation within the overall expenditure envelope. Cost estimates suggest that a targeted child benefit using a proxy means test could be provided at a cost of around 3.2% of GDP, which is unlikely to be affordable, given that this would be equivalent to Mali's entire public health expenditure (3.2% in 2004), while the overall fiscal deficit (including grants) was 3.8% of GDP in 2007. Only a more modest scheme (perhaps targeting the extreme poor with a lower benefit level) would be feasible in the short to medium term.

- **Senegal:** With annual tax revenue averaging 9.9% over 2002-2005 (the lowest level among the case study countries) and revenue yields already relatively high (tax revenue accounted for 18.8% of GDP in 2005), there is limited scope for creation of fiscal space through revenue generation. The overall size of the public sector in relation to the economy as a whole is also relatively high, as total spending averaged 24.8% of GDP over 2003-2007. Reallocation – rather than increases in total spending – may be an area where fiscal space could be created, as discretionary spending stood at 17.8% of GDP in 2007. Still, a very substantial portion of budgetary resources would need to be freed up, as estimates suggest that social protection would be relatively expensive for Senegal. A targeted child benefit, using a proxy means test, would cost around 3.7% of GDP, which would be much higher than total public health spending (2.4% of GDP in 2004). As with Mali, more modest schemes may need to be investigated.

The overall picture is therefore one of two broad country groups. First, the oil-rich countries of the Gulf of Guinea (including Congo and Equatorial Guinea) present a special case. As a result of soaring global oil prices and, in some cases, increases in the volume of oil production, these countries already have substantial available resources, with large overall fiscal surpluses (almost 10% of GDP in the case of Congo and Gabon and over 20% in the case of Equatorial Guinea in 2007). They also have low non-oil tax yields, which might be increased in the future. They thus have ample resources to finance additional expenditures on social protection, including a universal child benefit. At the same time, these countries have the lowest proportions of public spending on the social sectors and the lowest measures of institutional quality, suggesting that simple affordability is not the key barrier to the expansion of social protection. Rather, the main barriers are political and institutional in these countries, as evidenced by very low scores on measures of institutional quality. A further key consideration for these countries is the sustainability of increased levels of expenditure (for example to finance new or expanded social protection programmes), given the volatility of the oil market and oil's nature as a finite resource. The fiscal sustainability of increased expenditures therefore relies upon both the diversification of these countries' narrow oil-based economies and the building up of reserves (through a Norwegian-style oil fund, for example) to smooth revenues and finance future investments.

The three aid-dependent economies (Ghana, Mali and Senegal) form a second group, for which affordability is more of a problem. These countries spend a larger share of public resources on the social sectors, but tax yields and public spending are close to the limits of 'recommended' thresholds for fiscal and macroeconomic sustainability (all three had fiscal deficits including grants of 3.8% of GDP or more in 2007, for example). In these countries, measures of institutional quality are higher than in the oil-dependent countries (although still low by international standards) and it may prove possible to generate sustainable fiscal space for more modest social protection programmes over a five- to 10-year period, through increased revenues and some reallocation of expenditures, coupled with a strengthened medium-term perspective and policy focus in the budget process.

1. INTRODUCTION

Social protection systems have historically been weak and under-resourced in most of sub-Saharan Africa, with total spending of around 0.1% of gross domestic product (GDP). This is significantly below expenditure in the sector in other parts of the world, such as the Middle East and North Africa, where the average is approximately 5.7% of GDP (Coudouel et al., 2002). This report examines the current situation in the West and Central Africa region with regard to fiscal space, with a view to identifying scope for the additional financing of social protection systems and individual programmes and assessing whether there is the potential to raise expenditure on social protection in some or all of the countries in the region in a sustainable manner.

Fiscal space is important to this study. While the analysis in the other thematic reports that make up this regional study may conclude that scaling-up of spending on social protection is both desirable from the point of view of poverty reduction and politically and institutionally possible at sector level, it is crucial to have a rough indication of its feasibility from a macroeconomic and fiscal perspective. That is, spending decisions need to be taken from a 'whole of government' perspective, explicitly taking into account the need to maintain fiscal and macroeconomic stability which, among other factors, can ensure the sustainability of social protection systems in the medium and long term.

It is important to note at the outset the limitations inherent in a primarily quantitative analysis of countries with very limited statistical coverage. Of the 24 states in the West and Central Africa region, 14 were classified as fragile by the World Bank in 2007 (of a total of 34 fragile states worldwide). This is a hallmark of low state capacity, with implications for the availability of robust financial statistics. As a result, the following analysis is often based on scattered and potentially inconsistent data sources and is therefore indicative of broad trends and does not claim a high degree of precision. This does not invalidate the analysis: it simply means we should be aware of the limitations inherent in the coverage and quality of the data.

The major data sources employed for the analysis were: (i) the World Bank World Development Indicators (WDI) online database (April 2008)[4]; (ii) the International Monetary Fund (IMF) World Economic Outlook (WEO) database (April 2008)[5]; (iii) IMF staff estimates (as set out in IMF country analysis such as Article IV reports)[6]; (iv) the IMF's Africa Regional Economic Outlook (AFRREO) (April 2008)[7]; (v) the Heavily Indebted Poor Countries (HIPC) Public Expenditure Management (PEM) performance indicators; and (vi) the International Development Association (IDA) Resource Allocation Index (IRAI)[8]. Data sources are cited alongside tables and figures.

Judgments on fiscal space are inherently country specific, requiring detailed assessments of the position with regard to the eight criteria identified in Table 1 below. This report undertakes that analysis for the five case study countries: the Republic of Congo (henceforth Congo), Equatorial Guinea, Ghana, Mali and Senegal.

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[4] http://ddp-ext.worldbank.org/ext/DDPQQ/member.do?method=getMembers&userid=1&queryId=6 (subscription only).

[5] http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx.

[6] IMF Article IV Staff Reports are usually compiled once a year following a visit to the member country by IMF economists to gather information and hold discussions. They provide a comprehensive assessment of the national economy. See references for more information.

[7] http://www.imf.org/external/datamapper/index.php.

[8] http://www1.worldbank.org/operations/IRAI/2007/IRAI2007table1.xls. The IRAI is based on the World Bank's Country Policy and Institutional Assessment (CPIA) indicators.
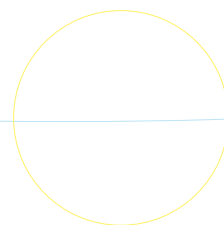
Section 2 sets out definitions of fiscal space and the related concept of fiscal sustainability. **Section 3** discusses some key characteristics of fiscal space and **Section 4** establishes an indicative framework to highlight some of the key macroeconomic and fiscal considerations for creating and sustaining fiscal space and how we might assess whether additional spending would be well used or might undermine macroeconomic stability. **Section 5** presents cost estimates for different social protection policy options drawn from simulations run for the case study countries and **Section 6** goes on to discuss the situation in the five case study countries against each dimension of the indicative framework. Finally, **Section 7** summarises the potential for fiscal space in each of the five countries. The report ends with a glossary of key terms for the analysis of fiscal space, followed by two **annexes** on indicators of fiscal space in the country case studies and the politics of reallocation in Ghana.

2. DEFINING FISCAL SPACE

At a general level, fiscal space refers to 'the ability of government to make budgetary resources available for desired purposes' (Hay and Williams, 2005). It is not a new concept; rather, governments have always had to face the challenge of how to finance policy priorities. It has come into common usage in recent years in order to support agendas for the scaling-up of aid and public spending in least developed countries.

In order to use the concept to undertake analysis, a more precise definition is required; here, there are different definitions in use in the literature. This is because different authors have emphasised different objectives through the use of the term fiscal space depending on their respective agendas. For example, some observers have stressed its usefulness as a means to finance additional borrowing for public investment (see Hemming and Ter-Minassian, 2004, for a discussion). Others have sought to use it as an advocacy tool for increased spending towards the achievement of the Millennium Development Goals (MDGs), playing down the importance of fiscal constraints (Brun et al., 2006; Roy et al., 2007). Roy et al. (2007) adopt the following definition: 'Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives.'

Fiscal space has also been defined as the 'room in a government's budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy' (Heller, 2005). The basic rationale is that such space needs to exist or be created in order for governments to increase spending on national priority areas, which may include social protection, in a sustainable manner[9]. The sustainability of a government's financial position (i.e. 'fiscal sustainability') refers to whether current fiscal policy can be continued into the future without threatening government solvency (Chalk and Hemming, 2000). An important point to note in this definition is that fiscal space means nothing as a concept independent from the national budget, i.e. it is inherently linked to the budgetary process.

The two broad definitions of fiscal space outlined above imply very different approaches. The former starts with a normative needs-based assessment of resources required to meet the MDGs, whereas the latter starts with a positive assessment of resources already available[10]. In this paper, we adopt the latter definition, not least because if the Paris Declaration's emphasis on ownership is to be implemented, it is important to resist the temptation to occupy the available fiscal space for developing country governments: fiscal space should be used to free up policy space for nationally determined policy priorities.

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[9] In the long term, the main source of fiscal space is economic growth. The concept of fiscal space is therefore often accompanied by the argument that the additional spending should be focused on areas that boost growth, thereby increasing future fiscal revenues and hence wholly or partially paying for itself. This is not explicitly considered here, although there is considerable evidence that social protection can contribute to economic growth rates by increasing investment by the poor in productive assets and human capital development.

[10] See Alexander (2007) for a discussion of the political origins of 'fiscal space' among multilateral institutions.

3. CHARACTERISTICS OF FISCAL SPACE

Fiscal space has a number of characteristics that are not immediately apparent from the definition but are important to understand. First, to say that fiscal space exists or might be created for additional expenditures does not mean all or even some of these funds will be spent on social protection: the allocation of fiscal space obviously depends on national political priorities. Although aid is often earmarked for specific sectors, fungibility limits the extent to which the additional funding is spent in the targeted area. For example, a study on fiscal space for the health sector concludes that the effect of additional aid on health expenditures has been quite small: empirical analysis suggests that only 3.6% of each additional dollar of aid has been spent on health (Hay and Williams, 2005).

While fiscal space cannot easily be tied to a specific sector, increased expenditures in a particular sector do influence the available fiscal space. Moreover, different types of expenditures (variations in the composition of public expenditure) will have different impacts on the available fiscal space in the medium to long term through their impact on fiscal sustainability. Some expenditures – investments in economic infrastructure, for example – may well boost economic growth, contributing to fiscal sustainability by generating future revenue and perhaps even paying for themselves. On the other hand, some recurrent expenditures may well create entitlements that are politically very difficult to revoke once provided and therefore require fiscal space in future years too. Where such expenditures are initially financed by aid, this may create a fiscal obligation that the government has to meet once the aid is phased out. Social protection payments may contribute to economic growth through a number of channels. They may also create costly entitlements that represent a significant contingent liability for the state.

Fiscal space is typically allocated to specific expenditures through the national budget process (Schick, 2008). This has a number of implications for how easily and quickly simple affordability in terms of macroeconomic and fiscal aggregates can be converted into budgetary resources, as appropriated by parliament. Public finance management (PFM) good practice argues strongly for predictable expenditure plans linked to government policy priorities, for a credible budget that ensures consistency between appropriation and execution and for budget comprehensiveness, so that all government revenues and expenditures are included in a single budgeting process and subject to (annual) appropriation by parliament[11]. Good practice deliberately constrains arbitrary or selective reallocation in the short term, except for urgent and unforeseen expenditure requirements that could not reasonably have been planned for during the budget process (Hedger et al., 2008). Decisions such as the adoption of a substantial social protection scheme do not typically fall into this category – indeed, they require particularly long-term planning. Thus, fiscal space for newly introduced social protection programmes only exists in future years as provided through the government budget process. It is also important to bear in mind that there will be intense competition from other government spending entities over any fiscal space that becomes available within the budget.

This fundamental link between fiscal space and public budgets and the associated principles of good PFM practice has immediate implications for the nature of fiscal space. In particular, it means that fiscal space is a forward-looking, dynamic concept, reflecting the incremental increases in resources available for allocation among competing priorities in future budgets. Figure 1 provides a stylised (and somewhat exaggerated) illustration of how fiscal space or budgetary 'room' might open up over time. Within the current fiscal year, there will be little or no fiscal space, depending on the flexibility of budget ceilings. In year t+1,

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[11] See, for example, Schick (1998a) and Schiavo-Campo and Tommasi (1999).

while non-discretionary expenditures are likely to continue to grow, one-off expenditures such as certain capital expenditures will start to reduce and revenue can be expected to increase as a function of economic growth (and possibly higher tax yields). In this way, fiscal space begins to emerge between the profile of total available resources and the government's total existing commitments. For most countries in West and Central Africa, the central question is not therefore whether they have surplus funds available today, but whether they have the capacity to build that space gradually (perhaps finding around 1-2% of GDP) over the next five to 10 years. In certain oil-rich countries in the Gulf of Guinea, however, the central question is rather different. They already have substantial fiscal surpluses, raising the question as to whether they could use part of this surplus to expand social protection while ensuring long-term fiscal sustainability.

It is important to note that the 'rigidity' or 'stickiness' of public sending means that only a very small percentage of the budget is reallocated to new policy initiatives (such as a new social protection scheme) from year to year. Schiavo-Campo and Tommasi (1999) note that the annual 'margin of manoeuvre' is typically no more than 5% of total budgeted expenditure. Debt repayments, interest payments and transfers and subsidies are all inflexible or non-discretionary (i.e. their costs cannot be avoided in the short to medium term). Greater discretion may exist in practice to reduce or divert planned capital spending, especially in response to shortfalls in aid flows, but the consequences for economic growth and development may be severe in the longer term. In some cases, such funding is ring-fenced or earmarked to prevent such reallocation. Operations and maintenance spending is a frequent candidate for 'flexibility' but there are well-documented dangers in failing to fulfil the recurrent cost implications of capital expenditure. While public sector wages and salaries are technically discretionary expenditures (i.e. outlays where the amount spent is under government control), they are often de facto non-discretionary in nature as there are severe political constraints to reductions in such expenditures over the short to medium term.

Figure 1: Poverty rates in West and Central Africa
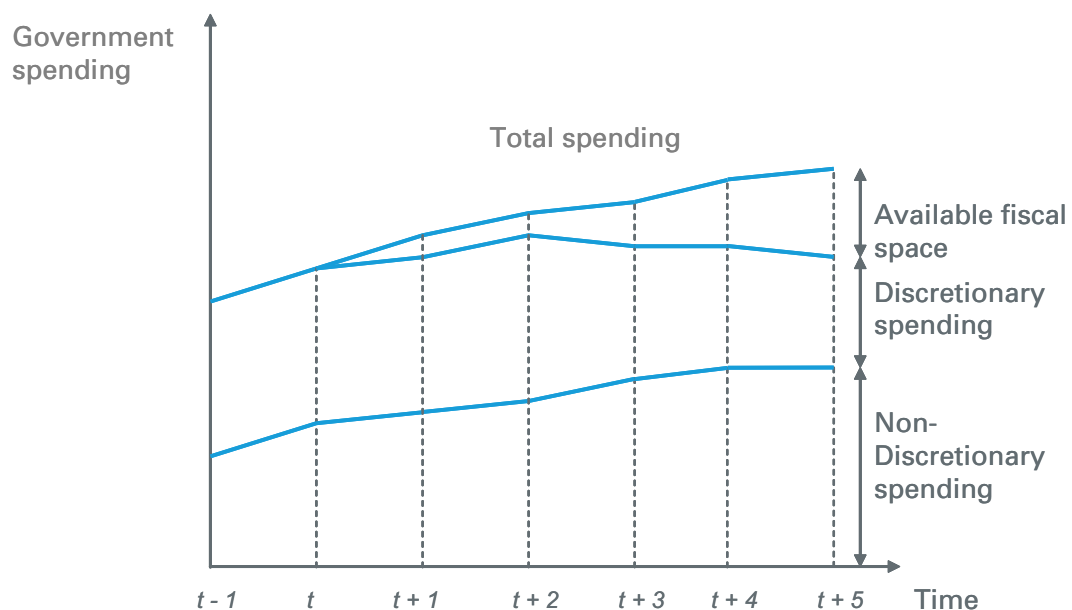
The government's ability to identify the available fiscal space and allocate it to priority expenditures therefore depends on the quality of budgetary institutions and, in particular, the credibility of the annual budget (i.e. that budget execution does not deviate substantially from budget appropriation), the existence of a medium-term perspective in the budget formulation process and, ideally in the case of long-term spending commitments, some long-term budget projections. Many developing countries struggle with even the first of these three criteria (see Section 6.7). As regards the adoption of a medium-term perspective, this is usually provided through the use of medium-term expenditure frameworks (MTEFs), although the extent to which these approaches to budgeting have taken hold in sub-Saharan Africa is somewhat limited (Le Houerou and Taliercio, 2002). Long-term budget projections are at present only made by a handful of developed countries (Ulla, 2006).

