

Fiscal Rigidities and their Effects in Ghana

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Structure of the Presentation

- Introduction
- Conceptual Issues
 - What are Fiscal Rigidities?
 - The General Effects of Fiscal Rigidities
- The Behavior of Rigid Expenditures in Ghana
 - Earmarked Expenditure
 - Wages and Salaries
 - Debt Service Expenditure
- The Effects of Fiscal Rigidities in Ghana
 - The Effect on the Free Fiscal Space
 - The Effect on Fiscal Consolidation
 - The Effect on Macroeconomic Stability and Real GDP Growth
- Concluding Remarks and Policy Recommendation

Introduction

- Effective fiscal management has long been seen as critical to economic growth and development.
- Consequently,
 - Considerable amount of time has been devoted to study fiscal institutions that may lead to improved fiscal management.
 - International development agencies have spent increasing amounts of money to help reform budgetary institutions in the developing world.
- In the quest for effective fiscal management, what has not received enough attention is the degree of fiscal rigidity.
- Most of the existing applied research on fiscal rigidities are in regard to countries in Latin America.
- Research focusing on fiscal rigidities in African countries is hard to find.
- To the best of our knowledge, there is no published research dedicated to studying fiscal rigidities in Ghana.

Introduction

- Yet, evidence shows that high degree of fiscal rigidity can pose a serious challenge for fiscal management, which can seriously undermine economic growth and development.
- For example, Fitch Ratings found in 2013 that fiscal rigidities had weakened the credit worthiness of Latin American countries. **How?**

According to Fitch Ratings, fiscal rigidities reduced the quality of fiscal adjustments in Latin American countries following the global financial crisis as public spending tilted in favor of current spending as against investment spending, which hampered investment in infrastructure, capital accumulation, competitiveness, and GDP growth in these countries.

- **The main question:** Are the constantly recurring and particularly the current fiscal and macroeconomic difficulties in Ghana attributable to fiscal Rigidities?
- Other questions are:
 - What is the extent of rigidity in Ghana's budget and how have fiscal rigidities behaved historically in Ghana?
 - What have been the fiscal and macroeconomic effects of rigidities in Ghana's budget?
 - What should the government do in the face of the difficulties and challenges posed by fiscal rigidities as it prepares its maiden budget statement and economic policy?

Conceptual Issues

What are fiscal rigidities?

- Fiscal Rigidities are institutional, legal, contractual or other constraints that limit the ability of the government to change the size and structure of the public budget at least in the short term.
- Fiscal Rigidities are of 3 types:
 - Expenditure Rigidities – Examples: Wages and salaries, debt service exp.
 - Revenue Rigidities – revenue earmarking
 - Other Rigidities – Example: Tax expenditure
- All these rigidities are found in Ghana's budget.
- Fiscal rigidities arise from the desire for some actors or interest groups to protect their slices of public budget from other actors through institutional, legal or contractual arrangements.

Conceptual Issues

The General Effects of Fiscal Rigidities

- Although some fiscal rigidities in the public budget may be justifiable, a large number of fiscal rigidities constituting a big chunk of public spending is problematic.
- The immediate effect of fiscal rigidities is that the government loses control over fiscal policy to the extent of the size of the fiscal rigidity.
- Thus, in the presence of high degree of fiscal rigidities, governments lose fiscal discretion and policy maneuverability.
- Therefore:
 - Governments are unable to create enough fiscal space without resorting to borrowing.
 - Governments become ineffective in managing fiscal crisis.
 - The quality of fiscal adjustment reduces.
 - Incentives to improve efficiency in spending is lowered.
 - Misallocation of resources may arise.
 - Government spending becomes pro-cyclical.

The Behavior of Rigid Expenditures in Ghana's Budget from 1993 to 2015

- There are 4 rigid expenditure categories in Ghana's budget'.
 - Earmarked expenditure
 - Wages and salaries
 - Debt service expenditure
 - Tax Expenditure
- Although *tax expenditure* is recorded as an expenditure item, an equivalent amount is recorded in the revenue side of the budget as *tax exemptions* making it have no net impact on the budget.
- Before 2007 tax expenditure (and thus tax exemptions) was not accounted for in the fiscal table.
- In 2016 budget statement, tax expenditure was again taken away as a direct budget line, treating it as a mere memorandum item.
- For these reasons, we have excluded tax expenditure as a fiscal rigidity.
- Therefore, we have also excluded tax exemptions from total revenue.

