WEST AFRICAN
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The Commission

THE COORDINATION OF FISCAL POLICIES IN THE WEST AFRICAN ECONOMIC AND MONETARY UNION (WAEMU)

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INTRODUCTION

The existence of a single currency and a common monetary policy requires the establishment of a mechanism to coordinate the economic policies of the different member states to avoid negative externalities that could in the long term weaken the integration process.

This concern is now acquiring renewed relevance with the debt crisis in the European Union.

Within the WAEMU, Article 4(b) of the Treaty establishing the Union advocates the establishment of a **multilateral surveillance** mechanism to ensure the viability of the member states' macroeconomic framework by offering them economic guidelines accompanied by strict convergence rules.

The actual establishment of this mechanism took place gradually. In 2000, by Additional Act adopted by the Heads of State, the convergence system was reorganized by means of a **Convergence, Stability, Growth, and Solidarity Pact**, which became the framework of reference for coordination of the macroeconomic policies of the Union.

After a brief review of the current multilateral surveillance system, this paper will address the Convergence, Stability, Growth, and Solidarity Pact between the member states of WAEMU and analyze the results achieved since its adoption.

I. REVIEW OF THE MULTILATERAL SURVEILLANCE SYSTEM

Multilateral surveillance is based on the following principles:

- implementation of a flexible process for consulting and coordinating the member states, within a defined organizational framework and according to a specific timetable;
- preparation and publication of a half-yearly progress report to determine how far the national economies and the Union economy have met the Community objectives;
- implementation and management of a credible and transparent information system to monitor compliance with the standards laid down and, if necessary, prevent or identify slippage;
- definition of a set of basic rules and criteria to set standards for national economic policies.

1. The institutional and organizational system

Multilateral surveillance was launched through implementation of Directive 1/96 of January 15, 1996. The Directive establishes **a National Committee for Economic Policy (NCEP)** in each country, bringing together the main national economic services (treasury, taxes, customs, budget, debt, forecasting, planning, statistics, national agency of the BCEAO, etc.). The Committee's mission is to assist the

Commission in gathering, processing, and analyzing the information necessary for monitoring the Union's economic policy. Thus, each committee has the task of managing a database and preparing quarterly reports on the economic situation in the country to which it belongs. To sum up, these committees are the Commission's real correspondents in the multilateral surveillance exercise.

Under the terms of the Directive referred to above, **the BOAD**, **the BCEAO**, and **the Commission** are required to cooperate to ensure that economic policies, in particular fiscal policies, are consistent with the common financial and monetary policies. To do this, the three institutions meet regularly in a **joint secretariat**, which has the role of preparing multilateral surveillance dossiers for submission to the Council of Ministers.

In this connection, it is worth mentioning the importance of the "**Half-yearly Progress Reports**" on the macroeconomic policies of the member states, prepared by the Commission and submitted to the Council of Ministers of the Union in December and July of each year.

2. The "Half-yearly Progress Reports"

The multilateral surveillance exercise is implemented within the Union primarily through the process of preparing and examining "Half-yearly Progress Reports."

The first half-yearly report (the December report) takes stock of the current year's macroeconomic situation in relation to the previous years and provides projections for the coming years (next five years). It is the framework for review of the member states' multiyear programs.

The second half-yearly report, which is presented in July, reviews the economic situation in the year elapsed and provides projections for the current year. It enables a midterm review of the multiyear programs to be carried out.

It thus proposes possible adjustments to the current year's economic policy in the light of the evolution of the economy. This second report of year also has the task of formulating economic policy guidelines for the following year. Those guidelines are included in the form of **Recommendations** adopted by the Council of Ministers.

3. The statistical system

To guarantee the quality of the analytical work of multilateral surveillance, it is important to harmonize the methods and approaches used in the different countries, particularly in regard to statistics. Indeed, multilateral surveillance can serve as the basis for the adoption of decisions relevant to the Union only if it is based on comparable data and concepts. To address this concern, the Commission has established in each country a so-called "limited scope" database and an IT application to manage it. It has also carried out harmonization work, which has resulted in the adoption of common methodologies for calculating the consumer price index (see Regulation No. 05/97/CM/UEMOA of December 16, 1997), core inflation (see Regulation No. 08/2006/CM/UEMOA of June 29, 2006) and Gross Domestic

Product (see Regulation No. 11/2002/CM/UEMOA of September 19, 2002). Similarly, effective implementation of the directives on public finances should help to enhance the relevance of the convergence criteria.