Finally, one must consider the central importance of politics in the allocation of fiscal space. Good practice rightly emphasises the central role of domestic political processes in deciding where public funds are spent – and ideally these trade-offs should be formalised within a policy-based budget process. New social protection programmes therefore require 'political space' as well as fiscal space. Moreover, the 'politics' of PFM in many developing countries is such that the formal budget process often bears an imperfect relation to the reality of budgetary decision making and expenditure allocation (Santiso, 2007). For example, strongly 'clientelist' political systems may distort the profile of expenditure in favour of sectional interests and patronage networks. These political realities will tend to resist development-oriented fiscal flexibility, at least in the short term. In extreme cases, the formal budget process becomes almost entirely ritualistic, masking the reality of a shadow allocation process driven by patronage and preferences antithetical to development-oriented public policy[12]. These political considerations mean that, even where prospective fiscal space is identified through efficiency gains or discontinuation of low-priority/poorly performing programmes, there may not be corresponding political commitment within the executive to pursue reallocation. Purely technocratic calculations of fiscal space disregard the political dimension of decision making around the budget. The analysis here does present some aggregate indicators of institutional quality such as those used in the World Bank's CPIA, but meaningful consideration of these crucial political dimensions of the fiscal space question require in-depth case studies and cannot be addressed through a desk-based study such as this.

[12] See for example Killick (2004; 2005) on the politics of the budget process in Ghana, one of the strongest performers on measures PFM in the entire West and Central Africa region.

4. AN INDICATIVE FRAMEWORK FOR ANALYSING FISCAL SPACE

There are three core components of an analysis of available or potential fiscal space for social protection: (i) whether fiscal space exists or how it can be created; (ii) whether such fiscal space is sustainable; and (iii) the expenditure quality and macroeconomic feasibility of the use of that fiscal space. In order to assess whether fiscal space might be created in a given country, it is necessary to examine overall macroeconomic and fiscal aggregates and associated risks. This can be done with reference to a number of recognised indicators covering different dimensions of macroeconomic and fiscal sustainability. Six principal mechanisms have been highlighted in the literature for developing countries (Hay and Williams, 2005):

(i)   **Increase revenue** through two principal channels: increased economic activity (real GDP growth) for a given tax system and structure and increases in revenue yields (average tax burden as a proportion of GDP). The latter may involve the creation of new taxes, higher tax rates, improved tax administration or a broadening of the tax base (for example, Ghana's 2007 budget noted that, of five million potential tax payers, only one million were paying income taxes). While some limited gains are possible as a result of such reforms, the former channel (economic growth) is the key medium- to long-term engine of higher revenues.

(ii) **Reallocate spending** from lesser to higher priorities and from less to more effective and productive programmes. This may also include realising efficiency gains, although this is not explicitly discussed here owing to paucity of comparable data and time constraints. As well as freeing up fiscal space, reallocation should improve allocative efficiency (i.e. the strategic prioritisation of expenditure across policies, programmes and projects in line with government priorities).

(iii) **Reduce debt** by writing off all or part of a country's debt stock with a view to freeing up fiscal space for developmental spending that would otherwise have been spent on meeting government's future debt service obligations. The HIPC initiative and the Multilateral Debt Relief Initiative (MDRI) discussed in Section 6.3 are examples of this approach.

(iv) **Increase borrowing** from either external or domestic sources. This in turn limits future fiscal space, as it implies future debt service obligations and can also result in the crowding out of private sector borrowing and hence lower growth. In order to minimise the negative impacts of borrowing on fiscal space, countries often operate a 'golden rule', which requires balancing the recurrent budget and borrowing only for investment (which it is hoped will more than pay for itself through returns to investment). Thus, while borrowing heavily to finance infrastructure investments may well be justified, social protection payments are recurrent in nature and it is clearly inadvisable to borrow in order to finance them, even though they may also contribute indirectly to growth by enabling the poor to invest in human capital and productive assets.

(v)   **Increase aid** in the form of grants and concessional loans. The fiscal space created by aid depends on the level, duration and predictability of donor spending as well as on the 'fiscal rule' used by the ministry of finance when budgeting. Most ministries of finance ensure that total revenue is greater than or equal to recurrent spending so that they are insulated from the costs of the unpredictability of grant aid. It is less politically costly to defer capital expenditure than to fail to pay wages and salaries and debt service payments. This means that recurrent expenditures such as social protection are rarely if ever financed by aid (including budget support), irrespective of any earmarking donors may impose. This is the case in all five case study countries – see Figure 8.

(vi) **Seignorage**, or the revenue generated by money creation, comes from the fact that those who hold currency or similar domestic claims on the central bank are giving an interest-free loan to the bank. This is transferred to the government as central bank profits or below-market loans (CGD, 2007). Its usefulness as a sustainable source of fiscal space is constrained, however (see discussion in Section 6.6 below).

Although fiscal space can be created relatively easily by most governments over the short term, the real challenge lies in sustaining fiscal space – i.e. creating fiscal space that lasts. This is particularly important in the context of social protection, which requires governments to enter into long-term commitments that are politically very difficult to revoke[13]. The very long-term nature of these recurrent commitments demands prudent choices of means in generating fiscal space. Of the six mechanisms highlighted above, the first two would appear to offer the best options for national government policymakers seeking to build lasting fiscal space. The following analysis therefore focuses on these two mechanisms in particular.

As regards the expenditure quality and macroeconomic feasibility of the use of fiscal space, we follow Heller (2005) in complementing the analysis of possible avenues for the creation of fiscal space with an examination of prospects that additional spending can be properly managed and that the macroeconomic framework can withstand the increases in demand pressures that the creation of fiscal space (and hence increased public spending) is likely to stimulate. Table 1 lists these six mechanisms for creating fiscal space together with the two measures of use and feasibility as well as associated indicators.

The oil-rich countries of the Gulf of Guinea present a special case. As a result of soaring global oil prices and in some cases increases in the volume of oil production, these countries already have substantial available resources, with large overall fiscal surpluses (almost 10% of GDP in the case of Congo and Gabon and over 20% in the case of Equatorial Guinea in 2007). The key question for these countries is the sustainability of increased levels of expenditure (for example to finance new or expanded social protection programmes), given the volatility of the oil market and oil's nature as a finite resource. The analysis of fiscal space needs to take into account the challenge of diversification of these narrow oil-based economies and the importance of building up reserves (through a Norwegian-style oil fund for example) to smooth revenues and finance future investments.

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[13] In this sense, they become an implicit liability that the government is obliged to meet in future years owing to domestic public expectations and associated political pressures (Polackova, 1998).

Table 1: Creating, sustaining and using fiscal space - An indicative framework

#	Mechanism/measure	Indicators
1	Mobilisation of domestic revenues (tax measures, strengthening tax admin.)	• Real GDP growth (% p.a.) • Tax revenue growth (annual % change) • Tax yield (tax revenue as % of GDP)
2	Reallocation between sectors (cut lower priority expenditures to make room for more desirable ones) and efficiency gains	• General government final consumption expenditure (% of GDP) • Non-discretionary spending (wages and interest) (% of GDP) • Discretionary spending (% of GDP) • Public education expenditure (% total government expenditure) • Public education expenditure (% GDP) • Public health expenditure (% GDP) • Military expenditure (% GDP)
3	Increase discretionary expenditure through debt reduction	• HIPC completion point? • Net present value external debt stock (% GDP)
4	Increase borrowing (from domestic or external sources)	• External debt service (% exports of goods and services) • Total government debt service (% government revenue)
5	Increase aid	• Official grants (% of GDP) • Official grants (% of central government expenditures)
6	Seignorage (central bank prints money in order to lend it to the government)	• Broad money (money and quasi money or M2) as % of GDP • Inflation (average consumer prices, annual % change)
7	Prospects that additional spending can be properly managed	• IMF/World Bank assessment of HIPC PEM: number of indicators out of 15 fulfilled • Selected CPIA scores on economic management and public sector management and institutions • Government effectiveness
8	Prospects that additional spending will endanger macroeconomic and fiscal sustainability	• Credit to the private sector (% of GDP) • Current account deficit including grants (% of GDP) • Overall fiscal balance, including grants (% GDP) • Overall fiscal balance, excluding grants (% GDP) • Non-oil fiscal deficit (% non-oil GDP)

Sources: Hay and Williams (2005) and Heller (2005).

5. HOW MUCH FISCAL SPACE DOES SOCIAL PROTECTION REQUIRE?

In examining fiscal space for social protection, it is useful to ask at the outset how much fiscal space is required in order to finance social protection schemes? Clearly, the answer depends very much on the type of scheme adopted and the demographic profile of the beneficiary population. Estimates for seven low-income countries in sub-Saharan Africa developed in recent work by the International Labour Organization (ILO) (Pal et al., 2005) suggest that (universal) social assistance requires around 3% of GDP, comprising around 1% of GDP to provide a social pension and 1-2% for a child school-related transfer, whereas targeted pensions and school transfers could be provided at a fraction of this cost, although usually with high inclusion and exclusion errors[14]. In addition, social insurance in the form of basic health insurance is estimated to require around 3-4% of GDP. Social assistance is normally tax financed, whereas social insurance has mixed financing from private contributions and government subsidies or cost recovery (with tax financing likely to be needed to cover a fraction of the estimated cost, to meet the health insurance premiums of households in poverty, for example). Overall, we might therefore work with the very rough estimate that roughly 1% of GDP for social assistance and 2% of GDP for social insurance would be needed to provide a social protection package from tax revenues.

For the case study countries, Notten et al. (2008) have provided more detailed estimates for Congo, whereas Barrientos and Bossavie (2008) have done the same for Mali and Senegal. These estimates are based on simulations of two different social protection policy options: (i) a universal child benefit (UCB), involving a payment equivalent to one-third of the food poverty line to every child up to 14 years of age; and (ii) a targeted child benefit (TCB), involving a payment equivalent to one-third of the food poverty line to every child of 0-14 years of age living in a household identified as poor before the transfer (using a proxy means test to identify these households, thereby introducing some error)[15]. It is assumed that the costs of administering and delivering the programmes are 10% of benefit expenditure for the universal child benefit and 15% of benefit expenditure for the targeted programme. Notten et al. (2008) also produced cost estimates for a universal old age pension of FCFA 12,000 per month (i.e. 70% of the food poverty line) with an assumed administrative cost of 10%.

More basic cost simulations have also been undertaken for Equatorial Guinea and Ghana (Barrientos, 2008), which involved simulations of the costs of: (i) a UCB transfer equivalent to 30% of the poverty line to each child of 0-14 years of age (costs of administering and delivering the programmes assumed to be 10% of benefit expenditure); and (ii) a universal social pension transfer equivalent to 70% of the poverty line to each older person aged 60 or over (10% administrative costs)[16]. The estimated costs are very different between the two countries because per capita GDP is much higher in Equatorial Guinea than in Ghana, owing to the former's oil exports (ibid). Targeting of social protection makes little difference to cost in Equatorial Guinea, but significantly reduces costs in Ghana, from 8.7% to 1.7% of GDP for UCB and from 2.6% to 0.5% of GDP for a social pension. Table 2 summarises the monetary costs of the simulations undertaken for the five case study countries.

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[14] The ILO study covered Burkina Faso, Cameroon, Ethiopia, Guinea, Kenya, Senegal and Tanzania.

[15] Barrientos and Bossavie (2008) also simulate a targeted child benefit with perfect targeting (TCBpt), involving a payment equivalent to one-third of the food poverty line to every child of 0-14 years of age living in a household identified as poor before the transfer (where it is assumed hypothetically that these households can be identified without error). This simulation is not discussed here as it is purely hypothetical. In reality, it is impossible to achieve 'perfect' targeting with no inclusion or exclusion errors.

[16] Barrientos (2008) also simulates a UCB transfer with perfect targeting to every child up to the age of 14 in households below the poverty line (with 15% administrative costs) and a targeted social pension transfer equivalent to 70% of the poverty line, with perfect targeting, to elderly people in households below the poverty line (15% administrative costs). Again, these simulations are not discussed here as, in reality, it is impossible to achieve 'perfect' targeting with no inclusion or exclusion errors.
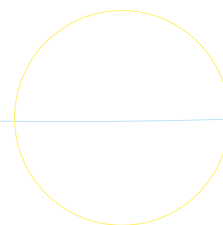
Table 2: Annual programme expenditure cost estimates of child benefit options - Simulations for Congo, Mali, Senegal, Equatorial Guinea and Ghana

Costs	Congo, Republic			Mali		Senegal		Equatorial Guinea**		Ghana	
	UCB	SCB [17]	Social pension	UCB	SCB	UCB	SCB	UCB	Social pension	UCB	Social pension
FCFA billion	91.8	54.3	45.5	211.2	116.2	232.1	135.7	N/A	N/A	N/A	N/A
% of GDP	2.0	1.2	1.0	5.9	3.2	6.4	3.7	0.9	0.2	8.7	2.6
% of recurrent expenditure*	16.7	9.9	8.3	42.8	23.5	30.0	17.6	20.8	5.0	46.3	13.9

Notes: *Author's calculation based on IMF staff estimates for recurrent expenditure. **Equatoguinean cost projections presented here are based on United Nations (UN) estimates of total population (around one million). Using government population estimates (around 0.49 million) lowers cost estimates significantly to e.g. 0.42% of GDP for a UCB and 0.1% of GDP for a universal social pension. See Barrientos (2008) for more details on the underlying assumptions.

Sources: Barrientos (2008) for Equatorial Guinea and Ghana; Barrientos and Bossavie (2008) for Mali and Senegal; Notten et al. (2008) for Congo.

We refer back to these cost estimates in Section 7, which summarises the fiscal space available for social protection in the case study countries.

[17] Selective child benefit.

6. POTENTIAL FOR FISCAL SPACE IN THE CASE STUDY COUNTRIES

This section presents a detailed discussion of fiscal space for social protection in the five case study countries (Congo, Equatorial Guinea, Ghana, Mali and Senegal) against each of the dimensions identified in Table 1.

6.1 MOBILISATION OF DOMESTIC REVENUES

The key driver of revenue growth and fiscal space in general is real GDP growth. Figure 2 illustrates that real GDP growth has been exceptionally strong in Equatorial Guinea in recent years (driven primarily by strong growth in oil and natural gas production), averaging 20.1% over 2000-2007. The Equatoguinean economy is now 20 times as large as it was in the mid-1990s as a result. However, growth has also been consistently strong in all of the case study countries over this period, averaging 4.1% in Congo, 5.2% in Ghana, 4.6% in Mali (driven by increased gold production and prices), 4.2% in Senegal and 5.0% in West and Central Africa as a whole.