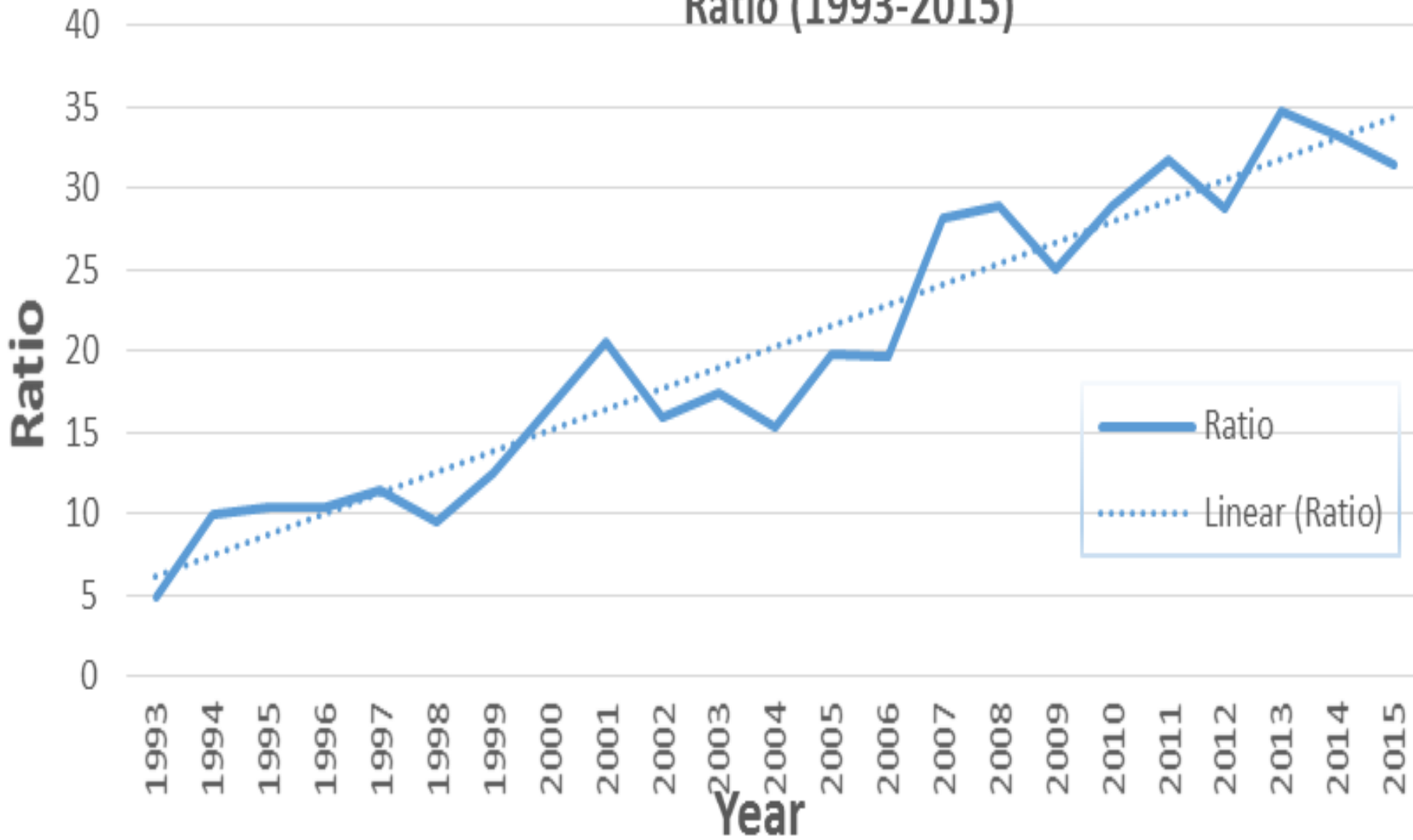
Earmarked Expenditure

- Currently, there are 11 active earmarking arrangements in Ghana.
- However, earmarked expenditure covers data on 10 earmarked (or statutory) payments – No actual transfers had been made to GIIF by the end of 2015 :
RB, DACF, RF, GETF, PRF, NHIF, RIGF, GSF, GHF, and TGNPC.
- The PRM Act gave the Minister of Finance the power to cap transfers to the GSF and required the amount above the cap to be transferred into Contingency Fund and Sinking Fund for debt repayment.
- Therefore, transfers to the Contingency Fund and the Sinking Fund, which began in 2014, are also included in the earmarked expenditure.
- Earmarked expenditure saw sharp increases during the period 1993-2015, which significantly contributed to rigidities in the country's annual budgets.

Table 1: Earmarked Expenditure and Its Revenue Ratio from 1993 to 2015

Year	Number of Earm. Expenditures in the Budget at the time	Total Earm. Expenditure (GH¢'000,000)	Total Earm. Exp. to Total Rev. and Grant Ratio (%)	Period Average (%)
1993	1	3.7	4.9	4.9
1994	2	11.7	10.0	
1995	2	19.3	10.4	10.7
1996	2	23.9	10.4	
1997	2	30.4	11.5	
1998	2	33.8	9.5	
1999	2	46.3	12.5	16.5
2000	4	89.0	16.5	
2001	5	174.7	20.6	17.3
2002	5	180.1	15.9	
2003	5	294.0	17.4	
2004	5	365.6	15.3	
2005	6	558.6	19.8	19.8
2006	6	629.8	19.7	
2007	7	1,206.9	28.2	27.8
2008	7	1,488.0	28.9	
2009	7	1,643.4	25.0	
2010	7	2,431.2	28.9	
2011	10	3,902.3	31.8	32.0
2012	10	4,573.7	28.8	
2013	10	6,461.7	34.7	
2014	10	7,842.1	33.3	
2015	10	9,415.4	31.4	

Figure 1: Earmarked Expenditure to Total Revenue and Grants Ratio (1993-2015)



