



# **MACRO-FISCAL COORDINATION AND HARMONIZATION IN EAMU**

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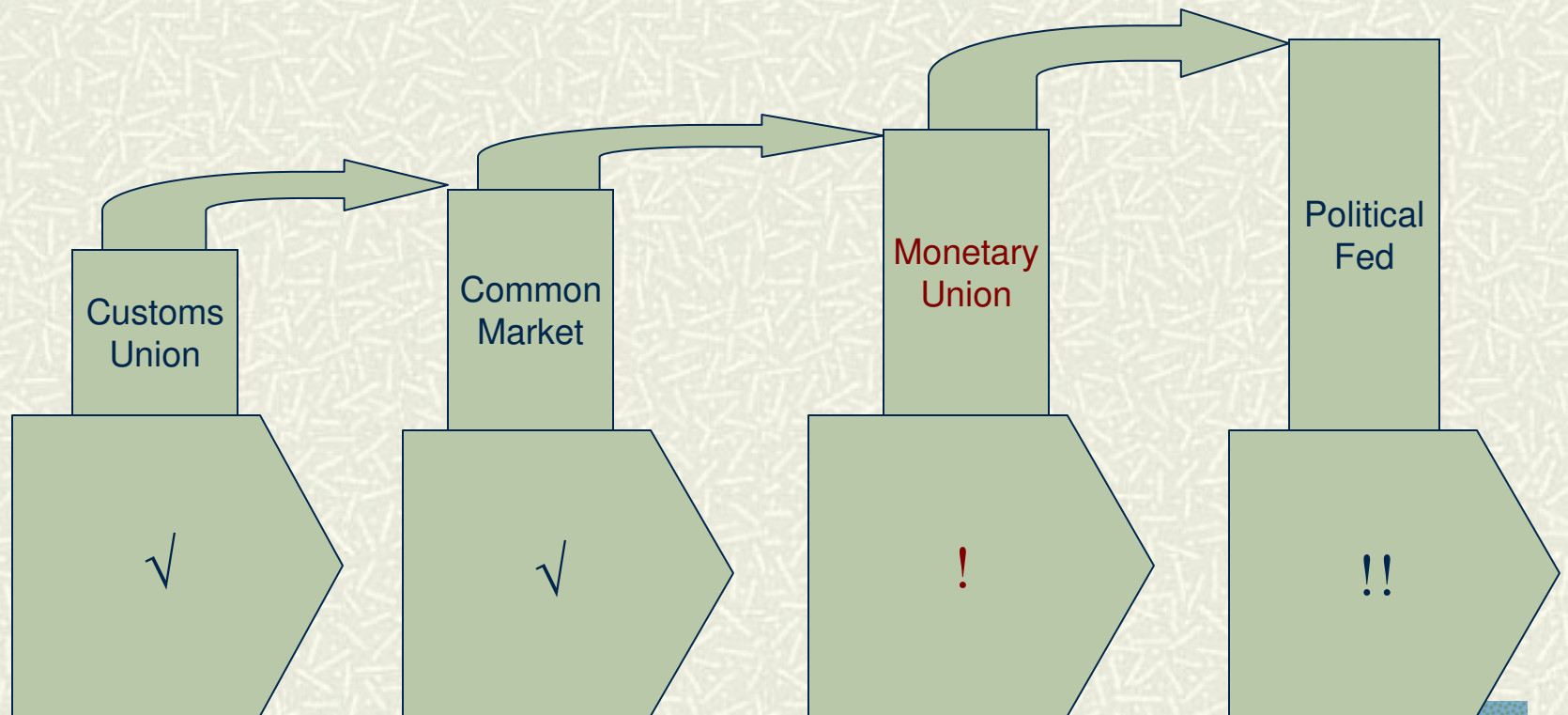
**28<sup>th</sup> February, 2012**

# Presentation Outline

1. Background to EAMU
2. Benefits of EAMU
3. Cost of Entering EAMU
4. Macro-Fiscal Policy: Context
5. Fiscal Policy Requirements for EAMU

# EAMU Background

- Attaining **RI** leading to a **MU** and finally a **PF** is a journey of years
- As EAC, this journey is in two phases - (EAC I and EAC II)



# EAMU Benefits

- Entering into EAMU offers potential benefits to EAC Partner States. Specifically:
  - A single currency eliminates bilateral XR risks thus reducing transaction and accounting costs;
  - Integration of financial markets promotes cross-border banking operations, boosts financial sector competition and lower interest rates;
  - Deepened regional trade and investment promotes economic growth, employment creation and poverty reduction; and
  - Entering EAMU Provides enhanced influence on the global stage;

# EAMU Benefits Cont..

- Strengthens institutional framework for macro-economic stability, necessary for long term investment and growth
  - Common currency provides potential for reinforcing the discipline and credibility of monetary and XR policies
  - It achieves this by separating responsibilities for monetary and XR policies (regional) and fiscal policy (national), however, close coordination is necessary