Figure 2: Real GDP growth, 2000-2007

Source: IMF WEO Database, April 2008.
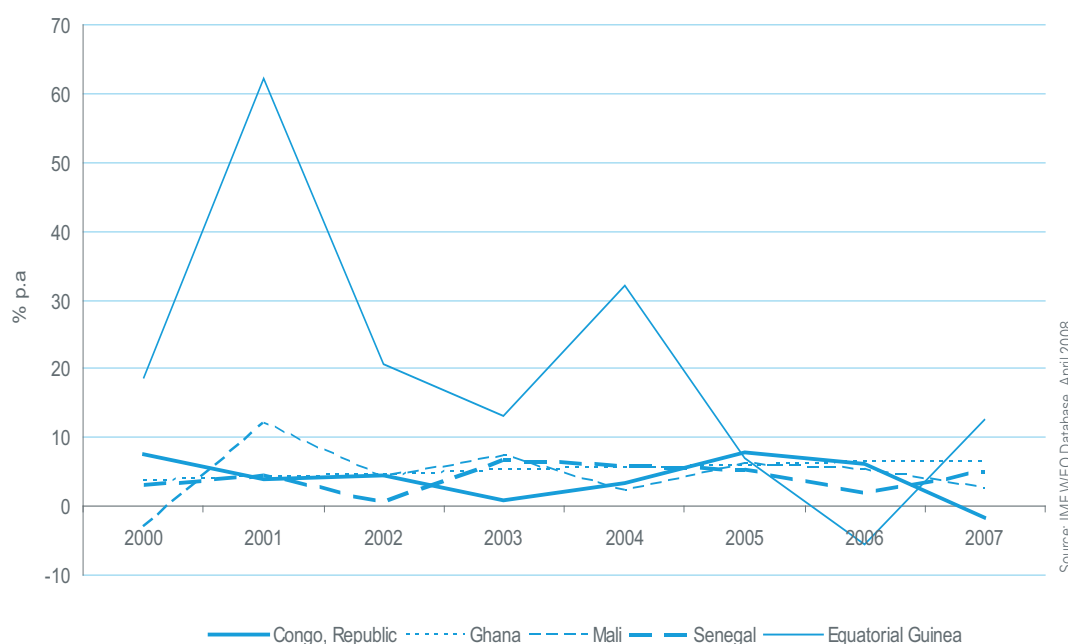
This strong real GDP growth has also driven substantial revenue growth in the case study countries. As Table 3 shows, revenue growth has been strongest where economic growth has also been strong, with the oil-producing economies (Congo and Equatorial Guinea) performing particularly strongly. It is also notable that Ghana has increased total revenues dramatically in recent years. Although high inflation (see Figure 9 below) means that revenue increases have been less pronounced in real terms, the gains are still impressive: Ghana's tax revenues expressed as a proportion of GDP rose from 16.3% in 2000 to a projected 20.0% in 2007 (see Table 4). Mali has also realised impressive revenue increases in recent years as a result of improved tax administration of both direct and indirect tax bases (IMF, 2006a).
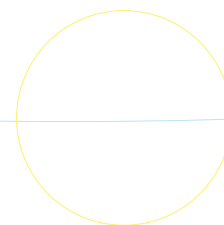
Table 3: Growth in revenue, 2002-2005 (annual % change)

	2002	2003	2004	2005	Average 2002-2005
Congo, Republic	-9.0	5.6	22.2	68.0	21.70
Equatorial Guinea	19.1	13.7	78.2	81.9	48.23
Ghana	27.5	56.2	38.2	21.9	35.94
Mali	15.9	13.7	7.8	11.4	12.20
Senegal	10.3	8.3	7.9	13.3	9.94

Source: IMF staff estimates.

Low tax to GDP ratios – i.e. those below 15% of GDP – are often a sign of low tax effort and suggest that there may be scope for increased revenue collection. However, additional tax effort is only likely to result in gains of the order of an additional 2% of GDP by 2015 (Commission for Macroeconomics and Health, 2001). Table 4 summarises non-oil tax revenue to GDP ratios in the five case study countries over the period 2000-2007[18]. These ratios are already relatively high by regional standards in Ghana (20.6%) and Senegal (18.8%). Tax revenues in Mali stand at around 15.8% of GDP, suggesting that here there may be scope for an increase in domestic revenues.

Table 4: Revenue yields (non-oil tax revenue to GDP ratios) in case study countries, 2000-2007

	2000	2001	2002	2003	2004	2005	2006 est.	2007 proj.
Congo, Republic	N/A	6.2	6.0	6.5	6.5	5.3	N/A	N/A
Equatorial Guinea	2.8	2.5	2.7	2.8	2.3	1.6	N/A	N/A
Ghana	16.3	17.2	17.5	20.2	21.7	20.6	19.6	20.0
Mali	N/A	N/A	13.1	N/A	15.1	15.8	15.3	15.1
Senegal	N/A	17.3	18.1	17.1	17.6	18.8	19.1	N/A

Source: IMF staff estimates.

Non-oil tax revenues as a proportion of GDP are relatively small in Congo and Equatorial Guinea (5.3% in Congo and 1.6% in Equatorial Guinea). These countries rely instead predominantly on revenues from hydrocarbons, and on oil revenues in particular: they are the sixth- and fourth-largest oil producers in sub-Saharan Africa, respectively (IMF, 2007e)[19]. Oil revenues, which were equivalent to 32.4% of GDP in Equatorial Guinea and

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[18] Note that, following the convention adopted for revenue data in IMF Article IV Staff Reports, these figures do not include customs, oil and non-tax revenues.

[19] Sub-Saharan Africa's main oil-producing countries in 2005, in order of volume, were: Nigeria, Angola, Sudan, Equatorial Guinea and Congo.

40.5% of GDP in Congo in 2005 (according to IMF staff estimates), accounted for the major share of total revenues (68.7% in Congo and 81.1% in Equatorial Guinea in 2003 – see Table 5 below).

Table 5: Fiscal indicators for oil-producing African countries, 2003

	Oil sector output (% of GDP at constant prices)	Oil fiscal revenue (% of total government revenues)	Oil export revenues (% of total export receipts)
Angola	32.3	75.1	91.3
Congo, Republic	33.7	68.7	81.9
Equatorial Guinea	71.8	84.4	95.8
Gabon	28.2	54.4	84.1
Nigeria	30.9	75.4	97.3

Source: IMF staff estimates, cited in Bhattacharya and Ghura (2006).

A key determinant of fiscal space in these countries in future years is therefore future oil and gas production volumes. While future production of hydrocarbons is notoriously difficult to forecast, recent IMF estimates suggest that only Gabon and Nigeria have larger proven and possible oil and gas reserves in the West and Central Africa region (see Table 6).

Table 6: Estimates of oil and gas reserves in West and Central Africa, 2005

	Cameroon	Chad	Congo, Republic	Côte d'Ivoire	Equatorial Guinea	Gabon	Nigeria
Oil reserves (billions of barrels)							
Proven reserves (1P)	0.5	0.7	2	0.3	1.2	2.1	34
Proven plus possible reserves (2P)	1.5	2.2	5.5	0.5	2.3	7.3	55
Gas reserves (billions of barrels of oil equivalents)							
Proven reserves (1P)	0.5	0	0.8	0.2	0.6	0.2	34
Proven plus possible reserves (2P)	1.4	0	2.8	0.9	2.5	3.5	53.5

Source: Olters (2007).

Still, these supplies will eventually run out. Production in Congo is forecast to decline over the next decade and possibly be depleted by around 2050; even under relatively favourable assumptions, oil revenue is projected to decline to 25.5% of GDP by 2012 (from 32.4% in 2005). Projections suggest that Equatorial Guinea's proven reserves will last for at least another two decades. Although the timing is difficult to forecast, it is

clear that both countries will eventually face a serious structural fiscal adjustment (see Box 1). In the medium term, however, oil revenues are likely to continue to soar.

Regional economic cooperation has led to the establishment of harmonised domestic consumption taxes in many countries (albeit not yet fully implemented in many cases). This limits the autonomy of individual countries to raise domestic consumption tax rates such as value-added tax (VAT) to collect additional revenues and create fiscal space[20]. While consumption taxes constitute a relatively small portion of total tax revenues in West and Central Africa, it is important to note that Ghana (a member of WAMZ) retains more discretion over VAT rates than other case study countries. It has recently used this discretion to increase the VAT rate in order to create fiscal space for social protection, raising the rate from 12.5% to 15% in 2004. This National Health Insurance Levy aims to finance the new national health insurance scheme, providing estimated additional revenues for the budget of over 1% of GDP per year (IMF, 2004).

6.2 REALLOCATION

Figure 3 summarises total expenditure as a percentage of GDP over the period 1997-2008. Figure 4 provides an overview of discretionary and non-discretionary expenditure as a percentage of GDP in 2005. The former gives an indication of how much scope there is for increasing fiscal space through raising expenditures as a proportion of GDP; the latter provides a rough indication of how much room for reallocation there is within the overall expenditure envelope. Accurate measures of 'non-discretionary' spending for the case study countries were not available: instead, we follow Heller (2005) and use the sum of 'wages and salaries' and 'interest payments' (as measured by IMF staff estimates) as a rough proxy for non-discretionary expenditures.

Figure 3: Total expenditure, 1997-2008

Source: IMF AFRREO, April 2008.
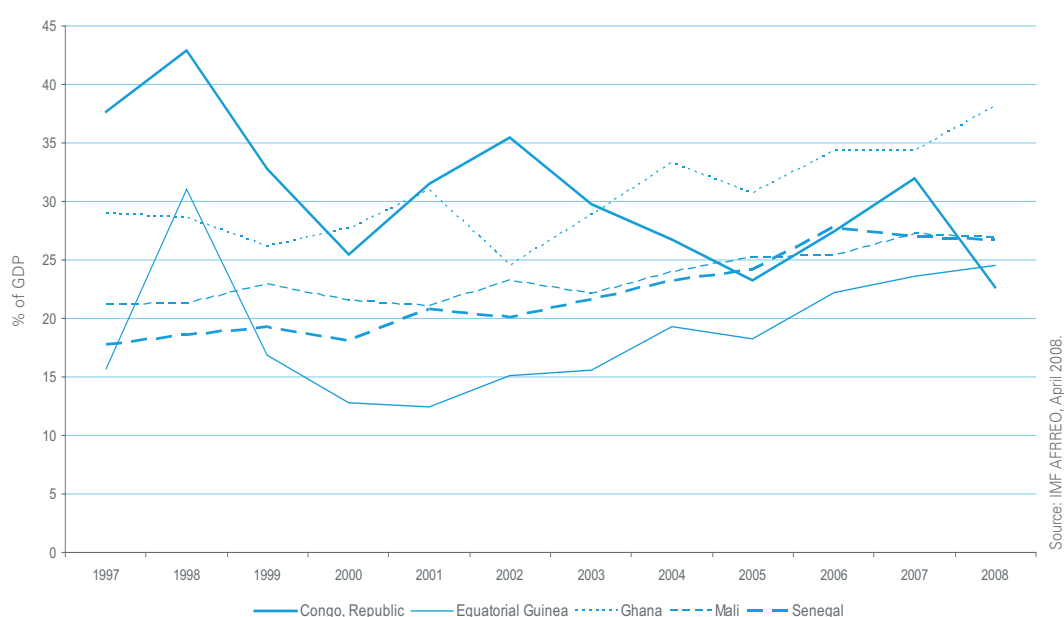
[20] Congo and Equatorial Guinea are members of the Economic and Monetary Community of Central Africa (CEMAC). Mali and Senegal are members of the West African Economic and Monetary Union (WAEMU). WAEMU is in turn part of a larger group of 15 countries known as the Economic Community of West African States (ECOWAS). Within ECOWAS, there is a non-WAEMU group called the West African Monetary Zone (WAMZ), of which Ghana is a member.

Figure 4: Discretionary and non-discretionary spending, 2005

Source: IMF staff estimates.
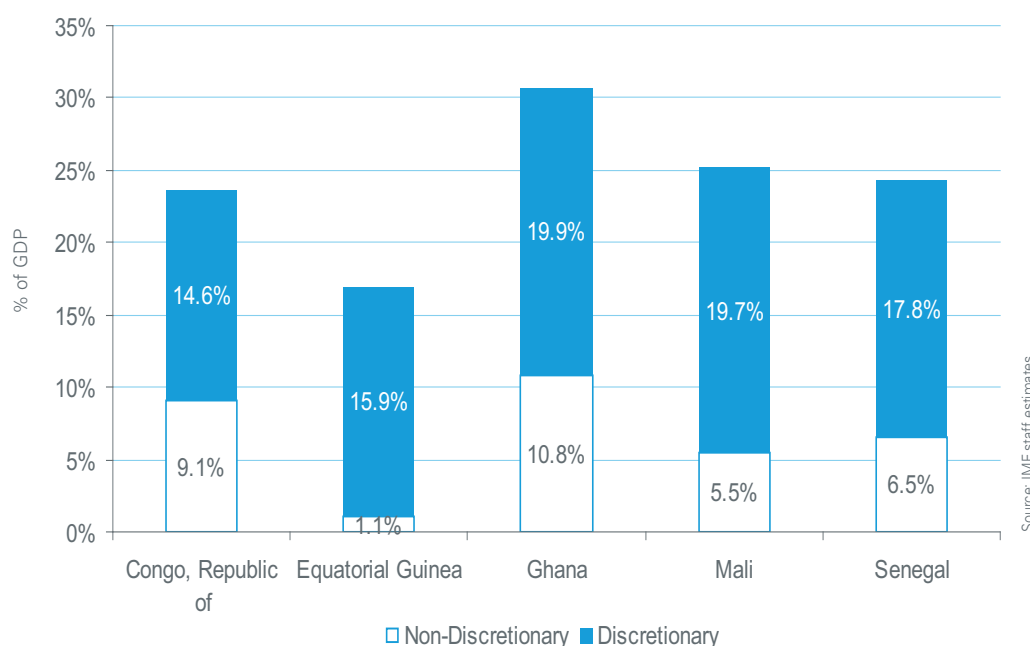
Figure 3 reveals a high degree of variation in total expenditure relative to the size of the economy within countries over time as well as significant variation between countries in any given year. The observation that as economies grow the share of public expenditure in GDP tends to grow (see e.g. Schick, 1998a) is also borne out by this data. Figure 4 highlights the significant variation in the composition of the five case study countries' aggregate expenditure profiles, with non-discretionary expenditures ranging from 1.1% to 10.8% of GDP.

Ghana has the highest total public expenditure as a proportion of GDP (30.7% in 2005). Moreover, within that figure, a relatively large proportion is taken up by non-discretionary expenditures, which accounted for around 10.8% of GDP in 2005. Much of this owes to an increase in wage spending, which grew by around 4.5% of GDP over the period 2001-2006, claiming an increasing share of domestic revenue and total spending (see Annex 2 for a discussion). In 2005, wages and salaries accounted for 28% of total expenditures in Ghana, a considerably larger ratio than in the other four case study countries: Congo (17%); Equatorial Guinea (6%); Mali (19%); and Senegal (23%).

Total public expenditures in Congo, Mali and Senegal ranged from 23% to 25% of GDP in 2005, although Congo had substantially higher non-discretionary commitments (9.1% of GDP) than Mali or Senegal (5.5% and 6.5%, respectively). In contrast, total expenditure in Equatorial Guinea is the lowest of the five countries as a proportion of GDP, and this country also has the lowest share of non-discretionary spending (1.1% in 2005), suggesting that there may be scope for both increases in total spending and reallocation of discretionary spending – i.e. substantial available fiscal space.

Is it likely that reallocations among non-discretionary expenditures might favour social protection expenditures? Such questions of allocative efficiency – the allocation of public expenditures according to government policy priorities – are inherently political, and analysis by desk review such as this can provide only circumstantial

evidence by examining existing expenditure patterns. Table 7 provides an indication of existing priorities in public spending among the case study countries. This in turn gives an indication as to what fiscal space might be spent on were it to become available. Notably, despite having the lowest proportion of non-discretionary expenditures among the case study countries, Equatorial Guinea has the lowest public education expenditure (whether expressed as a percentage of total government expenditure or as a percentage of GDP) and the joint-lowest public health expenditure as a percentage of GDP. This raises question marks as to where fiscal space would be allocated here were it to become available. Congo also measures up badly against these indicators, with only Equatorial Guinea ranked lower against each measure.

Table 7: Priorities in public spending: Selected measures of spending composition

	Public education expenditure (% total government expenditure) 2005	Public education expenditure (% GDP) 2005	Military expenditure (% GDP) 2005	Public health expenditure (% GDP) 2004	Private health expenditure (% GDP) 2004	Out-of-pocket health expenditure (% of private expenditure on health) 2004	Total health expenditure (% GDP) 2004
Congo, Republic	8.1	2.2	1.4*	1.2	1.3	100.0	2.5
Equatorial Guinea	4.0*	0.6*	N/A	1.2	0.4	75.1	1.6
Ghana	N/A	5.4	0.7	2.8	3.9	78.2	6.7
Mali	14.8	4.3	1.9	3.2	3.4	99.5	6.6
Senegal	18.9	5.4	1.5	2.4	3.5	94.5	5.9
Region mean	14.7	3.7	1.2	2.3	2.6	93.2	5.0
Case studies mean	14.0	4.3	1.4	2.2	2.5	89.5	4.7

Source: World Bank WDI, April 2008.

Note: *Data for 2003.