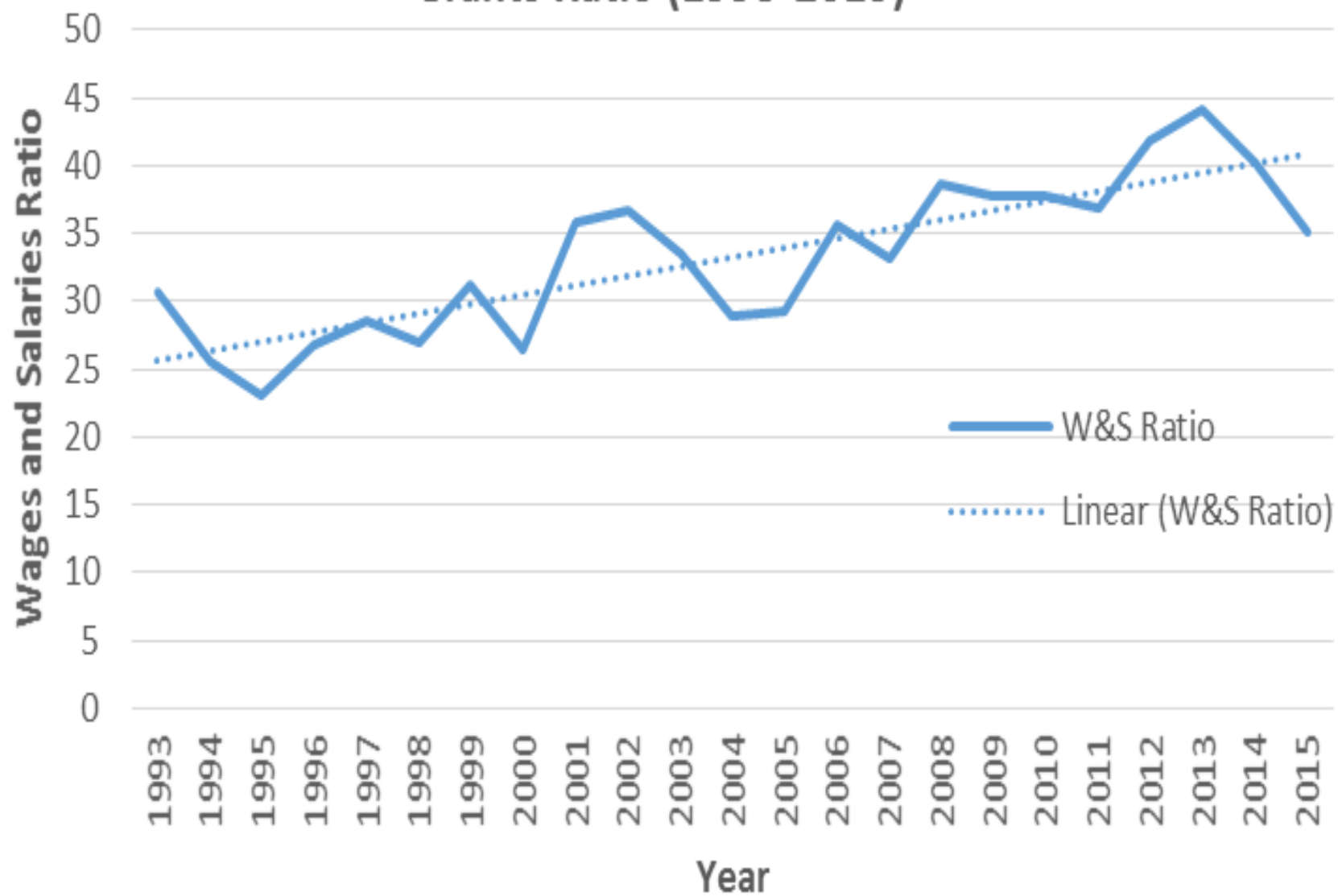
Wages and Salaries

- In nominal terms, wages and salaries saw sharp increases throughout the period.
- This is not surprising as increase in the size of revenue resulting from inflation and economic growth naturally leads to increases in most budgetary expenditure items like wages and salaries.
- What is therefore more interesting is the dynamics of wages and salaries after the effects of revenue increases have been isolated.
- So how has wages and salaries as a ratio of total revenue and grants behaved?

Table 2: Wages and Salaries and its Revenue Ratio, 1993-2015

Year	Wages Salaries (GH¢'000,000)	Wages and Salaries to TR&G Ratio (%)	Period Average (%)
1993	22.76	30.6	26.5
1994	29.71	25.6	
1995	43.10	23.1	
1996	61.26	26.8	
1997	75.06	28.5	28.3
1998	95.68	26.9	
1999	116.11	31.3	
2000	142.28	26.4	
2001	303.65	35.8	33.8
2002	414.18	36.7	
2003	566.10	33.6	
2004	694.67	29.0	
2005	824.35	29.2	34.2
2006	1,137.05	35.6	
2007	1,418.78	33.2	
2008	1,987.64	38.6	
2009	2,478.69	37.8	38.6
2010	3,182.53	37.8	
2011	4,534.87	36.9	
2012	6,665.52	41.9	
2013	8,242.94	44.2	39.9
2014	9,448.57	40.2	
2015	10,555.93	35.2	

Figure 2: Wages and Salaries to Total Revenue and Grants Ratio (1993-2015)



Debt Service Expenditure

- Debt Service Expenditure has two components:
 - Interest Payment
 - Principal amortization
- In nominal terms, total debt service expenditure and its components saw upward moving trends.
- However, the behavior of total debt service expenditure as a ratio of total revenue and grants from 1993 to 2015 can be classified into four different periods:
 - *Period of ascent, 1993-2000*
 - *Period of descent, 2001-2004*
 - *Period of bottoming-out, 2005-2012*
 - *Period of re-ascent, 2013-2015*

Table 3: Debt Service Expenditures and their Revenue Ratios, 1993-2015

Year	Interest Payment		Amortization		Total Debt Service Exp.	
	<i>GH¢'000,000</i>	<i>% of TR&G</i>	<i>GH¢'000,000</i>	<i>% of TR&G</i>	<i>GH¢'000,000</i>	<i>% of TR&G</i>
1993	13.48	18.1	6.61	8.9	20.08	27.0
1994	23.05	19.9	11.50	9.9	34.54	29.8
1995	32.88	17.6	19.42	10.4	52.30	28.0
1996	57.93	25.3	43.71	19.1	101.64	44.4
1997	88.52	33.6	51.60	19.6	140.12	53.1
1998	120.35	33.9	59.90	16.9	180.25	50.8
1999	115.02	31.0	68.06	18.3	183.07	49.4
2000	203.34	37.8	186.75	34.7	390.09	72.4
2001	278.72	32.9	139.02	16.4	417.74	49.3
2002	253.21	22.4	116.03	10.3	369.24	32.7
2003	363.34	21.5	255.93	15.2	619.28	36.7
2004	347.24	14.5	192.02	8.0	539.25	22.5
2005	354.05	12.5	209.83	7.4	563.87	20.0
2006	393.37	12.3	235.13	7.4	628.50	19.7
2007	440.01	10.3	321.22	7.5	761.23	17.8
2008	679.18	13.2	497.41	9.7	1,176.59	22.9
2009	1032.32	15.7	457.71	7.0	1,490.04	22.7
2010	1439.36	17.1	502.31	6.0	1,941.67	23.0
2011	1611.18	13.1	584.28	4.8	2,195.46	17.9
2012	2436.15	15.3	623.60	3.9	3,059.76	19.3
2013	4396.97	23.6	821.41	4.4	5,218.38	28.0
2014	7080.87	30.1	1330.94	5.7	8,411.81	35.8
2015	9075.34	30.3	2734.09	9.1	11,809.43	39.4