4. basic rules and convergence criteria

The methodology chosen within the Union for the coordination of policies is to define **rules** that commit all countries to meet the common objectives. Thus, up to 1999, surveillance was based on criteria that were defined each year in directives adopted by the Council of Ministers.

This approach proved ineffective for various reasons, notably because there were no medium-term objectives, it was impossible to consolidate performances over time and there was no precise time horizon for convergence.

To correct those shortcomings, a Convergence, Stability, Growth, and Solidarity Pact was adopted by the member states on December 8, 1999.

II THE CONVERGENCE, STABILITE, GROWTH AND SOLIDARITY PACT

As part of a program of actions designed to strengthen convergence in the Union, the Conference of Heads of State and Government, held in Lomé on December 8, 1999, adopted Additional Act No. 04/99 of December 8, 1999 establishing a convergence, stability, and growth pact among the member states of WAEMU.

1. Definition

The Convergence, Stability, Growth, and Solidarity Pact is defined as a formal commitment undertaken by the member states of WAEMU to:

- strengthen the convergence of the member states' economies;
- consolidate macroeconomic stability;
- accelerate economic growth;
- deepen solidarity between the member states.

Ultimately, the Convergence, Stability, Growth, and Solidarity Pact is not only a code of budgetary discipline for all the member states of the Union, but also an accord seeking to accelerate the ongoing economic integration process.

It defines, for this purpose, adoption procedures and detailed rules for implementation and assessment **of the multiyear convergence, stability, growth, and solidarity programs of the member states**.

2. Organization of the Pact

The fundamental elements that characterize the Pact are:

- the convergence target date;
- the convergence criteria;
- the convergence conditions;
- and the multiyear convergence, stability, growth, and solidarity programs of the member countries.

2.1 the convergence target date

The pact is organized around two phases, namely:

- the convergence phase;

- and the stability phase, which begins at the moment when the convergence criteria of the Union have been met.

In view of the unsatisfactory economic performances of the member states, due in particular to the unfavorable international climate, the convergence phase originally scheduled for the period from January 1, 2000 to December 31, 2002, was extended first to December 31, 2005 and then to December 31, 2008. It has now been extended to December 31, 2013.

Thus, Additional Act No. 4/99 of December 8, 1999 establishing the Convergence, Stability, Growth, and Solidarity Pact, has been amended by the following acts:

- Additional Act No. 03/2003 of January 29, 2003;
- Additional Act No. 02/2006 of March 27, 2006;
- Additional Act No. 05/2009/CCEG/UEMOA of March 17, 2009.

2.2 the convergence criteria

Implementation of the Convergence, Stability, Growth, and Solidarity Pact in the Union is based on a set of macroeconomic indicators that serves to assess the performances of the member states. For this purpose, eight (8) indicators associated with specific standards have been chosen owing to their relevance and their suitability for reflecting the evolution of the economies of the Union. They are called convergence criteria and can be broken down into first-order and second-order criteria. In addition, there is also a set of scorecard indicators.

a) First-order criteria

There are four (4) first-order criteria, including a key criterion.

- **Basic fiscal balance-to-GDP ratio (key criterion):** it should be zero or positive.

This criterion measures the government's capacity to cover, with own resources, all its current expenditure and its capital expenditure that is not supported by external financing. It shows the adjustment efforts necessary to ensure fiscal sustainability. Meeting this criterion requires more rigor and discipline in budgetary management.

Calculation formula: Basic Fiscal Balance = (total receipts + budgetary grants + HIPC resources) -current expenditure -domestically financed public investment expenditure.

- **Average annual inflation rate:** it should be no more than 3 percent.

To meet the target of a stable real exchange rate, constraints must be imposed on price changes. Thus, since the CFA franc is pegged to the euro, the standard of 3 percent was chosen taking account of the inflation rate in the euro zone. This criterion also seeks to minimize inflation differentials between countries to prevent a misalignment of real exchange rates within the monetary union.

Calculation formula This criterion is calculated on the basis of the consumer price index

- **Overall debt-to-GDP ratio:** it should be less than 70 percent.

The excessive level of debt is an obstacle to using fiscal policy as an instrument of economic policy owing to the weight of debt service, which absorbs a large share of budgetary resources and thus reduces the financing capacity of the national economy.

Calculation formula: outstanding domestic debt + outstanding external debt / nominal GDP

- **Payment arrears:**

- domestic payment arrears: nonaccumulation of arrears in the management of the current period;
- external payment arrears: non-accumulation of arrears in the management of the current period

Through this criterion, the member states are called on to ensure sound management of public finances and to meet the budgetary objectives in the current period. This criterion has the more ambitious objective of totally eliminating the stock of arrears by the target date for convergence.

b) **Second-order criteria**

There are four (4) second-order criteria, namely:

- **Wage bill-to-tax receipts ratio:** it should not exceed 35 percent.