The data presented in Table 7 provide a very static picture of public expenditures. The overall trends in these spending areas are also a very important guide to the use of fiscal space. Unfortunately, the data here are very patchy indeed. One proxy used by the IMF in HIPCs (see Section 6.7 below) is the proportion of 'pro-poor' expenditure. Although it is defined differently in different countries, its core components remain similar: basic health care, primary education, agriculture, infrastructure, housing, basic sanitation and HIV/AIDS. Available evidence broadly supports the messages in Table 7, suggesting that Ghana has significantly increased the proportion of public expenditures focused on poverty-related areas in recent years, with rises from 4.5% of GDP and 13.9% of total government expenditure in 2001 to an estimated 6.9% of GDP and 24.5% of total government expenditure by 2004 according to IMF estimates (IMF, 2007a). Congo has also had some success in raising the proportion of its pro-poor expenditures, which increased from 4.0% of GDP in 2003 to a preliminary estimate of 6.4% in 2006 (IMF, 2007b).

6.3 DEBT REDUCTION

Debt service payments reduce available public expenditures. This means not only that some (potentially poverty-reducing) expenditures are directly forgone, but also that private investment in the economy is lower, thereby slowing growth (relative to a low/zero debt scenario), reducing revenue and thus fiscal space. Debt can also reduce fiscal

space through an 'import compression' mechanism, whereby governments ration imports in order to improve the current account balance to generate the trade surpluses needed to service foreign debt (Khan and Knight, 1988).

The negative impact of high debt stocks and the associated high debt service ratios on available fiscal space in low-income countries has prompted a concerted debt relief campaign in recent years. The HIPC initiative is a comprehensive approach to debt reduction for heavily indebted poor countries pursuing IMF- and World Bank-supported adjustment and reform programmes. It was developed to help poor countries obtain more manageable debt burdens and to free up funds committed to non-discretionary debt service payments for poverty-reducing expenditures. A separate debt relief initiative, the MDRI, has followed this by providing 100% relief of IMF, World Bank and African Development Fund (ADF) debt to countries reaching HIPC completion point (i.e. fulfilling a number of prior conditions or 'triggers'). As Table 8 illustrates, of the five case study countries, Ghana, Mali and Senegal have passed the HIPC completion point, Congo has yet to reach completion point and Equatorial Guinea is not participating in the initiative at all since it is not eligible as a high-income country without an IMF programme.

Table 8: West and Central African countries that have qualified, are eligible or potentially eligible and may wish to receive HIPC assistance (as of March 2008)*

Post-completion point	Interim (between decision and completion point)	Pre-decision point
Benin	Central African Republic	Côte d'Ivoire
Burkina Faso	Chad	Togo
Cameroon	Congo, Republic	
The Gambia	Congo, Democratic Republic	
Ghana	Guinea	
Mali	Guinea Bissau	
Mauritania	Liberia	
Niger		
São Tomé and Príncipe		
Senegal		
Sierra Leone		

Source: http://www.imf.org/external/np/exr/facts/hipc.htm.

Note: *Within the region, only Equatorial Guinea, Gabon and Nigeria are not captured here.

Figure 5 illustrates recent trends in external debt stocks among the case study countries (expressed as a % of GDP). This illustrates marked reductions in external indebtedness for the countries that have reached HIPC completion point (and therefore also benefited from MDRI relief), with Ghana reducing its external debt stock from 99% in 2003 to 22% in 2006, Mali reducing from 90% to 20% and Senegal from 67% to 17%. Congo has also realised significant improvements, reducing the external debt stock from 180% of GDP in 2002 to 78% in 2006 (although this is still a relatively high level). In addition, Congo is the only country likely to benefit from substantial debt relief (thereby creating fiscal space by reducing debt service payments) in the near future, once it reaches HIPC completion point, although progress towards meeting the conditions or 'triggers' has been very slow, with few triggers fully met as of March 2007; this suggests that completion point may not be reached in the near future (IMF, 2007b). Meanwhile, Equatorial Guinea has maintained consistently low and declining external debt stocks in recent years, reducing from 38.3% of GDP in 2000 to 10.2% in 2002 and 3.8% in 2005.
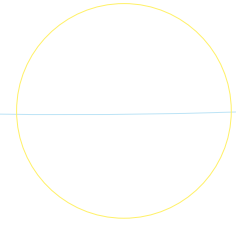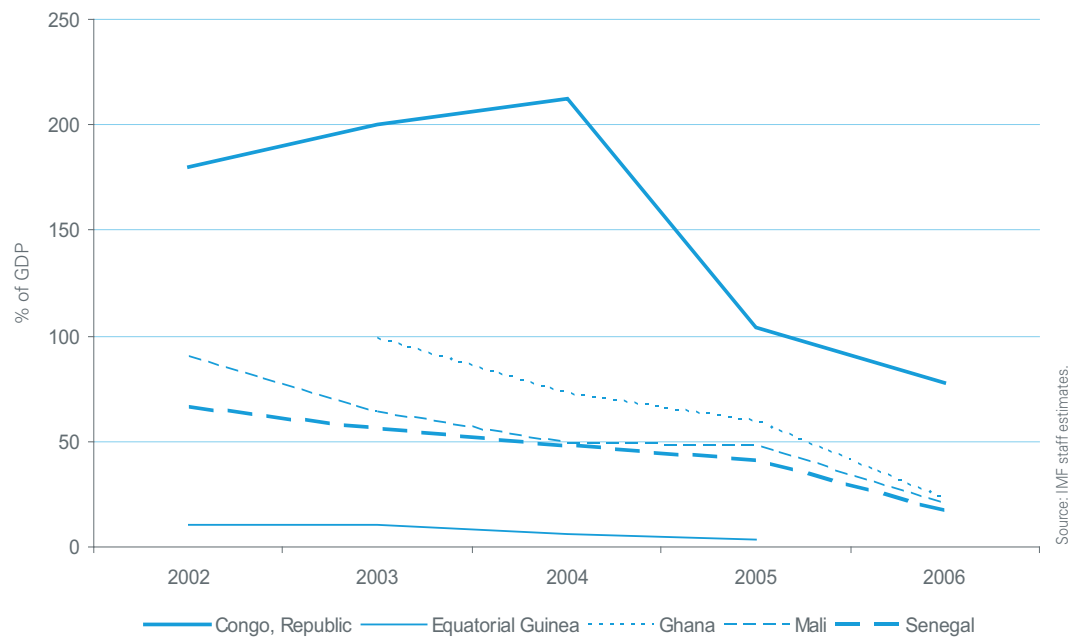
Figure 5: External debt stock, 2002-2006

Source: IMF staff estimates.

It should also be noted that official debt figures often do not capture some liabilities that can nonetheless have a significant (typically negative) impact on available fiscal space. In particular, the case study countries may have to make a series of large potential expenditures in the future, known as contingent liabilities. These are obligations triggered by a discrete but uncertain event not wholly within the government's control. While there is limited coverage of contingent liabilities and they are difficult to value, they can affect both fiscal and debt sustainability through losses that must eventually be absorbed by the budget. Including them in fiscal analysis would thus give a better picture of the 'true' underlying fiscal position. In Mali, for example, the state controlled cotton company (CMDT) posted an operating loss of 1.7% of GDP during the 2004/05 season. To cover these losses, the government lent the CMDT 1% of GDP in 2005 (IMF, 2006a). In addition to the cotton sector, the government of Mali faces fiscal risks from pension fund losses and bank recapitalisation. Similarly, Ghana Airways, the country's state-owned national airline, ceased operation in 2004 after five years of losses, in debt to the tune of about 1.6% of GDP. Ghana Airways' existing loans carry no government guarantee, but many of the creditors are other public enterprises, such as the Port and Harbour Authority and the Civil Aviation Authority. In addition, the government was liable for severance payments to Ghana Airways' former employees. A recent study has concluded that the overall fiscal deficit in Ghana has shifted from an average of 6.5% of GDP during the period 2000-2004 to more than 9% of GDP once these sorts of contingent liability are factored in (Chivakul and York, 2006).

6.4   INCREASE BORROWING

There is no quick and simple 'rule of thumb' on whether a country has room to contract additional external debt, not least because the debt levels that a country can sustain are influenced by the quality of its policies and institutions. The IMF Debt Sustainability Framework (DSF) therefore assigns different countries differing

sustainability thresholds (defined as the ratio of debt service payments to exports and debt service to receipts) depending upon their overall CPIA score. Table 9 provides a very rough indicative guide of how the case study countries are performing relative to IMF debt sustainability benchmarks.

Table 9: Comparison of case study countries against IMF DSF debt burden thresholds

	Overall CPIA score(2006)*	External debt service, after debt relief (% exports)**		External debt service, after debt relief (% government revenue)**	
		IMF debt burden threshold	Actual (2005)	IMF debt burden threshold	Actual (2005)
Congo, Republic	2.8 (weak policy)	15	11.8	25	25.8
Equatorial Guinea	N/A	15	0.2	25	14.0
Ghana	3.9 (strong policy)	25	2.4	35	N/A
Mali	3.7 (medium policy)	20	7.4	30	N/A
Senegal	3.7 (medium policy)	20	11.7	30	15.8

Sources: IRAI, 2006; IMF (2007c) and IMF staff estimates.

Notes: *According to the IMF DSF, a rating of 3.75 or more constitutes 'strong policy'; 3.25-3.75 connotes 'medium policy'; and 3.25 or less corresponds to 'weak policy'. CPIA scores for 2006 are used here: the IMF recommends that DSF analysis actually use a three-year moving average CPIA score to reduce the possibility of annual fluctuations creating undesirable uncertainty regarding the country's financing terms from IDA. **External debt service ratios do not include domestic debt service figures. A comprehensive debt sustainability analysis should clearly include analysis of domestic debt stocks and associated service payments. Comparable data on domestic debt were not available for the case study countries, unfortunately.

Available data suggest that most countries lie within their debt service thresholds, except Congo, which exceeded the debt service to revenue ratio threshold in 2005. However, the recurrent nature of social protection expenditures means that borrowing to finance them would violate the informal 'golden rule' (so widely accepted that it is often formally adopted as a fiscal rule by governments), which states that governments should borrow only to finance investment expenditures, maintaining a balanced recurrent budget[21]. Further, the very long-term nature of social protection expenditures means that borrowing is particularly unsustainable as a means of financing.

6.5 INCREASED AID

Figure 6 shows the evolution of grant aid as a proportion of GDP in the case study countries over 1997-2008. Figure 7 summarises the (limited) available data on grant aid as a proportion of total government expenditure in recent years (2001-2005). Ghana has clearly been the most aid dependent in recent years, with grants averaging 3.7% of GDP (1997-2008) and 17% of total government expenditures in 2005. Mali and Senegal are also reliant on grants, although to a lesser degree than Ghana, with aid averaging 1.8% and 1.9% of GDP (1997-2008), respectively (compared with a sub-Saharan average of 0.9%), and 16% and 7% of total expenditure in 2005. As oil-producing countries, Congo and Equatorial Guinea are almost entirely independent of external grants for financing fiscal space, and are not likely to receive substantial additional grants in the near future (setting aside potential debt relief for Congo discussed above).

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[21] Equatorial Guinea reportedly operates a similar rule, whereby recurrent expenditures are limited to non-oil revenues and capital expenditure is financed from oil revenue, although it has not yet been fully implemented (IMF, 2006c).

Figure 6: Official grants, 1997-2008

Source: IMF AFRREO, April 2008.

Legend: Congo, Republic — Equatorial Guinea — Ghana ·········· Mali ------ Senegal

y-axis: % of GDP

Figure 7: Official grants, 2001-2005

Source: IMF staff estimates.

Legend: Congo, Republic — Equatorial Guinea — Ghana ·········· Mali ------ Senegal

y-axis: % of total government expenditure
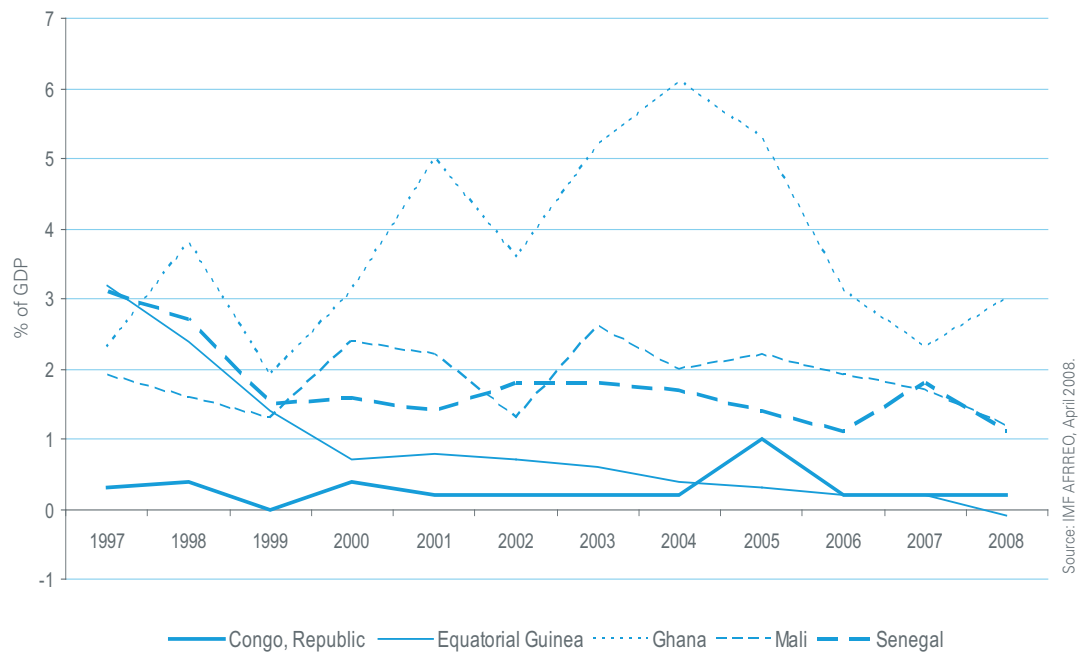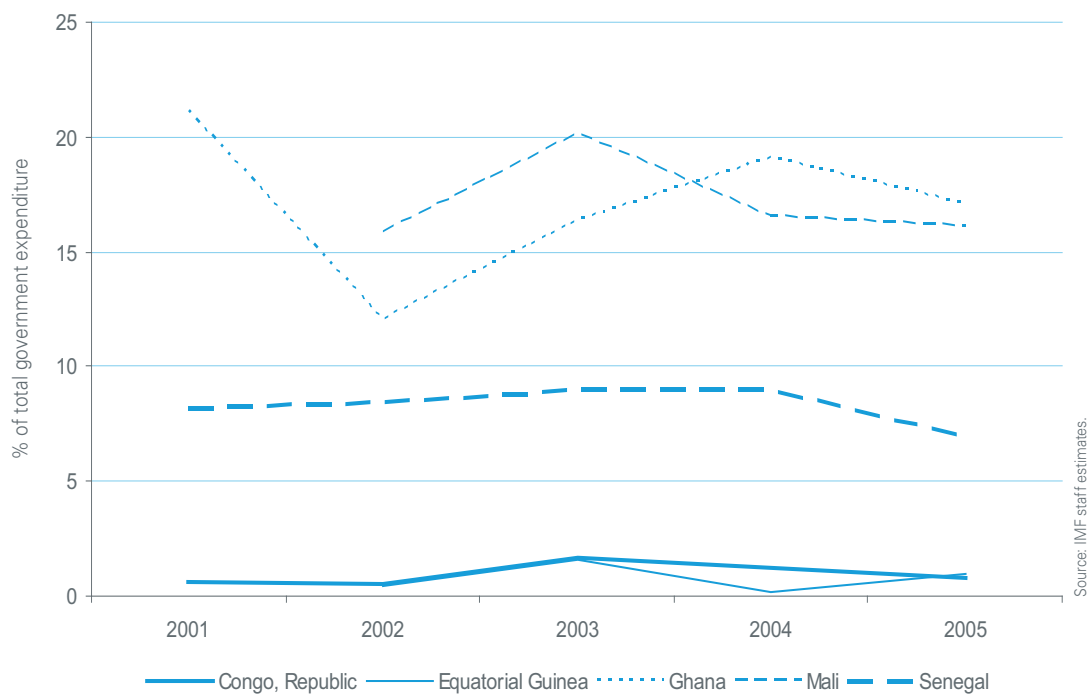
The most heavily aid-dependent countries in sub-Saharan Africa have much higher proportions of their budgets financed by grants (Mozambique received an average of 6% and Rwanda 10% of GDP from 1997 to 2008, according to AFRREO data). Why not simply rely on additional grant aid to finance fiscal space for social protection in the case study countries? A primary reason not to follow this course is that simply increasing aid commitments, even via highly fungible aid modalities such as general budget support, is not alone sufficient to create fiscal space. This is because 'governments need to believe that donors will increase aid and maintain it at the higher level before they will assume it in their expenditure plans' (Foster, 2005). In reality, few donors are able to offer aid commitments over a time horizon of more than two or three years and are often constrained by the length of their own domestic political cycles. Even then, they often reserve the right to reduce or withhold disbursements if performance conditions or underlying governance criteria are not met. While this may act as a means of incentivising governments to implement particular reforms, it is a poor basis on which to base the long-term financing of social protection provision which, once provided, will become a steady and very long-term obligation for governments. This is in contrast with the high volatility of Ghana's historical grant financing (as illustrated in Figure 6).