Figure 3a: Interest Payment and Amortization as Ratios of Total Revenue and Grants

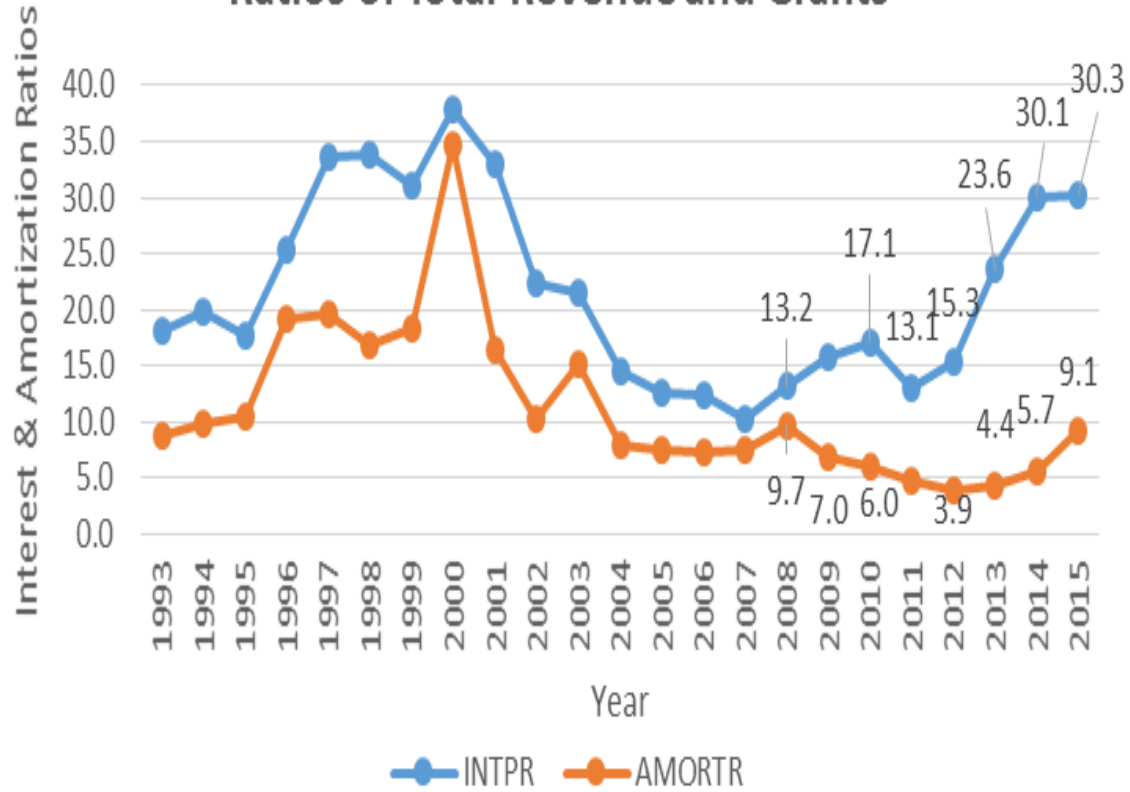
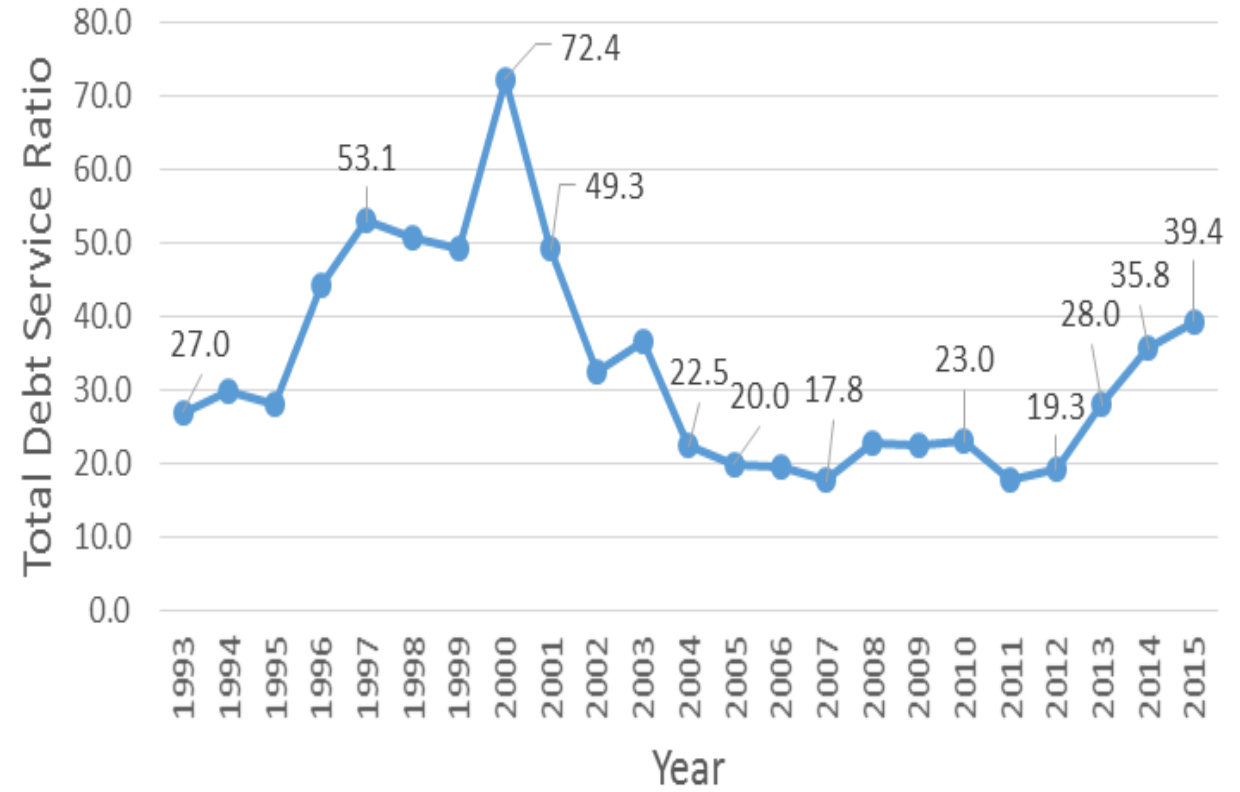