Calculation formula: wage bill / tax revenue

- **Ratio of domestically financed public investment to tax receipts:** it should be at least 20 percent.

Calculation formula: domestically financed investment / tax receipts

These two criteria are designed to force member states to have an expenditure profile geared to promoting economic growth. In order to do so:

- fiscal consolidation should be pursued by controlling the wage bill because staff costs represent a large share of the member states' current expenditure.
- States should make more effort to finance investment domestically to protect themselves against rationing of external resources.

- **External current account deficit excluding grants to nominal GDP ratio:** it should not exceed 5 percent.

Monitoring of this criterion serves to assess the degree of vulnerability of WAEMU economies, in particular their dependence on the outside world. Constant deterioration of this indicator may lead to a reduction in foreign assets and consequently weaker coverage of the currency.

Calculation formula: (see balance of payments) external current account excluding official transfers / GDP

- **Tax receipts to GDP ratio**: it should be equal to or over 17 percent.

The scarcity of external resources and the limits to the adjustment of public spending in a context marked by increasing social demand justify the need for more effort in mobilizing domestic resources.

Calculation formula: tax receipts / nominal GDP

2.3 The convergence conditions

The convergence conditions are laid down in Article 9 of the Additional Act establishing the Convergence, Stability, Growth, and Solidarity Pact. They require the States to meet the criteria by a specific target date, which is the deadline set by the WAEMU for its entry into the stability phase.

These conditions are constantly evolving in line with the different revisions of the legislation on the Pact, as indicated above.

Thus, at end-2002, which was the first convergence deadline, it was found that one of the difficulties encountered by the States was the large number of convergence criteria (8) to be met. To remedy this situation, it proved necessary to take into consideration the differentiation made between the convergence criteria (key criterion, first-order criterion, second-order criterion). Thus, referring to the provisions of Article 1 of the Additional Act, which regards the second-order criteria as indicative structural benchmarks, it was decided to emphasize only compliance with the first-order criteria.

Accordingly, under Additional Act No. 3/2003 of January 29, 2003, all member states of the Union must meet the four first-order criteria on December 31, 2005.

At end-2005, it was felt necessary to review this provision, which some observers felt was holding back the better performing member states, which were obliged to wait for the others. While this approach highlights the principle of solidarity, it is considered not to provide motivation and not to enable the objective of convergence to be attained.

It has also been noted that, for some member states, meeting convergence criteria over the long-term does not guarantee sustainable performance. The countries with the best performance have results that tend to be highly volatile over the period.

In the light of those different comments, two new concepts were introduced into the provisions on the convergence conditions laid down **in Additional Act No. 02/2006 of March 27, 2006**, namely, "critical mass" and "sustainability".

Thus, Additional Act No. 05/2009/CCEG/UEMOA of March 17, 2009, which is currently in force, defines the convergence conditions (see Article 9, para. 1) as follows: **"from January 1, 2009 when a <u>critical mass</u> of member states meets the four first-order criteria and this performance is considered to be sustainable, the Union shall then be in a phase of stability. However, member states that have not complied with the convergence conditions will be required to continue the convergence process to achieve the set objectives no later than December 31, 2013."**

The concept of critical mass was defined by Regulation No. 10/2007/CMUEMOA of September 17, 2007. According to that definition, the member states of the Union that meet the four first-order criteria in a sustainable manner can constitute a "critical mass" only if they are at least four (4) in number and collectively represent at least 65 percent of the GDP of the Union.

Moreover, "the sustainability of the member states' performances in terms of convergence shall be assessed on the basis of their records over the previous three years and projections for the following three years."

<u>2.4 - The multiyear convergence, stability, growth, and solidarity programs;</u>

The multiyear convergence, stability, growth, and solidarity programs prepared by the member states must allow the convergence criteria defined in the Pact to be met in the medium-term. They are five-year rolling programs updated yearly. They mark out the convergence path that the country intends to follow to achieve compliance with the prescribed standards as well as the measures to be implemented for this purpose. They must be compatible with programs adopted elsewhere, notably the programs supported by the Bretton Woods institutions and the monetary program. They must reach the Commission before the end of October each year.

The evaluation of these programs is based on a methodology to assess:

- coherence with the various other programs under way;
- continuous improvement in the indicators;
- compliance with the convergence conditions;

- the pertinence of the projection assumptions.