As a result of the costs of unpredictable grant aid, ministries of finance typically ensure that total revenues are greater than or equal to recurrent expenditures (see Figure 8). This means that aid is used to finance investment expenditures and any shortfalls owing to unpredictability result in deferral of investment projects rather than a failure to pay wages and salaries or meet debt service obligations. Failure to meet recurrent spending commitments has high political costs. Recurrent expenditures (including social protection programmes) are primarily financed by domestic revenues.

Figure 8: Total revenues and recurrent expenditures, average for 2003/04-2005/06

Source: IMF staff estimates.
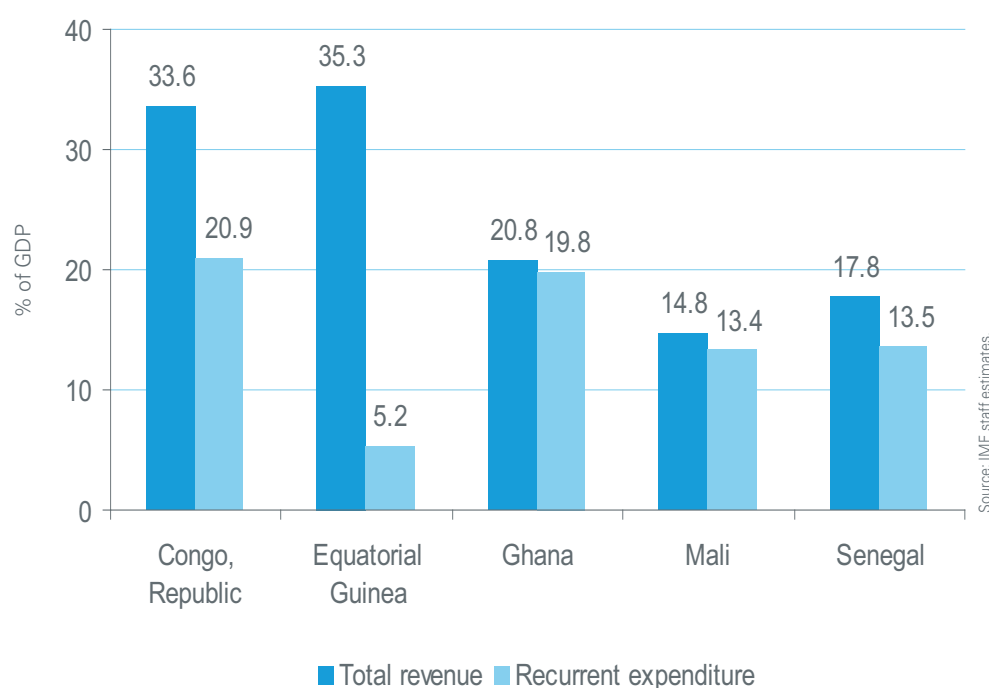
6.6 SEIGNORAGE

Seignorage is the revenue generated by money creation, in that those who hold currency or similar domestic claims on the central bank are giving an interest-free loan to the bank. This is transferred to the government as central bank profits (or dividends) or below-market rate loans. Total seignorage earnings have typically been in the range of 1-1.5% of GDP for low-income countries not experiencing very rapid inflation (CGD, 2007). The revenue generated through seignorage depends upon the degree of monetisation of the economy. That is, the size of the money stock determines the size of the 'interest-free loan' that the government receives. A relatively low degree of monetisation (usually reflecting the large share of the subsistence economy) implies limited scope for financing additional spending by printing money (Heller, 2005). The stock of broad money (M2) as a proportion of GDP therefore provides an indication as to how much seignorage revenue might be available to the government (see Figure 9).

Figure 9: Broad money (money and quasi money or M2), 1997-2008

Source: IMF AFRREO, April 2008.
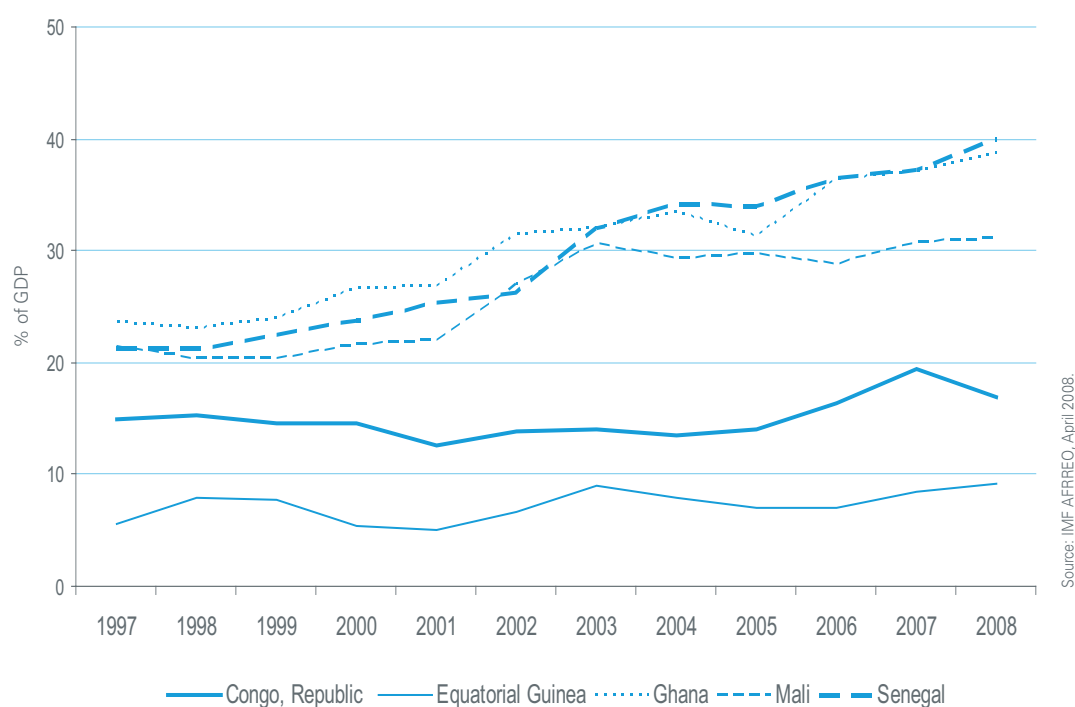
The stock of M2 remains below 20% of GDP in both Congo and Equatorial Guinea, suggesting little or no room for fiscal space creation through seignorage. The stock of broad money has risen to over 30% in Ghana, Mali and Senegal, suggesting a more highly monetised group of economies, where scope for printing money may be greater. However, it is also important to take into account inflation rates (Figure 10) because printing money in order to pay for government services creates inflationary pressure.

Figure 10: Inflation, 1995-2007
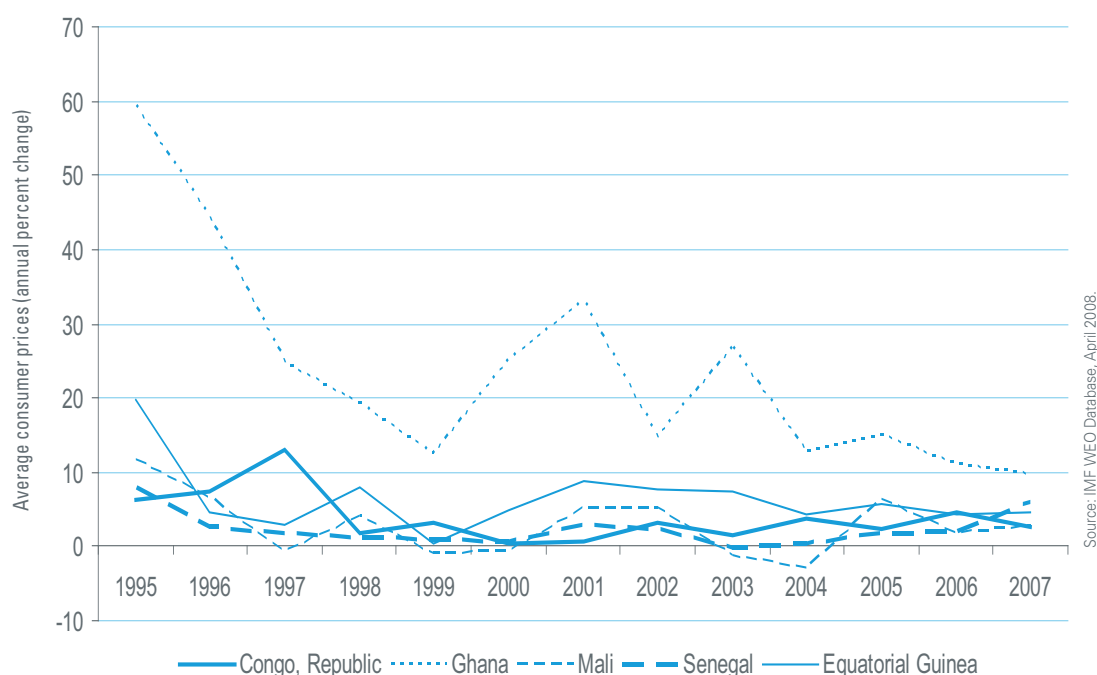
Moreover, the inflation generated by seignorage is 'regressive' – i.e. it worsens income distribution, hurting poor groups relative to wealthier ones (Brun et al., 2006). Inflation has historically been very high in Ghana; although it has been reduced in recent years, it still remains at a rate of around 10% per year, suggesting that seignorage financing is highly inadvisable. Inflation levels are more manageable in Congo, Equatorial Guinea, Mali and Senegal, but institutional factors (namely the degree of government discretion over monetary policy) limit the scope for the use of seignorage to create fiscal space in these countries: the monetary arrangements in CEMAC and WAEMU severely constrain scope for seignorage in franc zone countries (IMF, 2006b). Overall, it is not advisable to use seignorage as a means of creating fiscal space. In particular, Adam and Bevan (2005) identify a 'threshold' effect beyond which higher seignorage tends to have a negative effect on the true driver of fiscal space, economic growth, at about 1.25% of GDP.

6.7 PROSPECTS FOR FISCAL MANAGEMENT

Securing fiscal space is only part of the story. As discussed, it is also important to ensure that it is put to good use. Countries with relatively strong institutional environments (as measured by CPIA scores) and in particular with strong PEM systems are more likely to have the safeguards and management procedures in place to ensure that funds are spent efficiently and effectively. Efficiency can be understood both in allocative terms (the extent to which budget outturns reflect national policy priorities) and in operational terms (the extent to which outputs are maximised or unit costs minimised for a given input).

Under the HIPC initiative, a number of PEM indicators and benchmarks were devised to measure progress of eligible countries in strengthening PEM systems. The 15 HIPC PEM indicators are arranged into four groups corresponding to successive stages of the budget cycle: formulation (seven indicators); execution (four indicators); reporting (four indicators); and procurement (one indicator, introduced in 2004)[22]. Scores range from 'A' (highest) to 'C' (lowest). For each indicator, a benchmark or minimal standard is also defined; country results are reported on the number of benchmarks met[23]. Table 10 illustrates the number of benchmarks met among the HIPC completion point countries (Ghana, Mali and Senegal). The data suggest that overall PEM in Ghana has improved markedly in recent years, and that all three countries are at similar levels in terms of PEM system progress, having met around half of the PEM benchmarks.

Table 10: PEM performance (number of benchmarks met out of 15)

	2001	2004	2006	
Ghana	1	4	7	Source: de Renzio and Dorotinsky (2007).
Mali	7	7	6	
Senegal	4	7	N/A	

Note: *Data for 2001 and 2004 based upon World Bank and IMF HIPC assessment; data for 2006 correspond to most recent public expenditure and financial accountability (PEFA) assessment. No PEM assessments were available for Congo and Equatorial Guinea.

The CPIA, released publicly for the first time for 2005, rates each IDA country's present policy and institutional framework for fostering poverty reduction, sustainable growth and ability to effectively use development assistance on a scale of 1 (weakest) to 6 (strongest)[24]. The system has evolved over time and now comprises 16 criteria grouped in four equally weighted clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and (iv) public sector management and institutions. Table 11 provides a selection of key CPIA indicators for PEM. The overall CPIA score (right-hand column) gives a rough indication of overall institutional quality, with Ghana scoring highest (3.9), followed by Mali and Senegal (both at 3.7) and Congo (2.8). Equatorial Guinea is not classed as an IDA country and therefore does not have a CPIA score. Ghana also scores highly on individual measures that are important to the creation and use of fiscal space: fiscal policy (4.5); debt policy (4.0); equity of public resource use (4.0); quality of budget and financial management (4.0); and efficiency of revenue mobilisation (4.5). Mali and Senegal also perform relatively strongly on these measures and all three are above the West and Central Africa mean on these measures.

[22] The 16th HIPC PEM indicator was introduced in 2004, but performance against this is not reflected in Table 10 in order to maintain a degree of comparability with 2001.

[23] For more detailed country scores against individual indicators, see de Renzio and Dorotinsky (2007).

[24] IDA-eligible countries had a per capita income in 2006 of less than US$1065 and lack the financial ability to borrow from the International Bank for Reconstruction and Development (IBRD). The six point CPIA ratings scale is as follows: 1 Unsatisfactory for an extended period; 2 Unsatisfactory; 3 Moderately Unsatisfactory; 4 Moderately Satisfactory; 5 Good; 6 Good for an extended period.

Table 11: Official grants, 2001-2005

|	Macroeconomic management	Fiscal policy	Debt policy	Equity of public resource use	Social protection and labour	Quality of budget and financial management	Efficiency of revenue mobilisation	Quality of public administration	Transparency accountability and corruption in public sector	IRAI
Congo, Republic	3.5	2.5	2.5	2.5	2.5	3.0	3.0	2.5	2.5	2.8
Equatorial Guinea	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Ghana	4.0	4.5	4.0	4.0	3.5	4.0	4.5	3.5	4.0	3.9
Mali	4.5	4.0	4.5	3.5	3.5	3.5	4.0	3.0	3.5	3.7
Senegal	4.0	4.0	4.0	3.5	3.0	3.5	4.5	3.5	3.0	3.7
Regional mean	**3.5**	**3.4**	**3.0**	**3.1**	**2.9**	**3.0**	**3.3**	**2.9**	**2.8**	**3.1**
Case studies mean	4.0	3.8	3.8	3.4	3.1	3.5	4.0	3.1	3.3	3.5

Source: IRAI, 2006.

CPIA scores suggest that PEM systems are weak in Congo. This is corroborated by other sources, such as a recent IMF Article IV mission, which stressed the weak credibility of the budget, difficulties in managing oil revenues in a transparent fashion and the need for a strengthened medium-term fiscal strategy. The lack of a transparent budget classification in particular hampers the monitoring of public expenditures, thereby undermining efforts to improve expenditure quality (IMF, 2007e). CPIA scores have not been compiled for Equatorial Guinea, but reports suggest that PEM systems are also relatively weak which, together with crippling capacity constraints, helps to explain why the government has found it difficult to channel oil wealth to priority social areas. As with Congo, there are also difficulties in the transparent management of oil revenues and problems with the credibility of the budget: current expenditure consistently exceeds non-oil revenue (contrary to the government´s own fiscal rule) and there are severe overruns on capital expenditures relative to the budget. These problems raise doubts about the ability of the current budget process as a means of developing and executing fiscal policy (IMF, 2006b).