Figure 3b: Total Debt Service as a Ratio of Total Revenue and Grants



The Effects of Rigidities in Ghana's Budget

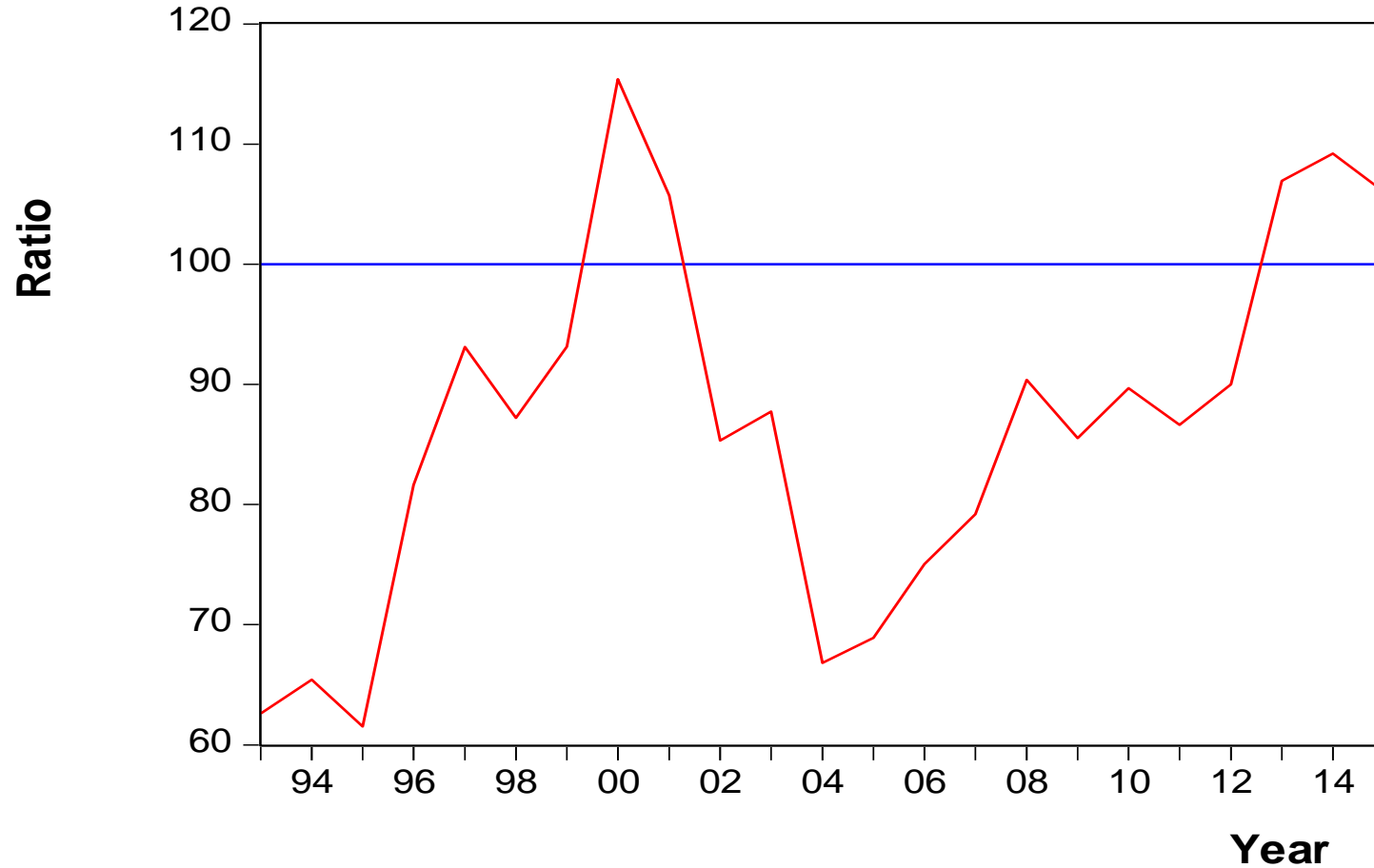
Total Rigid Expenditure, Revenue Limit and the Effect on the 'Free' Fiscal Space and Fiscal Policy Maneuverability in Ghana

- We consider here the behavior of the sum of the three rigid expenditure items (TRE) in relation to total revenue and grants (TR&G) from 1993 to 2015. This will help us to:
 - Understand the degree of absorption of total revenue and grants by fiscal rigidities in Ghana.
 - Identify the size of the government's available 'free' fiscal space, which determines the degree of fiscal policy discretion/maneuverability the government has before it decides to borrow.
- Since the government does not have control over rigid expenditures, we measure the level of the free fiscal space by the ratio at which total revenue and grants exceeds total rigid expenditure.

Table 4: Total Rigid Expenditure (TRE), Total Revenue and Grants (TR&G) and the Primary Fiscal Space

Year	TR&G (GH¢'000,000)	TRE (GH¢'000,000)	Revenue Limit (%)	TRE as Ratio of TR&G (%)	Extra Revenue Ratio/Free Fiscal Space (%)
1993	74.28	46.50	100	62.6	37.4
1994	116.02	75.91	100	65.4	34.6
1995	186.47	114.70	100	61.5	38.5
1996	228.86	186.80	100	81.6	18.4
1997	263.75	245.57	100	93.1	6.9
1998	355.16	309.76	100	87.2	12.8
1999	370.89	345.49	100	93.2	6.8
2000	538.50	621.41	100	115.4	-15.4
2001	847.69	896.14	100	105.7	-5.7
2002	1,129.14	963.47	100	85.3	14.7
2003	1,686.16	1,479.39	100	87.7	12.3
2004	2,393.84	1,599.53	100	66.8	33.2
2005	2,825.64	1,946.78	100	68.9	31.1
2006	3,191.77	2,395.39	100	75.0	25.0
2007	4,277.51	3,386.96	100	79.2	20.8
2008	5,147.50	4,652.22	100	90.4	9.6
2009	6,562.80	5,612.08	100	85.5	14.5
2010	8,424.43	7,555.41	100	89.7	10.3
2011	12,273.44	10,632.68	100	86.6	13.4
2012	15,889.49	14,298.97	100	90.0	10.0
2013	18,629.55	19,923.06	100	106.9	-6.9
2014	23,527.78	25,702.44	100	109.2	-9.2
2015	29,981.76	31,780.73	100	106.0	-6.0