This evaluation is submitted to the Council of Ministers for appraisal. If the Council deems a program to be unsatisfactory, it instructs the State concerned to present an adapted program within thirty (30) days. Similarly, implementation of the programs adopted is subject to monitoring by the Commission. After a mid-term review of a program, the Council may require a State to prepare a program of remedial measures if the trends observed preclude attainment of the objectives set.

In the stability phase, programs will be assessed on the basis of the evolution of the structural component of the key criterion.

3 - ANALYSIS OF THE CONVERGENCE STATUS OF THE WAEMU COUNTRIES

Analysis of the results of the member states of the Union in terms of economic convergence indicates that no country of the Union has met the four first-order criteria in a sustainable manner.

For each criterion, the number of countries meeting the prescribed standard

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010
Basic budget balance/GDP	4	5	5	4	3	3	3	4	6
Inflation	4	7	7	1	7	7	0	7	8
Debt ratio	3	3	4	5	5	5	6	6	7
Nonaccumulation of arrears	4	5	4	3	4	4	5	6	6
Wage bill/ tax receipts	3	4	3	4	4	4	4	3	4
Dom. fin. investment/ tax revenue	4	5	4	4	2	2	5	5	4
Current account balance (excl. grants)	1	1	1	1	1	1	1	1	1
Tax rate	0	1	1	1	1	1	2	1	2

Faced with the constraints on basic expenditure, the level of tax revenue has remained insufficient to meet the fiscal criteria, including that relating to the basic fiscal balance. The majority of member states fail to meet the tax rate criterion. For the Union, the annual average rate was 15.3 percent for the period 2008-11. It rose from 14.4 percent in 2002 to 15.1 percent in 2008, reflecting the slow rate of progress. Given its highly erratic trend, it is projected to be 14.6 percent in 2011.

Thus, the key criterion, in this case the basic fiscal balance, has also evolved unevenly in virtually all the States. For the Union, this criterion went from equilibrium in 2002 to -0.3 percent in 2006 and to 0.9 percent in 2008. According to recent estimates, it could turn out at -1.7 percent in 2011.

With regard to the debt ratio, this is the only criterion that has experienced a sustained performance during the period under review. In 2002, it was not met by three countries: Benin, Burkina Faso, and Senegal. At end-2011, it was met by seven member states of the Union, maintaining harmonious relations with the Bretton Woods institutions. The external debt relief initiatives of the international community (HIPC and MDRI) have helped bring about a substantial reduction in the average debt ratio of the Union, which decreased from 79.3 percent in 2002 to 43.5 percent in 2008. It should be 42.1 percent in 2011.

As regards inflation, the efforts made by the member states in recent years to make the Union an area of price stability have been thwarted by the persistent uncertainties

due to soaring international prices and the poor performance of agricultural production in some years. The years 2005 and 2008, which were target years for convergence, were marked by strong inflationary pressures. At the level of the Union, the annual inflation rate stood at 4.3 percent in 2005 and at 7.4 percent in 2008.

The Union's overall results shown in this analysis reflect the lack of a strong economic base, capable of reinforcing the convergence process. This situation highlights the vulnerability of the different national economies to exogenous shocks, such as weather conditions, fluctuations in the world prices of raw materials exported by the Union, and the continuing rise in the prices of oil and food. In addition to these factors, there are issues relating to the social and political stability of the subregion. The recurrence of conflicts, notably the Ivorian crisis, has been highly detrimental to the expected effects of the economic policies and programs implemented during this period.

The noncovergence of the Union can also be explained by factors related to economic management. Slow implementation of structural and sectoral reforms has impeded the impetus from a genuine competitive economy. Thus, serious electricity supply problems in some countries caused major economic losses and have therefore limited the scope for achieving significant results.

CONCLUSION

From the few elements presented above, it is clear that fiscal policy coordination exists in the WAEMU zone. Although this coordination has not yet resulted in convergence of the Union, it requires the Member States to take into consideration specific constraints in their macroeconomic frameworks. This has undoubtedly contributed to the results obtained over recent years in a very unfavorable economic environment.

It should be noted that the aim of the convergence process in which the Union is engaged is to encourage the member states to have a government finance situation that could allow the implementation of countercyclical policies (see Article 9, para. 4). From this point of view, convergence requires deeper integration and more rapid structural and sectoral reforms in each country, to lay the foundations of real economies that are able to consolidate performances.

It is due to this concern that the multilateral surveillance mechanism is designed as a review framework for senior officials with responsibility for the Union's economic affairs, with the main aim of regularly reviewing the half-yearly progress report and the multiyear programs of the member states.