As well as considering the overall prospects for fiscal management, it also makes sense to look more specifically at the quality of public sector management in social protection. The CPIA ratings include a composite indicator of government policies in the area of social protection and labour market regulation which rate how far government policies and programmes are in place which: (i) are designed to protect chronically poor and vulnerable, including the elderly; (ii) protect basic labour standards; (iii) work toward the elimination of harmful child labour; (iv) promote reduction of discrimination in the labour market; and (v) support the poor communities' own development initiatives. The case study countries' scores on this measure broadly mirror the pattern of scores for PEM systems: Ghana and Mali score highest (3.5); Senegal scores 3.0; and Congo is weakest at 2.5.

The overall observation that Ghana has relatively high-quality public sector institutions, with Senegal and Mali close behind and Congo and Equatorial Guinea faring much worse, is borne out by the World Bank's aggregate governance indicators on government effectiveness – a series that includes data for Equatorial Guinea. The evolution of country scores against the government effectiveness indicator is illustrated in Figure 11 below.

Figure 11: Government effectiveness scores, 1996-2005

Source: World Bank Aggregate Governance Indicators, cited in Kaufmann et al. (2006).
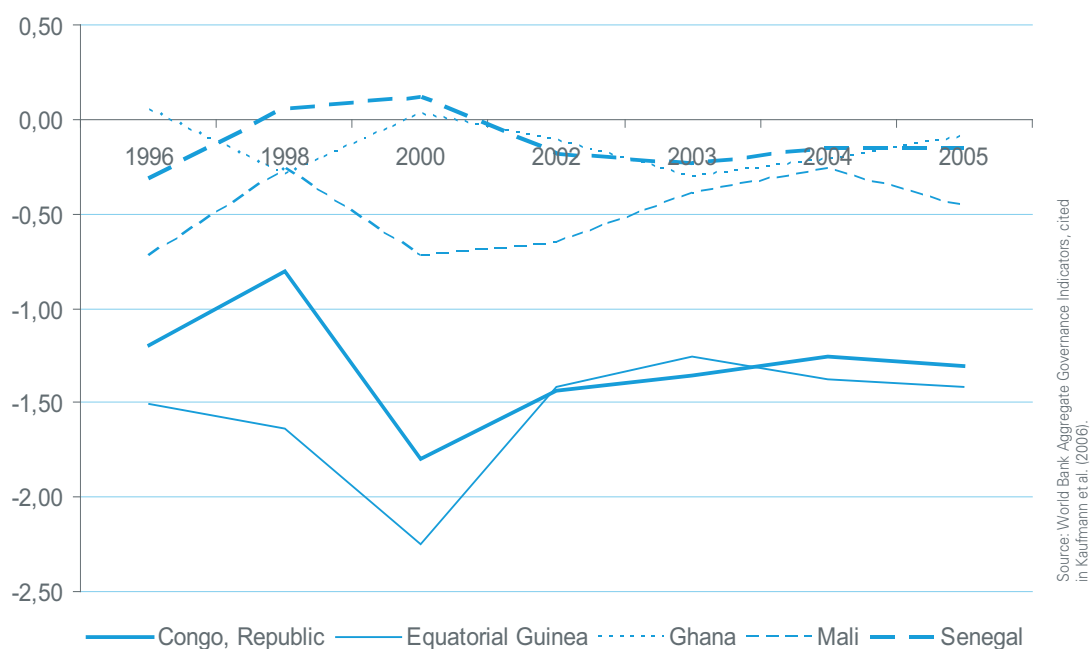
Note: The government effectiveness indicator is measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes.

6.8 DURABILITY OF MACROECONOMIC AND FISCAL FRAMEWORK

A second factor to take into account when examining the available fiscal space is the ability of the macroeconomic framework to withstand significant increases in demand pressures. Although space does not permit an in-depth assessment of this in all five case study countries, we follow Heller (2005) in examining two possible channels: (i) whether there is room to allow a healthy growth in credit to the private sector; and (ii) the size of the current account deficit. On the first of these channels, we seek to establish whether fiscal space can be created without adversely affecting borrowing by the private sector. The risk is that the additional public spending (unless it all went into imports) would increase liquidity in the economy, which would need to be sterilised by the central bank in order to avoid higher inflation. This may in turn push up the level of interest rates and therefore crowd out borrowing from the private sector, which would undermine investment, a key driver of economic growth. We therefore examine the levels of credit to the private sector as a proportion of GDP (see Figure 12).

Figure 12: Credit to the private sector, 1990-2006
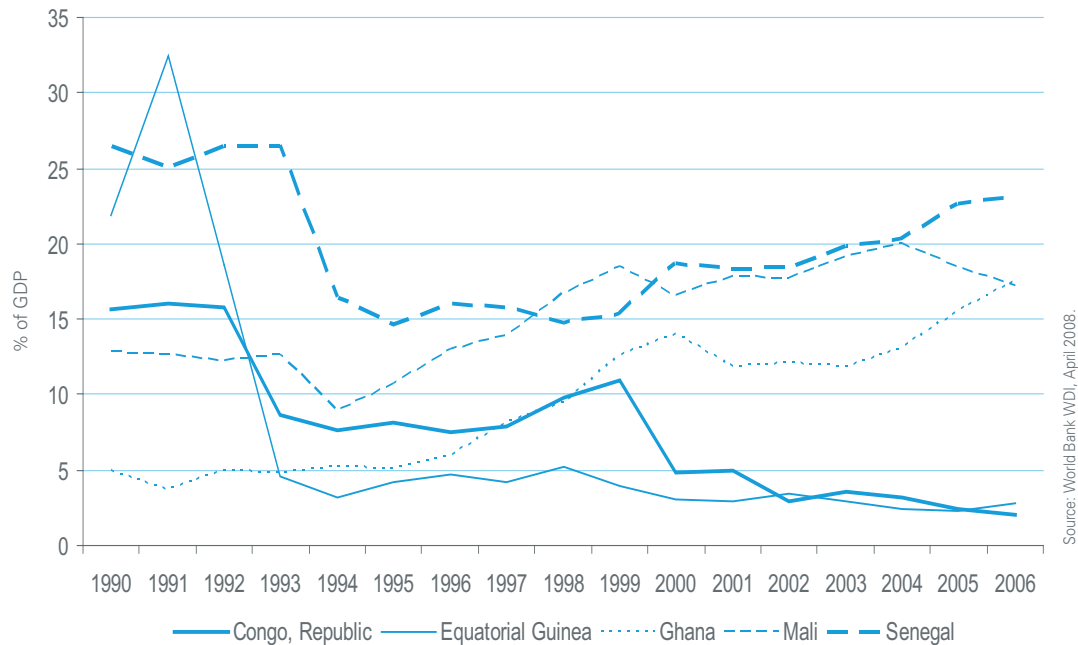
As in many preceding figures, the five case study countries can be divided into two broad groups here: the two oil-producing economies and the three more aid-dependent non-oil economies. Credit to the private sector as a proportion of GDP has risen steadily since the mid-1990s in Ghana, Mali and Senegal, whereas it has stagnated in Congo and Equatorial Guinea owing to the combination of a small non-oil private sector and high GDP. In Equatorial Guinea, this is mainly attributable to high GDP – in absolute terms, domestic credit to the private sector has actually expanded, particularly for services and construction activities (IMF, 2006b). Congo, however, has a relatively underdeveloped financial sector compared with other countries in the CEMAC region. While oil companies are likely to be raising credit on international markets, domestic companies in the non-oil economy are hampered by limited lending opportunities, the high cost of credit and legal and institutional constraints in recovering collateral (IMF, 2007h).

The second channel by which increased public expenditures may undermine the macroeconomic framework is the current account deficit. The theory is that a high level would exacerbate these countries' external vulnerability. Here, the pattern in levels of credit to the private sector is reversed, with the oil-producing economies (Congo and Equatorial Guinea) experiencing current account surpluses, whereas Ghana, Mali and Senegal have all had running deficits in recent years, even when we include grants in the calculation (excluding grants makes the picture even worse for these three countries). Equatorial Guinea in particular has made dramatic improvements in its current account balance over the period 1997-2008, going from -27% to +3% of GDP. On the other hand, current account balances in Congo and Equatorial Guinea have been considerably more volatile than in the other three countries, suggesting that the authorities have struggled to maintain macroeconomic stability. After the oil-producing countries, Mali has the strongest current account balance, helped by higher gold production and prices in recent years (projected to continue in the medium term) (see Figure 13).

Figure 13: Current account deficit including grants, 1990-2005

Source: IMF AFRREO, April 2008.

Congo, Republic ——— Equatorial Guinea ——— Ghana ·········· Mali ‑ ‑ ‑ Senegal ━ ━ ━
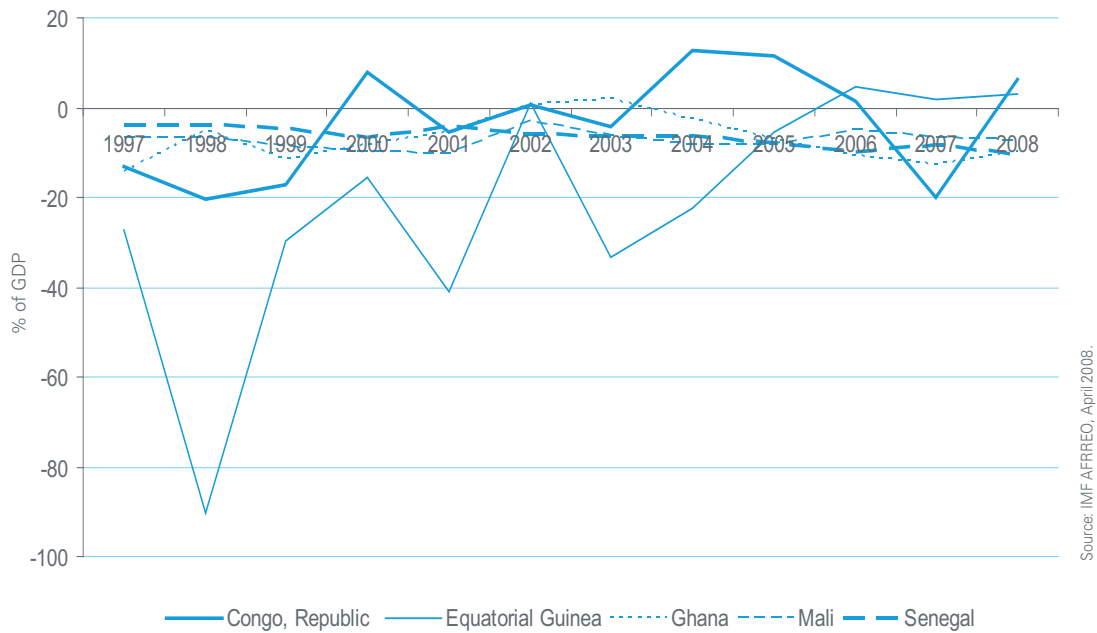
Figure 14: Overall fiscal balance, excluding grants, 1997-2008

Source: IMF AFRREO, April 2008.

Congo, Republic ——— Equatorial Guinea ——— Ghana ·········· Mali ‑ ‑ ‑ Senegal ━ ━ ━
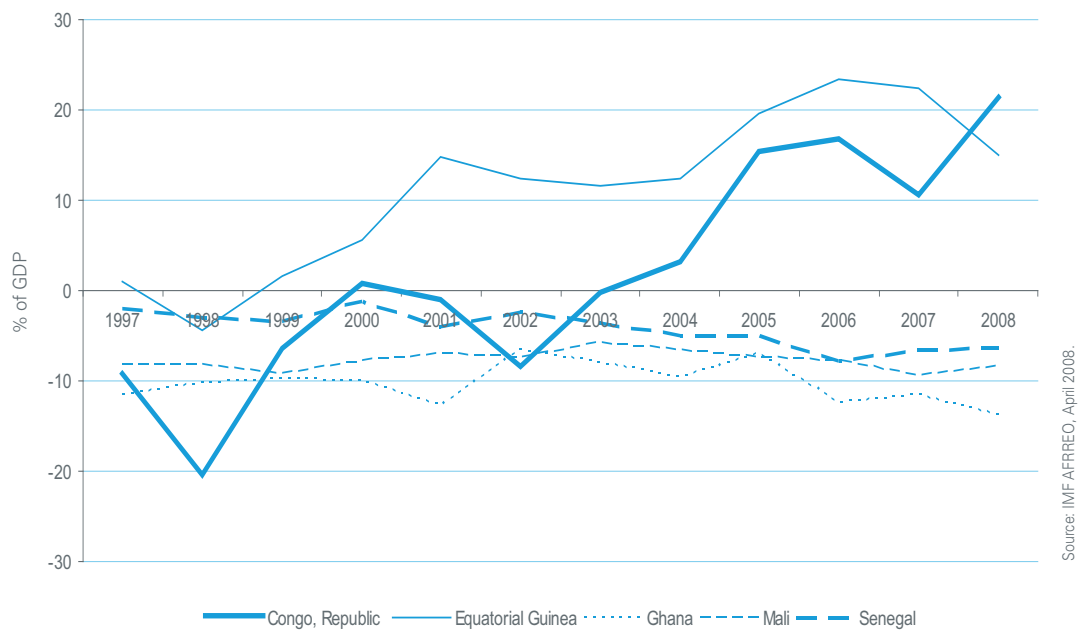
An important indicator of the long-term fiscal sustainability of overall expenditure levels in the three aid-dependent case study countries (Ghana, Mali and Senegal) is the overall fiscal balance excluding grants. Figure 14 illustrates how this indicator has evolved over the period 1997-2008. While strong oil revenues in Congo and Equatorial Guinea ensure that this measure has realised strong surpluses, the important thing to note is that Ghana, Mali and Senegal have all operated overall fiscal deficits before grants of over 5% of GDP in recent years. This illustrates the severe structural challenge to creating fiscal space over the very long term, especially if countries' dependence on grant aid is to be reduced.

Further, the overall fiscal deficit including grants for these countries is also over 3% of GDP (estimated at -6.9% in Ghana, -3.8% in Mali and -4.4% of GDP in Senegal in 2006, according to AFRREO data). This suggests that scope for additional expenditures within these countries, and in Ghana in particular (recent hydrocarbon discoveries notwithstanding), is severely constrained.

For the two oil-producing countries that are heavily reliant on oil revenues to finance expenditures (Congo and Equatorial Guinea), a more important measure of long-term fiscal sustainability is provided by the non-oil primary deficit, which can be compared with a benchmark such as the permanently sustainable non-oil primary deficit to give a measure of its sustainability (see Box 1 for a discussion of this concept)[25]. In 2006, the non-oil primary deficits in Congo and Equatorial Guinea, expressed as a proportion of non-oil GDP, stood at 47.8% and 143.4% of GDP, respectively.

By comparison, even using optimistic assumptions regarding the extent of exploration of proven and possible oil and gas reserves, permanently sustainable non-oil primary deficits in Congo and Equatorial Guinea are estimated at 38% and 32%, respectively[26]. This suggests the need for a significant fiscal adjustment in these countries in the long term, or, alternatively, the sorts of high-quality public investments that can grow the non-oil economy so as to generate future revenues. Otherwise, they will not be able to maintain current levels of public expenditure indefinitely without substantial growth in the non-oil economy (Olters, 2007).

[25] See also the glossary of selected terms below, which provides more detailed definitions of 'fiscal balance' and associated terms (e.g. primary expenditure) used in this section.

[26] Based on a calculation that assumes the exploration of all proven oil reserves, half of probable oil reserves, half of all proven gas reserves and a quarter of all possible gas reserves together with a financial rate of return of 3.2% (see Olters, 2007).
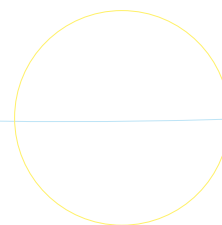
Box 1: Fiscal sustainability in oil-producing countries' oil wealth management

The large reliance on oil revenues highlighted in Table 5, the high volatility of oil prices and the exhaustible nature of oil reserves oblige oil-producing countries to be particularly prudent in the design of fiscal policy. Clearly, the consumption of oil and associated revenues cannot continue indefinitely and fiscal strategy should therefore identify mechanisms to transform exhaustible resources into other forms of revenue-generating wealth, such as physical infrastructure, financial assets and human capital (social protection is seen as a key means of promoting investment in the latter by the poor). However, although ensuring a sustainable path for fiscal policy is a high priority, the political and social costs associated with such an adjustment create incentives to delay it.