Figure 4: Total Rigid Expenditure in Total Revenue and Grants Space (in Ratios)



The Effects of Rigidities in Ghana's Budget

The Effects on Fiscal Consolidation

- Fiscal consolidation, which is defined as the policy to reduce the fiscal deficit and the rate of debt accumulation, has always been among the key policy objectives pursued by the government since 1993.
- We present here our findings with respect to how fiscal rigidities have affected:
 - the fiscal deficit
 - debt accumulation
 - the quality of fiscal consolidation.

Table 5: The Effect of Fiscal Rigidities on the Fiscal Deficit

Period	Average Total Rigid Expenditure as a Ratio of TR&G (%) (RIGIDR)	Average Overall Fiscal Deficit to GDP Ratio (%) (DEFICITR)	Correlation Co-efficient
1993-1996	67.8	5.9	0.72
1997-2000	97.2	8.5	
2001-2004	86.4	4.1	
2005-2008	78.4	4.6	
2009-2012	88.0	7.0	
2013-2015	107.0	8.9	

Note: Starting from 2006, the rebased GDP figures were used to generate the deficit ratios.

The Effects of Rigidities in Ghana's Budget

Debt accumulation

- Fiscal rigidity has been a more fundamental factor behind the usually high rates of debt accumulation in Ghana.
- Why?
 - We just saw above that the degree of fiscal rigidity has been a driving force behind fiscal deficit in Ghana.
 - Debt accumulation is directly impacted by the overall fiscal deficit.
- It is important for us to remember that through debt service expenditure, debt accumulation itself is a source of fiscal rigidity.
- Therefore, there is a reverse causality between debt accumulation and fiscal rigidities with the fiscal deficit serving as the medium. **Thus, debt accumulation can feed on itself.**
- How?

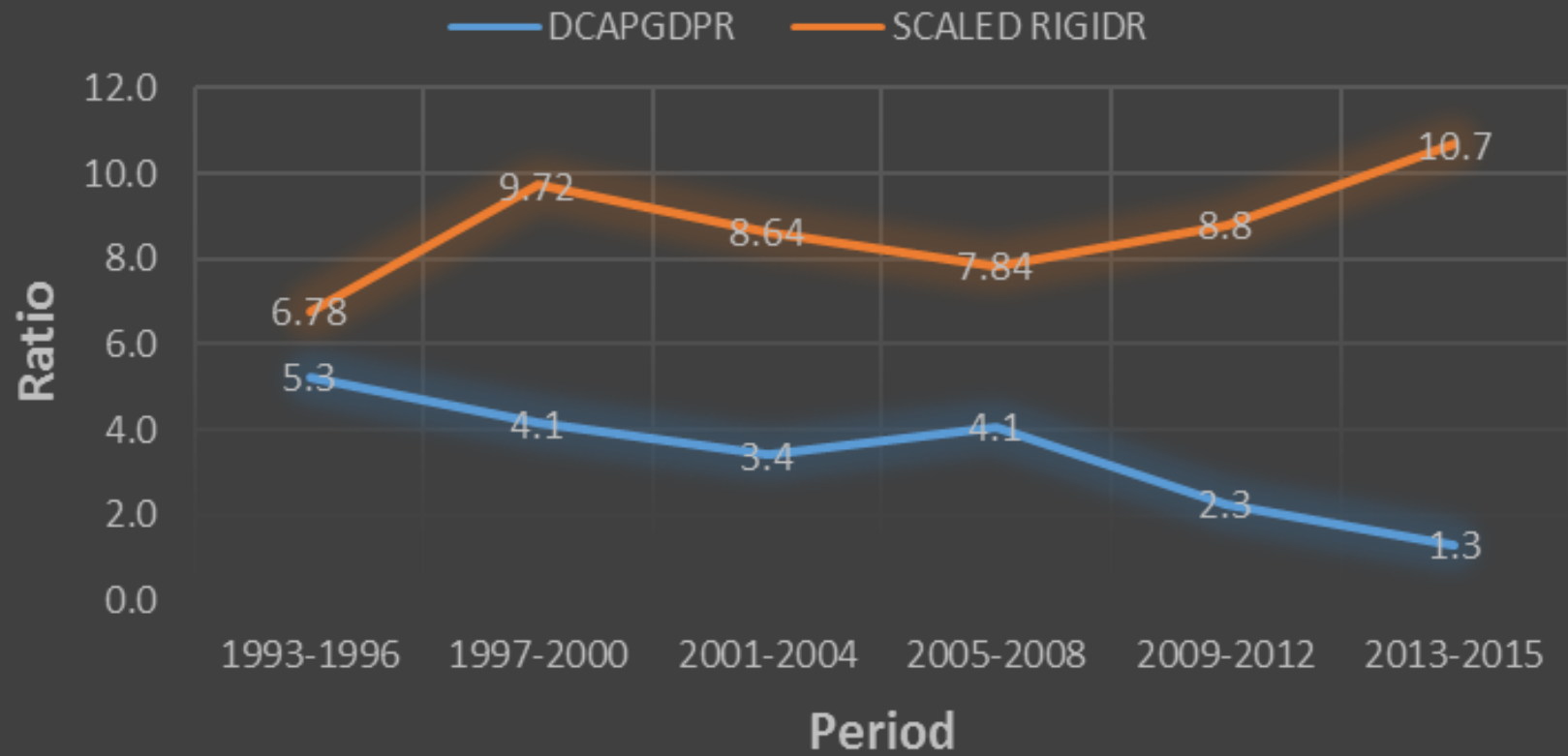
High rigidity → High deficit → High rate of Debt Accumulation → Greater levels of Debt Service Expenditure → Higher degree of rigidity (**and the cycle continues**).
- Without resorting to painful and extraordinary measures, this cycle is difficult to break.