# Costs of Entering EAMU

- The costs of entering EAMU mainly arise at macro level:
  - This entail loss of independence over monetary and exchange rate policy
    - lose of mechanism to protect itself from economic shock
  - Without clear and enforceable rules, EAMU can create moral hazard for borrowing policy
    - A bias towards higher deficit;
  - Loss of some fiscal sovereignty, especially taxation and level of debt stock
  - A a painful adjustment cost to asymmetric shocks (adverse economic shock) through fiscal and wage/price adjustments

# Costs of Entering EAMU Cont..

- # But such costs of entering MU is minimized if:
  - The shock affects partner states similar (symmetrical)
  - Prices and wages are flexible and labour sufficiently mobile
  - There exists a high product diversification and covariation in economic activities among partner states
  - Patterns of inflation exhibit similarities arising from similar conduct of economic policies and structure of economies

# Macro-Fiscal Policy: Context

- Macro-economic stability is critical for to ensure sustained growth, employment and poverty reduction.
- The key instruments for achieving macro-economic stability are:
  - (i) monetary policy; and
  - (ii) fiscal policy.
- In many cases of macro-economic instability, the main cause is usually the lack of fiscal discipline.
- Therefore, instilling fiscal discipline and getting the right fiscal framework are crucial for containing pressures on interest rates, inflation and exchange rates



# Macro-Fiscal Policy: Context Cont.

- The role of fiscal policy in economic development of EAC is achieved through:
  - **Allocative efficiency role**
  - **Distributive role; and**
  - **Stabilization role**
- These functions/roles can be mapped to a Budget outturn covering:
  - **Revenues** - taxation and its effects on economic agents' decisions
  - **Expenditures** - effects of budget composition on economic growth and income distribution
  - **Deficit and its financing** - debt either domestic or external, and its impact on investment, growth and macroeconomic stability

# Macro-Fiscal Policy: Context Cont.

- # The three functions can be wrapped up into a single but critical fiscal policy instrument/anchor – **deficit/debt**:
  - **Low deficit and debt** – low level of debt is ingredient for economic growth, essential for reducing poverty and improving welfare
  - It **reduces the risk of economic crisis** caused by government's ability to service its debt
  - It prevents interest rates on bills from rising **to avoid crowding out private sector**
  - It allows creation of fiscal space for countercyclical mgt
- # The **resultant macroeconomic stability** yields numerous benefits, including higher rates of investments, growth and educational attainment,- for sustained development of EAC

# Macro-Fiscal Policy: Context Cont.

■ To maintain a sustainable level of deficit and debt consistent with EAC development agenda, EAC fiscal policy must focus on three major sources, namely:

- Over-estimation of GDP forecast
- Under-performance in revenues
- Over-spending by spending agencies

i. **Over-estimation of GDP growth** due to:

- Technical capacity constraints – instruments (model) and skills
- Due to fiscal mischief to conceal high deficit
- Policy implementation challenges holding back growth; and
- Evolving budget/expenditure composition: Investing in future

# Macro-Fiscal Policy: Context Cont.

- ii. **Under-performance of revenue** – (direct and indirect taxes) due to:
  - Weaknesses in tax administration capacity
  - Policy implementation challenges by partner states
  - Asymmetric adverse economic shock
- iii. **Over-expenditures** – with recurrent or development or both due to:
  - Over-estimation of expenditure on account of high growth
  - Inclusion of new (unforeseen) expenditures midstream without corresponding resources
  - Lack of fiscal discipline in upholding hard budget constraint requirement

# Fiscal Policy Requirements for EAMU

- ✦ Given the adverse impact of deficit financing on macroeconomic stability, investment and growth
  - Fiscal policy under EAMU must be comprehensive covering:
    - Revenue and Taxation
    - Budget and Expenditure
    - Deficit and Debt level
  - Requirements must also cover Economic and institutional frameworks:
    - Fiscal coordination rules
    - Enforcement and surveillance framework

# Fiscal Policy Requirements for EAMU

- # Requirements under **Revenue and Taxation** should include:
  - Establish the tax gap and agree on a min revenue as a share of GDP to be raised by each partner state
  - Harmonize domestic taxes for regional economic efficiency, including mobility of factors
  - Establish a framework to manage intra-regional VAT refund system
- # Under **Budget and Expenditure**
  - Develop **fiscal rules** to guide preparation and execution of budget
    - Share of expenditures to defense, wages to reduce crowding out dev
    - Budget surplus to release resources for funding development
    - Type of development expenditure to be funded under PPP
  - A framework to **bias expenditure** toward 3-key areas of:
    - Infrastructure development
    - Human capital development
    - Security and enforcement of property rights

# Fiscal Policy Requirements for EAMU

## ■ Under **deficit and debt**:

- Set a level of medium term deficit, including grants (for instance 3%)
- Strictly monitor non-temporal income, non-grant and non-resource deficits – to gauge fiscal sustainability
- Set a ceiling for net debt stock consistent with DSA (for instance upper limit of 50% to GDP)
- Establish fiscal rules for sources and deployment of borrowed funds

## ■ The requirements must also cover institutional issues such as:

- Separation between fiscal and monetary policy operations
- Mechanism for coordinating monetary and fiscal policy
- A framework for coordinating macro forecasting and reporting
- Fiscal disclosure rules
- Institutional framework for surveillance and enforcement with legal powers

# FISCAL POLICY EAMU

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