Experience in Congo illustrates the costs of poor fiscal management of oil revenues. Congo's lack of a strategy to manage fiscal oil revenue in the 1980s, including considerations to preserve the nation's oil wealth, resulted in unsustainable growth and an eventual sharp decline in living standards. Even though Congo's human development index is higher than the average for sub-Saharan Africa, it has been falling steadily since 1985 (Carcillo et al., 2007).

To this end, policymakers and other key stakeholders (parliament, civil society, etc.) could benefit from a clear indicator to help to distinguish between forward-looking policies and those that address only immediate demands. One indicator (rarely seen in national budget documents of oil-producing states) that might be used to do this is the non-oil primary deficit. This is defined as the difference between non-oil revenues, including grants, and total primary expenditures (and expressed as a proportion of non-oil GDP). It excludes oil income on the grounds that this is more like financing than revenue. But how do we interpret these figures – i.e. what level of non-oil primary deficit is consistent with fiscal sustainability?

One approach advocated by the IMF is to compare non-oil primary deficits with a fiscal benchmark based on the prudent management of oil wealth. The sustainable non-oil deficit is determined by government wealth (including the present discounted value of oil revenues), rather than by the flow of oil revenue. The idea is that governments should accumulate assets (wealth) in order to sustain the non-oil deficit once oil reserves have been exhausted. This requires the accumulation of enough assets for the return on those assets to finance the non-oil deficit once oil reserves are exhausted (Barnett and Ossowski, 2003). Put more formally, the permanently sustainable non-oil primary deficit is the primary deficit that could be sustained indefinitely if spending were set on a constant path equal to the expected annuity value of oil wealth and non-oil revenue (Olters, 2007).

This indicator should not represent a formal fiscal target, not least because it does not capture growth feedback effects: public investment today can stimulate economic growth, increasing government revenues and improving the sustainability of a given expenditure path. However, it could usefully be used to guide debate as to the long-term sustainability of current fiscal policy, helping to inform investment and spending decisions and focusing attention on the quality of public investment.

The low scores on government effectiveness measures for both Congo and Equatorial Guinea highlighted in Section 6.7 suggest there are severe institutional constraints that need to be overcome if this challenge is to be met. One important element of any strategy to do so would be to pursue efforts to put in place locally appropriate institutions to support the sustainable and transparent management of oil wealth (see Box 2).

Box 2: Oil wealth management [27]

Oil-producing states have established a number of special institutional arrangements to manage oil wealth, such as oil funds and fiscal rules. The creation of oil funds is a particularly common measure, which seeks to address three objectives: (i) macroeconomic stabilisation (smoothing government expenditure in the face of volatile oil revenues); (ii) financial saving of oil wealth; and (iii) enhanced transparency.

The Equatorial Guinea authorities have recently created a Fund for Future Generations (FFG) and committed to allocating 0.5% of oil revenues into the dedicated fund held at the regional central bank (BEAC). Early indications are that the FFG is explicitly captured in the financing component of budget documentation and that the revenue share rule has been adhered to in the recent years. The Equatorial Guinea government also has a fiscal rule that current expenditures are to be funded only from non-oil revenues. However, this rule has not been effectively observed in recent years, and current expenditure in the 2005 budget exceeded non-oil revenue by more than 40%, the shortfall being met through oil proceeds. This de facto practice is formalised in

other countries: for example, in Norway, a variable proportion of each year's net oil-tax revenue is transferred from the Norwegian Petroleum Fund to the government's budget (Toto Same, 2008).

Important good practice principles from Norway's oil fund include: (i) making all decisions on spending and the fiscal policy stance within the budget process; and (ii) using stringent transparency and accountability provisions to govern the fund. Of course, the institutional solutions that work in wealthy Organisation for Economic Co-operation and Development (OECD) democracies cannot be directly transplanted into low-income countries with challenging governance environments and weak capacity (see Schick, 1998b, for example). Nonetheless, Equatorial Guinea could improve the transparency and accountability of its oil wealth management by adhering to the Extractive Industries Transparency Initiative (EITI). Equatorial Guinea obtained Candidate status from the EITI Board in early 2008 and now has until March 2010 to meet the validation criteria that will provide the status of an EITI Compliant country (see EITI, 2006, for more details).

[27] See IMF (2007f) for a more detailed discussion of the role of fiscal institutions in managing the oil revenue boom.

7. SUMMARY OF POTENTIAL FISCAL SPACE IN CASE STUDY COUNTRIES

This section draws together the analysis presented in Sections 5 and 6 in order to summarise the situation with regard to potential fiscal space in each of the five case study countries. This should be read in conjunction with Annex 1, which presents summary data for each country against each of the dimensions of fiscal space creation and use identified in Table 1. It should also be noted that these findings are indicative only – the more detailed country case studies provide more in-depth institutional and political detail (Holmes and Villar, 2009; Jones et al., 2009; Pereznieto and Diallo, 2009; Pereznieto and Fall, 2009; Villar and Makosso, 2009).

7.1 CONGO

Headline figures suggest that Congo shows significant potential fiscal space. It has seen sustained economic growth as a result of an oil boom, averaging 4.1% real growth over the period 2000-2007. Revenue growth (including oil revenue) has also been strong, averaging 21.7% over the period 2002-2005, with a relatively low non-oil tax to GDP ratio of 5.3% in 2005. Total expenditure averaged 30.6% of GDP over the period 1997-2008, although this has fallen in recent years and in 2008 was projected to be the lowest of the five case study countries, at 22.7% of GDP. In 2005, non-discretionary expenditures were relatively high, at around 9.1% of GDP. Congo has also realised significant reductions in its external debt stock, which fell from 180% of GDP in 2002 to 78% in 2006; it is the only country still due to benefit from substantial debt relief once it reaches HIPC completion point, although slow progress relative to key triggers means that its HIPC completion point may not be reached in the near future.

The economy is heavily dependent on oil and this is reflected in the structure of public finances. Oil-related fiscal revenue represented around 68.7% of total revenue in 2003; the non-oil primary deficit as a proportion of non-oil GDP stood at 47.8% in 2006 (one of the largest non-oil deficits in Africa), compared with a permanently sustainable non-oil primary deficit of 38% of GDP. This, together with a projected decline in oil production over the next decade, suggests there will need to be a substantial fiscal adjustment in the long term as oil revenues decline. The macroeconomic implications of large increases in public expenditures would also need to be monitored carefully, as domestic credit to the private sector (and financial sector development more generally) is at a low level and vulnerable to interest rate rises. This means that reallocation and reprioritisation of existing expenditures are likely to be an important source of fiscal space, particularly for a long-term commitment such as social protection.

The simulations of the costs of different social protection policy options for Congo indicate that a UCB providing a transfer equivalent to 30% of the extreme (food) poverty line to every child aged 0-14 would cost 2.0% of GDP; a TCB with the same transfer value to children in households below the poverty line would cost 1.2% of GDP. Notwithstanding the cautionary remarks above, this suggests that even a UCB would be affordable in Congo, since this would cost only a fraction of the country's overall fiscal surplus, which was 11.1% of GDP in 2007 (AFRREO). However, the very low levels of health and education spending (2.2% and 1.2% of GDP, respectively) suggest a very low level of government commitment to converting oil wealth into fiscal space for improved social service provision, although there are indications of some improvements in the 'pro-poor' emphasis of spending, with the pro-poor proportion of public spending increasing from 4.0% of GDP in 2003 to 6.4% in 2006 (IMF, 2007b). Further, low measures of institutional quality suggest that government capacity – and PEM systems in particular – need to be strengthened before it will be possible to ensure that intended beneficiaries receive the transfer. This would be an added argument for an administratively simpler and less easily manipulated universal approach rather than one requiring targeting and more complex administrative mechanisms.

7.2 EQUATORIAL GUINEA

Equatorial Guinea is by far the strongest candidate country for the affordability of social protection provision, benefiting as it does from vast oil wealth. Driven by oil, real economic growth averaged an exceptionally high rate of 20.1% over the period 2000-2007 and the economy is now 20 times larger than in the mid-1990s. As a result, revenue growth averaged 48.2% over the period 2002-2005. Meanwhile, the non-oil tax revenue to GDP ratio is extremely low, at 1.6% of GDP in 2005, and total expenditure is relatively low, averaging 19.0% of GDP over the period 1997-2008 and projected to reach 24.5% in 2008. Non-discretionary expenditure stands at only 1.1% of GDP and discretionary expenditure at 15.9% of GDP. Inflation is in single digits, levels of indebtedness are very low and there is a strongly positive current account balance, suggesting that the macroeconomic framework is relatively robust for increased spending.

To an even greater extent than Congo, Equatorial Guinea's economy is reliant on oil, with 84.4% of oil fiscal revenue as a proportion of total revenue in 2003 and a non-oil primary deficit as a proportion of non-oil GDP of -143.4% in 2006, compared with a permanently sustainable non-oil primary deficit of around 32%. That is the highest non-oil deficit in sub-Saharan Africa. Even so, there is clearly potential fiscal space for additional expenditures, particularly those that enhance the productivity of the non-oil economy (as social protection may well do). Indeed, the estimated costs of social protection are relatively low for Equatorial Guinea when expressed as a proportion of GDP – both a UCB and a universal social pension could be provided for a combined cost of around 1% of GDP.

However, although social protection is clearly affordable in simple aggregate terms, it is not immediately clear whether sufficient organisational capacity exists to develop and administer social protection programmes in light of the very low government effectiveness scores (of the case study countries, Equatorial Guinea scored lowest on government effectiveness in 2005). Offsetting this to some extent, the widespread nature of poverty means that such schemes would not require very specific targeting, thereby lessening the administrative requirements for satisfactory delivery. Overall, social protection is certainly affordable for Equatorial Guinea, but the feasibility of undertaking the associated institutional reform required to deliver benefits to the poorest requires further investigation.

7.3 GHANA

In the short term, the government of Ghana is probably the least able to afford additional spending on social protection among the case study countries, notwithstanding possible future growth and revenues associated with the exploitation of recently discovered oil reserves over the medium to long term (see Bogeti , 2007, Annex 1 for a discussion). Ghana experienced real economic growth of 5.2% per annum on average over the period 2000-2007 and very strong revenue growth too, averaging 35.9% over the period 2002-2005. Revenue is also high as a proportion of GDP: in 2005, the tax revenue to GDP ratio was 20.6%, the highest among the five case study countries (excluding oil revenues). The prognosis for potential fiscal space is mixed, however, as alongside strong revenue growth there has been strong growth in the size of the public sector relative to the economy, with total expenditure as a proportion of GDP averaging 30.6% of GDP over the period 1997-2008 and projected to reach 38.1% by 2008, again the highest value of the case study countries. In terms of the composition of expenditures, a relatively large share is taken by non-discretionary expenditures (10.8% of GDP), partly as a result of rapid growth in wages and salaries in recent years, which constituted around 28% of total expenditure in 2005. While this suggests that there is limited scope for reallocation, there is also evidence that pro-poor expenditures increased from 4.5% of GDP in 2001 to 6.9% of GDP in 2004.

Further, Ghana has already showed willingness to spend on social protection, with the addition of 2.5% to the VAT rate in 2004 to finance the new national health insurance scheme (NHIS). More recently, Ghana's Ministry of Manpower, Youth and Employment launched the Livelihood Empowerment Against Poverty Programme, or LEAP, in March 2008. By June 2008, 3200 households were each receiving monthly payments of US$8. The total cost of LEAP over the next five years (2008-2012) is estimated at 0.1-0.2% of total government expenditure (Sultan and Schrofer, 2008).

Having reached the HIPC completion point, Ghana has benefited from substantial debt relief and the external debt stock has declined dramatically (from 99% of GDP in 2003 to 23% in 2006), although contingent liabilities continue to pose a serious threat to debt and fiscal sustainability, adding possibly as much as 2.5% of GDP to the overall fiscal deficit. Even so, the macroeconomic framework is relatively robust.

Overall, there is limited room for manoeuvre in Ghana, but better prospects that any available fiscal space will be spent equitably and efficiently than in the other case study countries. Developing one of the less costly options proposed in the simulations, such as a well-targeted social pension (at an estimated cost of around 2% of recurrent expenditure and 0.5% of GDP per year) may well be a feasible aim within the confines of the government budget process; as the government scores relatively highly on the CPIA – including the dimensions that relate to fiscal and budgetary management – it is more likely to be well administered than in countries such as Congo and Equatorial Guinea. A significant child benefit (at an estimated cost of around 46% of recurrent expenditure and 8.7% of GDP) would be much more difficult to accommodate, equivalent to over three times total public health expenditure and politically challenging in light of the issues associated with reducing the large public sector wage bill. Other pressing needs include infrastructure bottlenecks – particularly in energy and water and sanitation – which will compete for attention when any fiscal space is allocated (see Estache and Vagliasindi, 2007). An alternative option in Ghana might be to consider an extension of the LEAP cash transfer programme to cover all extreme poor households – at present it is planned to reach only one-sixth of extreme poor households within five years, based on a very narrow form of categorical targeting (orphans and vulnerable children (OVC), persons with severe disabilities who are unable to work and elderly people with no other means of support).

7.4   MALI

Mali achieved a 4.6% rate of real economic growth over the period 2000-2007 and nominal revenue growth averaged a relatively modest 12.2% over the period 2002-2005. The revenue yield (tax revenue to GDP ratio) was 15.8% in 2005, suggesting some room for an increase when compared with levels in Ghana and Senegal. Total expenditure as a percentage of GDP averaged 23.5% over the period 1997-2008, and was projected to reach 26.9% in 2008, second only to Ghana among the case study countries. Within total expenditure, non-discretionary expenditures comprise a relatively small share (equivalent to 5.5% of GDP in 2005, compared with discretionary expenditure at 19.7% of GDP), which suggests there may be some scope for reallocation within the overall expenditure envelope. This avenue for creating fiscal space is supported by a recent IMF review, which stressed that meeting social goals depends as much on reinforcing the impact of spending as on increasing its level (IMF, 2008). There may also, in theory at least, be scope for inter-sectoral reallocation: military expenditure as a proportion of GDP was the highest of any case study country, at 1.9% in 2005. The fiscal balance excluding grants over the period 1997-2008 averaged -7.7% and including grants stood at -3.8% of GDP in 2007, the healthiest balance among the three aid-dependent case study countries.
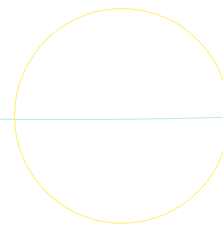
The external debt stock has reduced markedly in recent years as a result of debt relief and now stands at 22.6% of GDP. Having reached the HIPC completion point, the scope for additional debt relief seems limited and, although increasing borrowing may be feasible in the short term, it does not offer a long-term solution for the financing of social protection. Additional aid also seems a dubious avenue for financing social protection, given the unpredictability associated with aid flows and the already high level of aid relative to total government expenditure (which stood at 20.4% in 2007, the highest proportion in any case study country).

Cost estimates based on detailed simulations of different social protection options suggest that a UCB could be provided at a cost of around 5.9% of GDP per year and a TCB using a proxy means test at a cost of 3.2% of GDP. Both options are clearly unaffordable. To put these costs in perspective, the TCB would be equivalent to Mali's total public health expenditures, which accounted for 3.2% of GDP in 2004, or three-quarters of its public education expenditure (4.3% of GDP in 2005). Only a more modest scheme would be feasible in the short to medium term, although simple measures of government institutional capacity such as the CPIA suggest that such funds may well be relatively well managed compared with some other case study countries. Alternatives might be a lower level of benefit and/or targeting households below the extreme (food) poverty line rather than the poverty line.

7.5   SENEGAL

Senegal achieved a real economic growth rate of 4.2% over the period 2002-2007, with growth in annual tax revenue averaging 9.9% over 2002-2005 (the lowest level among the case study countries). In addition, revenue yields are already relatively high, with tax revenue accounting for 18.8% of GDP in 2005. The overall size of the public sector in relation to the economy as a whole is also relatively high, as total spending averaged 24.8% of GDP over 2003-2007. The overall fiscal deficit before grants stood at -6.6% in 2005, improving to -4.4% once grants are included, but still relatively large for a developing country (only Ghana had a larger fiscal deficit in 2007).