On the Quality of Fiscal Consolidation

Table 6: The Effect of Fiscal Rigidities on the Size of Domestic Capital Expenditure to GDP Ratio in Ghana

Period	Average Total Rigid Expenditure as a Ratio of TR&G (RIGIDR) (%)	Domestic Capital Expenditure to GDP Ratio (DCAPGDPR) (%)	Correlation Co-efficient
1993-1996	67.8	5.3	- 0.78
1997-2000	97.2	4.1	
2001-2004	86.4	3.4	
2005-2008	78.4	4.1	
2009-2012	88.0	2.3	
2013-2015	107.0	1.3	

Figure 6: The Effect of Fiscal Rigidities on Domestic Public Investment in the Face of Fiscal Consolidation Policy



The Effect on Macroeconomic Stability and Real GDP Growth

On macroeconomic Stability,

- The higher the size of the total rigid expenditure ratio, the higher has been the inflation rate, the depreciation rate of the cedi, etc. in Ghana, and vice versa.
- What explains this?
 - We saw earlier that fiscal rigidity is a driving force behind the size of the fiscal deficit in Ghana.
 - And the size of the fiscal deficit is a major cause of macroeconomic instability in Ghana (see, for instance, Ghartey, 2001 and Boakye, 2009).

On real GDP growth,

- High degree of fiscal rigidity results in lower rate of real GDP growth in Ghana, and vice versa.
- What explains this?
 - The macroeconomic instability, which results from fiscal rigidities dampens real GDP growth.
 - The decline in public investment that emerges during the implementation of fiscal consolidation policies due to the presence of high level of fiscal rigidity also depresses real GDP growth.

Table 7: Effect of Fiscal Rigidities on Macroeconomic In/Stability and Real GDP Growth

Period	Average RIGIDR (%)	Average GH¢/US\$ Dep. Rate (%)	Average INF Rate (%)	Average Non-Oil Real GDP GR (%)
1997-2000	97.2	27.6	22.6	4.2
2001-2004	86.4	6.0	21.5	4.9
2005-2008	78.4	6.7	13.9	6.4
2009-2012	88.0	10.1	10.5	7.3
2013-2015	107.0	20.5	16.1	4.9
<i>Correlation Co-efficient (with RIGIDR)</i>		0.79	0.26	-0.57

Figure 7a: The Effect of Fiscal Rigidities (RIGIDR) on the Deprec. rate of the Cedi against the US\$ (EXRdepr)