Reallocation – rather than increases in total spending – may be an area where fiscal space could be created, as discretionary spending stood at 17.8% of GDP in 2007 (compared with a level of non-discretionary spending of approximately 6.5% of GDP); wages and salaries accounted for 23% of total public spending in 2005. Still, a very substantial portion of budgetary resources would need to be freed up, as estimates suggest that the social protection options for which simulations were run would be relatively expensive for Senegal. A UCB would cost 6.4% of GDP per year (equivalent to 30% of recurrent expenditure) whereas a TCB using a proxy means test would cost around 2.5% of GDP (12% of recurrent expenditure). The latter, cheaper, option would be equivalent to over three-quarters of total public health spending (which accounted for 3.7% of GDP in 2004). Even the targeted option would cost more than Senegal's entire public health expenditure (2.4% of GDP in 2004) and would cost more than two-thirds of actual expenditure on education (5.4%). As with Ghana and Mali, more modest schemes may need to be investigated.

On the plus side, Senegal scores relatively well on CPIA and government effectiveness measures compared with other case study countries (outscored only by Ghana), suggesting that there may be an adequate base from which to strengthen state capacity to manage social protection programmes. Further, headline indicators suggest that the overall macroeconomic framework is relatively robust. Inflation averaged 2.0% per year over 2003-2007, the current account deficit averaged 7.6% of GDP over the same period and credit to the private sector as a percentage of GDP averaged 20.9% over 2002-2006.

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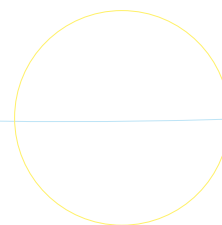
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GLOSSARY OF SELECTED TERMS

Allocative efficiency: The strategic prioritisation of expenditure across policies, programmes and projects in line with government priorities. This requires strong capacity to define national priorities and capacity and willingness to reallocate expenditures from lesser to higher priorities and from less to more effective programmes. In order for allocative efficiency to be fulfilled, it is important that all public expenditures are captured 'on-budget'. Activities placed outside the official 'budget' (including those financed by foreign aid) are not subject to the discipline of the resource allocation process. A comprehensive budget process promotes allocative efficiency because it forces trade-offs between the different ways a government uses financial resources (World Bank, 1998).

Appropriation: The budget approved by the legislature and any subsequent (approved) additions to it, giving legal authority to the executive to make expenditures up to the amounts specified. The authorisation to spend may be given to individual ministries or departments or it may be granted specifically to the chief executive or his representative who retains the freedom to subsequently authorise spending by the ministries (IMF, 1986).

Broad money: The widest of various measures used to gauge the growth of a nation´s money supply. While there is some discretion at national level as to its precise definition, it typically includes all holdings of notes and coin by the public, as well as borrowings by non-bank financial institutions and all holdings in cash management trusts.

Budget documentation: Includes the annual budget presentation, the budget-supporting documents, including but not limited to background to policy proposals and discussion of fiscal risks, within-year budget reports for monitoring budget execution and the final accounts. (IMF, 2007g).

Contingent liability: Contingent liabilities are obligations triggered by a discrete but uncertain event. They are therefore possible obligations whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the government's control (this should be contrasted with direct liabilities, which are predictable obligations that will arise in any event). There is a second useful distinction to be made between explicit liabilities defined by law or contract that the government is legally obliged to settle when due and implicit liabilities that the government may be obliged to meet owing to public expectations and political pressures (Polackova, 1998).

Efficiency: The relationship between outputs, in terms of goods, services or other results, and the resources used to produce them. An efficient activity maximises output for a given input, or minimises the unit cost of output. Effectiveness is the extent to which the objectives of the activity have been achieved and economy is the extent to which resources of a given quality are acquired at the lowest cost (Schiavo-Campo and Tommasi, 1999).

Entitlement: Any spending programme where expenditure is open-ended (usually transfer/grant payments) and where recipients must be paid or given transfers/grants, if they meet certain criteria. Some common examples are found in social security programmes, unemployment programmes and poverty programmes (DFID, 2001).

Fiscal balance: The fiscal balance (also known as the overall, conventional or total balance) equals expenditure (comprising expenditure and lending minus repayments) minus income (including both revenue and grants). If

the fiscal balance is negative then the government is spending more money than it takes in over the budget year and there is said to be a fiscal deficit (often simply referred to as a 'deficit'). The government then has to raise funds to finance the deficit by borrowing, running down deposits or via currency emission in order to make up for the shortfall. If the fiscal balance is positive there is said to be a fiscal surplus. If the fiscal balance is greater than or equal to zero it is often said that there is a balanced budget. Public debt consists of all liabilities that require payments of interest and/or principal by the government to its creditors in the future. It is essentially an accumulated flow of fiscal deficits. In other words, a deficit is a flow and debt is a stock (hence public debt is often referred to as the debt stock). There are a series of related terms that provide important fiscal indicators in addition to the fiscal balance:

- **Primary expenditures** are expenditure minus interest payments on public debt.
- The **primary balance** equals the fiscal balance minus interest payments on public debt.
- The **operational balance** equals the primary balance plus real interest payments.
- The **current balance** equals recurrent revenues minus recurrent expenditures.
- The **fiscal balance** excluding grants equals expenditure minus revenue. The 'fiscal balance including grants' is thus synonymous with the fiscal deficit.
- The **non-oil primary balance** is the difference between non-oil revenues, including grants, and total primary expenditures (and expressed as a proportion of non-oil GDP).
- The **permanently sustainable non-oil primary deficit** equals the level of non-oil primary deficit that could be sustained indefinitely if spending were set on a constant path equal to the expected annuity value of oil wealth and non-oil revenue (Olters, 2007).

Fiscal policy: government policies with respect to taxes, spending and debt management that affect macroeconomic outcomes, particularly with respect to employment, the size of the economy, price level stability and equilibrium in balance of payments. The budget process is a major vehicle for determining and implementing fiscal policy (DFID, 2001).

Fiscal space: Room in a government's budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy (Heller, 2005).

Fiscal sustainability: This is a concept with multiple dimensions arising out of the different perspectives of those urging attention to the issue (Schick, 2005). The definition adopted here is the capacity of a government, at least in the future, to finance its desired expenditure programmes, to service any debt obligations (including those that may arise if the created fiscal space arises from government borrowing) and to ensure its solvency (Heller, 2005).

Fiscal transparency: Openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts and projections. It involves ready access to reliable, comprehensive, timely, understandable and internationally comparable information on government activities so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications (IMF, 2007g).

Fiscal year: The government's accounting period, often referred to by the year in which it ends (DFID, 2001).

Fungibility: At its most generic level, fungibility is the interchangeability of funds resulting from standardisation. In the context of foreign aid, it means that if a government undertakes a donor-financed project in the absence of that financing, then donor funds simply relax the government's budget constraint and finance, at the margin, something else. In a federal structure of governance, aid earmarked for a subsidiary government could end up replacing funds that the federal government would have given in the absence of that aid (Devarajan and Swaroop, 1998).

Governance: The process by which decisions are made and implemented (or not implemented). Within government, governance is the process by which public institutions conduct public affairs and manage public resources. Good governance refers to the management of government in a manner that is essentially free of abuse and corruption, and with due regard for the rule of law (IMF, 2007f).

Grant: Transfers made in cash, goods or services for which no repayment is required.

Import compression: The rationing of imports, typically introduced in order overcome current account imbalances, thereby generating the trade surpluses required to gain foreign exchange and pay foreign debt (Khan and Knight, 1988).

Outturn: Actual revenues and expenditure (DFID, 2001).

Progressive (regressive) tax: A tax on income in which the tax paid as a proportion of income increases (decreases) as income increases.

Proven reserves: In terms of recoverable hydrocarbon reserves we follow Olters (2007) in defining proven reserves (1P) as representing the estimated quantities of oil that have a probability of at least 90% of being recovered from already discovered fields and probable or unproven reserves (2P-1P) as representing quantities of oil that have a probability of at least 50% of being recovered from discovered or suspected fields.

Public expenditure management (PEM): The way in which public money is allocated to alternative uses and in which these decisions are implemented. It is broader than the traditional budget process through its focus on the link between expenditure and policy and its recognition of the importance of a broad range of institutional and management arrangements (DFID, 2001).

Recurrent budget: Expenditures on wages and salaries, operations and maintenance that are not of an investment nature (DFID, 2001).

Seignorage: Profit on the issue of coinage by government, representing the difference between the face value of currency issued and its cost of production including the cost of base metals (IMF, 1986).

Transparency: One of the characteristics of a robust PEM system. A transparent PEM system provides an understandable guide as to how resources are planned to be used and what results are expected to be achieved. Reporting should also enable easy monitoring of performance against government's stated intentions (DFID, 2001).

ANNEX 1. INDICATORS OF FISCAL SPACE IN CASE STUDY COUNTRIES

#	Mechanism/measure	Indicators	Congo	EG	Ghana	Mali	Senegal	Data source
1	Mobilisation of domestic revenues (tax measures, strengthening tax administration)	Real GDP growth (% p.a.), avg. 2002-2007	4.1	20.1	5.2	4.6	4.2	WEO
		Tax revenue growth (annual % change), 2002-2005	21.7	48.2	35.9	12.2	9.9	IMF staff estimates
		Revenue yield (tax revenue as % of GDP), 2005	5.3	1.6	20.6	15.8	18.8	IMF staff estimates
2	Reallocation between sectors (cut lower priority expenditures to make room for more desirable ones) and efficiency gains	General government final consumption expenditure (% of GDP), 2003-2007	27.8	19.8	32.3	24.8	24.8	AFRREO
		Non-discretionary spending (wages and interest) (% of GDP), 2005	9.1	1.1	10.8	5.5	6.5	IMF staff estimates
		Discretionary spending (% of GDP), 2005	14.6	15.9	19.9	19.7	17.8	IMF staff estimates
		Public education expenditure (% total government expenditure)	8.1	4.0 (2003)	N/A	14.8	18.9	WDI
		Public education expenditure (% GDP), 2005	2.2	0.6*	5.4	4.3	5.4	WDI
		Public health expenditure (% GDP), 2004	1.2	1.2	2.8	3.2	2.4	WDI
		Military expenditure (% GDP), 2005	1.4 (2003)	N/A	0.7	1.9	1.5	WDI
		Overall fiscal balance, including grants (% GDP), 2007	11.1	22.5	-6.9	-3.8	-4.4	AFRREO
		Overall fiscal balance, excluding grants (% GDP), 2007	10.7	22.5	-11.6	-9.3	-6.6	AFRREO
		Non-oil fiscal deficit (% non-oil GDP), 2006	-47.8	-143.4	N/A	N/A	N/A	IMF staff estimates
3	Increase discretionary expenditure through debt reduction	HIPC completion point?	N/A	Interim	Completed	Completed	Completed	IMF
		External debt stock (% GDP), 2007	78.2 (2006)	3.8 (2005)	23.6	22.6	18.3	IMF staff estimates
4	Increase borrowing (from domestic or external sources)	Debt service (% exports), 2005	11.8	0.2	2.4	7.4	11.7	IMF staff estimates
		Debt service (% receipts), 2005	25.8	14.0	N/A	N/A	15.8	IMF staff estimates
5	Increase aid	Official grants (% of GDP), 2003-2007	0.4	0.3	4.4	2.1	1.6	AFRREO
		Official grants (% of central government expenditures), 2007	0.8 (2005)	1.0 (2005)	15.0	20.4	7.1	IMF staff estimates
6	Seignorage (central bank prints money in order to lend it to the government)	Broad money (money and quasi money or M2) as % of GDP, 2003-2007	15.46	7.92	34.02	29.82	34.82	AFRREO
		Inflation (average consumer prices, annual percent change), 2003-2007	3.0	5.2	15.0	1.3	2.0	WEO
7	Prospects that additional spending can be properly managed	IMF/World Bank assessment of HIPC PEM: number of indicators out of 15 fulfilled, 2006	N/A	N/A	7	6	7 (2004)	IMF
		Selected CPIA scores on economic management and public sector management and institutions for 2005, e.g.:						
		• Fiscal policy	2.5	N/A	4.5	4	4	World Bank
		• Equity of public resource use	2.5	N/A	4	3.5	3.5	World Bank
		• Transparency, accountability and corruption in the public sector	2.5	N/A	4	3.5	3	World Bank
		IRAI	2.8	N/A	3.9	3.7	3.7	World Bank
		Government effectiveness, 2002-2005	-1.4	-1.5	-0.1	-0.5	-0.1	Kaufmann et al. (2006)
8	Can the macroeconomic framework withstand significant increases in demand pressures?	Credit to the private sector (% of GDP), 2002-2006	1.6	2.8	14.0	18.5	20.9	WDI
		Current account deficit including grants (% of GDP), 2003-2007	0.36	-10.92	-6.34	-6.88	-7.58	AFRREO

ANNEX 2. THE POLITICS OF REALLOCATION IN GHANA

Spending on wages and salaries in Ghana provides a useful case study in the highly political nature of some public expenditures. We focus on Ghana because the issues here are better documented, and also because, as one of the countries performing most strongly against institutional performance measures in the region, issues in Ghana are suggestive of perhaps even more severe challenges elsewhere too.

The health and education sectors in Ghana have received significant increases in budget allocations, which have grown substantially in real terms. Rises in wages and salaries won by health and education workers have been a major driver of these budget increases. While it is clearly important to ensure that sufficient incentives are provided for public sector workers, there are question marks as to how efficient and effective this spending has been. In addition, not only is the wage bill increasing, but there are consistent and large wage bill overruns relative to the approved budget, which may mean other expenditures have to be sacrificed (IMF, 2007d). Where spending is inefficient and imbalanced, it does not go as far as it could in supporting the poor. This is doubly problematic if political constraints prevent the funds being used more usefully elsewhere: the difficulties inherent in reducing expenditures on wages and salaries as a proportion of total recurrent spending limit the scope for the creation of fiscal space for social protection through reallocation.

In terms of sector-level results, increased spending on education has translated into significant improvements in access to education services, with a 5% growth in the number of public schools and an 8% growth in the number of teachers between 1999/2000 and 2004/05. Total enrolment of 6-11 year-old pupils, in private and public schools, jumped by nearly 20% between 2004/05 and 2005/06. Realising progress in health has been more difficult, despite increasing resources. Allocative efficiency has been hampered by the fragmentation of sector budgets, the lack of control over the wage bill and the rising administrative costs of health service provision. Weak performance may also be partially explained by the fact that the health sector employs relatively few tertiary skilled workers (doctors and nurses), undermining the ability of health facilities to provide the high levels of care needed to significantly improve the performance of health indicators. Primary education, on the other hand, requires fewer tertiary skilled workers, partly explaining how it has been able to deliver more significant service delivery improvements for a very similar overall level of resources (see table).

Public spending and employment in health and primary education in Ghana, 2004

	Health		Primary education	
	Expenditure (billion cedis)	% total expenditure	Expenditure (billion cedis)	% total expenditure
Total	2322	100	2288	100
Labour	936	40	1700	74
Unskilled	0	0	29	1
Skilled	495	21	983	43
Tertiary	441	19	688	30

Source: Bogetic et al. (2007).

In terms of fiscal space, wage increases represent a severe constraint. Wages and salaries in Ghana accounted for 28% of total expenditures in 2005, a considerably larger ratio than in the other four case study countries. Moreover, there continue to be strong pressures to raise the already large wage bill still further. For example, recent moves by the government to radically improve rewards within the health service in 2005-2006 (and their likely spill-over effects elsewhere in the public service) are in stark contrast to the overall strategy on public sector reform and the design of the promised new integrated salary structure by a newly created Fair Wages Commission.

As a result, the wage bill in the budget was expected to rise by 60% in 2005-2007, even before accounting for the usual overspend on this item during 2007. Political control over staff recruitment remains strong, suggesting that appointments are not always made with improved service delivery as the primary objective. Further, it is unlikely that one of the key issues in public sector reform – the large disparity between public and private sector wages for skilled workers – can be addressed within the constraints of budget discipline without simultaneous reductions in the 650,000 people said to be employed in the public sector (Lawson et al., 2007).

What is really needed in order to address this challenge is not significant additional (and arguably unsustainable) expenditure, but increases in the productivity of public sector personnel and more efficient use of resources. This will require concerted and broad-based political support for a more efficient allocation of expenditures within the health sector. However, there are aspects of the political culture of Ghana that make it unrealistic to expect strong government-wide political commitment to reform (Booth et al., 2005).

Overall, this illustrates that the primary constraint to improved performance in health is not fiscal but political. What is often presented as an overly simplistic conflict between fiscal constraints and improvements in service delivery to reach the MDGs masks a deeper and more intractable problem.