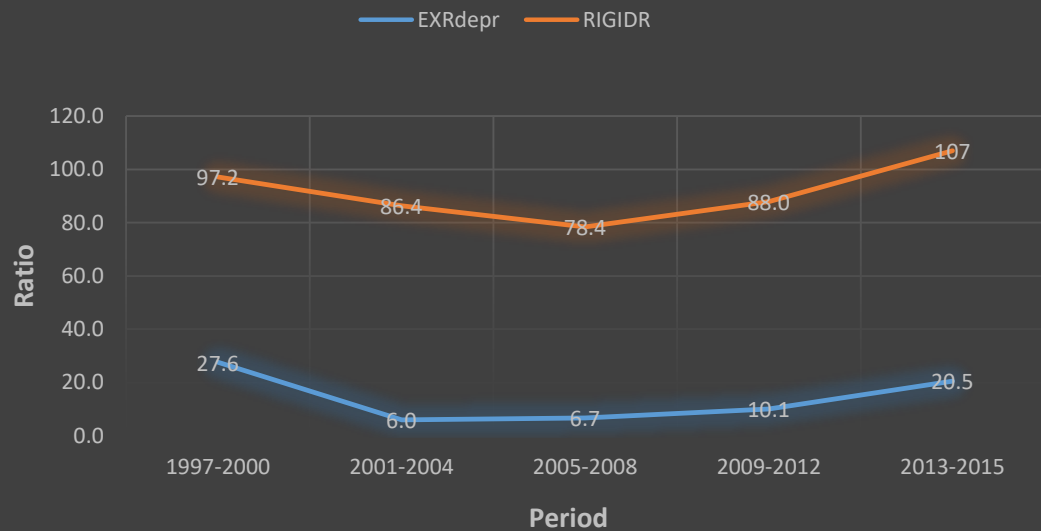


Figure 7b: The Effect of Fiscal Rigidities (RIGIDR) on Inflation Rate

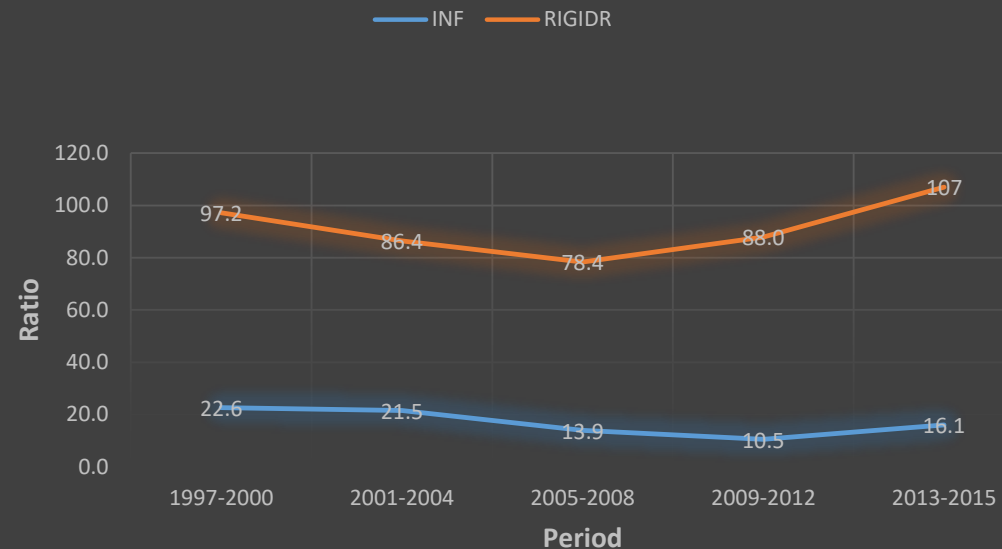
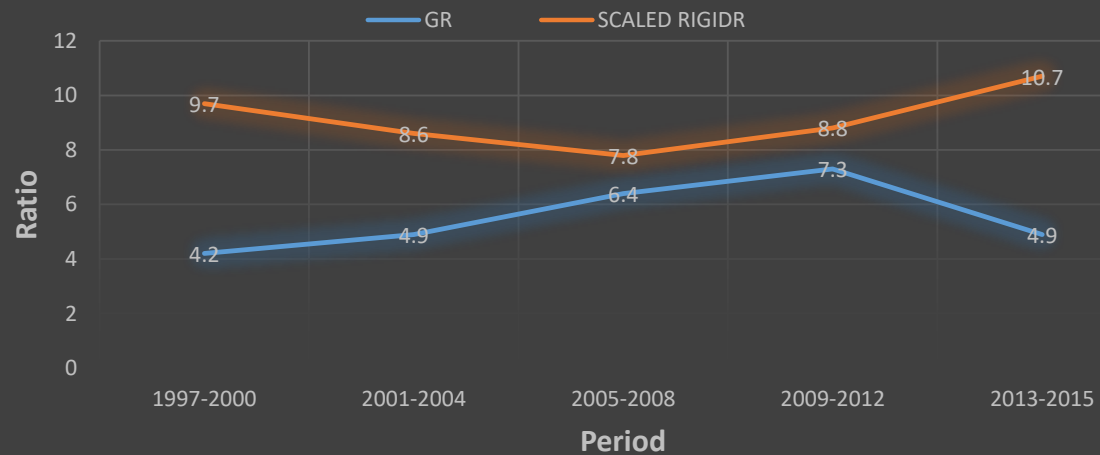


Figure 7c: The Effect of Fiscal Rigidities (RIGIDR) on Real GDP Growth Rate (GR)



Concluding Remarks and Policy Recommendation

- Since 2013, total rigid expenditure has been extremely high – it has alone exceeded total revenue and grants.
- Thus, without having even begun to consider any discretionary expenditure, the government has to resort to borrowing in order to be able to cover its total rigid expenditure alone.
- Clearly, the fiscal and macroeconomic difficulties the country is currently going through is caused by this fiscal entanglement.
- When the country was in a similar situation in 2000/2001, it was rescued by debt reliefs the government gained through the opting for the HIPC and the MDRI initiatives.
- Because the HIPC and MDRI options are currently unavailable, the country would have to swallow bitter policy pills.
- The excessive rigidities in the national budget in terms of earmarked expenditure, wages and salaries, and debt service expenditure that have been found to be the underlying cause of the enormous fiscal challenge the country is facing should be urgently addressed.

Policy Recommendations

On Earmarking:

1. The establishment of new earmarked funds should be avoided, at least until the country is able to significantly reduce the total rigid expenditure ratio below the revenue limit.
2. The existing earmarked funds should also be urgently reviewed with the goal to:
 - a) cut, where necessary, parts of the earmarked revenues and return them to the general budget in order to gain some level of flexibility to address the enormous fiscal challenge.
 - b) close down nonessential funds so that the monies involved could be passed through the general budgeting process.
3. For those funds that cannot be closed down, greater management efficiency should be pursued, since most of these funds have been managed inefficiently. In this regard,
 - a) Political interference that has the tendency to undermine the usefulness of earmarked funds should be halted.
 - b) The management boards of the earmarked funds should be made to sign performance contracts and the provisions therein should be enforced to the letter. The contracts should aim at cost minimization.
 - c) Strong sanction mechanisms should be instituted to deter corrupt practices and inappropriate use of the earmarked funds.

Policy Recommendation

4. The current practice whereby the parent MDAs seek to perform some of the same functions delegated to the funds' managers, as if transfers to the earmarked funds are mere statutory obligations that do not form part of the government's programs, should be brought to a halt. This creates duplication in the system.

On Wages and Salaries:

5. The rate of growth in wages and salaries of public sector workers should not be allowed to exceed the rate of revenue growth anymore. This should serve as a guiding principle during wage negotiations and when forecasting the 'wage bill' for the budget.
6. A thorough review of public sector employment should be undertaken in order to right-size the sector by getting rid of redundant workers.
7. Public sector recruitment and the payroll system should also be effectively managed. While the efforts being made to remove "ghost" names from the payroll systems is commendable, there should be constant auditing of the payroll to prevent new "ghost" names from entering the system.

Policy Recommendations

On Debt Service Expenditure:

8. The country is clearly caught in a debt trap. Therefore, budgetary expenditures should not be allowed to follow their current trajectories.
9. Discretionary expenditures should be drastically cut while making sure that growth is not badly affected. Importantly, all non-essential discretionary expenditure items should be eliminated.
10. A complete moratorium on borrowing may not be feasible in the short term given that total rigid expenditure currently exceeds total revenue and grants. However, borrowing should be significantly reduced by directing it to finance only most essential expenditure items.

Policy Recommendations

On Revenue growth:

11. Increased pace of revenue growth has the potential to improve the excess revenue ratio with the possibility of turning it from the current negative into positive.
12. However, revenue growth that is not matched by deliberate efforts to change the growth patterns of earmarked expenditure may not be sufficient to get the country out of the present fiscal and macroeconomic predicament.
13. The expected increase in oil revenue (mostly from TEN) provides hopes. However:
 - a) We should not forget that crude oil price is still weak.
 - b) Also, recent history shows that, for the most part, actual oil revenues have fallen short of targets as both price and quantity are outside the government's control.

Thank You