

Optimizing Ghana's Fiscal Rule

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The vice-president of Ghana, Dr. Mahamudu Bawumia, recently announced the government's plans to restore fiscal sustainability in the country. Later this year, the new government will submit a fiscal responsibility law to parliament as an amendment to the Public Financial Management Act of 2016.¹ The current proposal calls for a fiscal deficit target of 3 to 5 percent from 2018 onward, down from 9.3 percent in 2016. The government plans to commit to this target through binding fiscal rules. This move by the new government toward greater fiscal discipline is laudable.² But the proposal's success depends on its details and how it is implemented. This paper sets out some key recommendations to help make it work.

Ghana has been an economic success story for the last few decades. But more recently, rapid growth in spending and borrowing, especially during election years, has led the country down an unsustainable economic path. By 2016, the government estimated that interest payments alone equaled 29 percent of domestic revenues—an amount equivalent to three times the Ministry of Health's budget for the year. With rapidly escalating debt, which peaked at over 70 percent of GDP, the country resorted to an International Monetary Fund (IMF) program for financial assistance in 2015, due to end in 2018.

While authorities hoped that oil would lift Ghana's economy, it may have made things worse. Revenues from petroleum have been modest so far, representing, on average, only 4 percent of total government revenues.³ Given petroleum's relatively small role in Ghana's economy, the Petroleum Revenue Management Act (2011), which aimed at ensuring prudent management of oil revenues, did not address challenges of overall budget sustainability and volatility on its own. While the law required saving a moving seven-year average of 30 percent of oil receipts into two sovereign wealth funds—a Heritage Fund and a Stabilization Fund—it did not prevent the government from borrowing in parallel to saving. For example, in

1 "Cabinet approves Fiscal Responsibility Law to cap fiscal deficit to 3-5% of GDP," 25 July 2017, <http://www.myjoyonline.com/business/2017/july-25th/cabinet-approves-fiscal-responsibility-law-to-cap-fiscal-deficit-to-3-5-of-gdp.php>.

2 See our previous recommendations on the topic in the 2017 Resource Governance Index results for Ghana and in Mark Evans, *In Ghana, Fiscal Responsibility Remains Elusive Even as Oil Flows* (Natural Resource Governance Institute, 2015), http://www.piacghana.org/portal/files/downloads/articles/in_ghana_fiscal_responsibility_remains_elusive_even_as_oil_flows.pdf.

3 "Even without oil we are doing well...with oil as a shot in the arm, we are going to fly." — President Kufuor, 2007. <http://news.bbc.co.uk/2/hi/africa/6766527.stm>

2014, the government saved about GHS 1.7 billion in the petroleum funds, but also increased public debt by about GHS 70 billion.⁴

There is reason to believe that expectations of oil wealth helped fuel the borrowing spree and subsequent debt crisis. Five consecutive issuances of Eurobonds started just after the discovery of oil, and government officials cite oil as a key reason for optimism in their investor presentations and prospectuses.⁵ Ghana is not alone; cross-country research reveals a tendency for short-term growth disappointment after oil discoveries in countries with weak governance.⁶

Given the turbulence in Ghana's public financial management over the past few decades, legislating rules on fiscal responsibility is a step in the right direction. Where properly designed and implemented, fiscal rules can help countries achieve sustainable levels of government debt and deficit, contribute to macroeconomic stability and prevent unsustainable spending policies.⁷ Botswana, Chile, Norway and Peru all present good examples of effective use of fiscal rules. Fiscal rules also help make fiscal policy design and execution more resilient to political pressures from special interests.⁸ They could yield positive political prospects by increasing transparency and certainty over how the government carries out its fiscal policy. But just having fiscal rules in place is no panacea. In Cameroon, Chad and Mongolia, for example, fiscal rules were seldom followed, and hence failed to achieve their intended goals—a situation that further undermined the government's fiscal credibility. In order to work, fiscal rules need to be appropriate to a country's economic priorities and have a credible enforcement strategy.

This brief identifies five characteristics of a good fiscal rule based on international experience, and provides recommendations on how to effectively tailor them for Ghana:

- 1 A good fiscal rule should be tailored to a country's economic challenges and opportunities.
- 2 A good fiscal rule should be simple and easy to understand.
- 3 A good fiscal rule needs well-defined escape clauses.
- 4 A good fiscal rule requires transparency and strong oversight.
- 5 A good fiscal rule should build on existing institutions and national consensus.

The brief concludes with 11 recommendations for improving the effectiveness of Ghana's fiscal rule, based on an analysis of policy priorities, historical performance and international experience.

4 The interest rate difference is also striking: Ghana's Eurobond interest payments amount to about 8 percent, while savings in the sovereign wealth funds only accrue interests of about 2 percent.

5 "The Ghana 2013 Eurobond Transaction," Eurobond briefing, press conference, 12 August 2013, http://www.mofep.gov.gh/sites/default/files/press_release/Eurobond_Press%20Briefing_Aug_12%20Press%20Version.pptx.

6 A phenomenon labeled the "presource curse." James Cust and David Mihalyi, *Evidence for a Presource Curse? Oil Discoveries, Elevated Expectations, and Growth Disappointments* (Washington, D.C.: World Bank, 2017).

7 The cross-country findings are based on NRG's research on fiscal rules for the 2017 Resource Governance Index and on Natural Resource Funds.

8 Charles Amo-Yartey, *Improving Fiscal Management in Ghana: The Role of Fiscal Policy Rules* (Institute of Economic Affairs, Ghana: 2014), <http://ieagh.org/wp-content/uploads/2014/08/Improving-Fiscal-Management-in-Ghana-final-inside.pdf>.

1. A GOOD FISCAL RULE SHOULD BE TAILORED TO A COUNTRY'S ECONOMIC CHALLENGES AND OPPORTUNITIES

About half the countries in the world (96 countries) have some fiscal rule or rules. Fiscal rules may constrain debt, deficit, expenditure, revenue or a combination of these. Some rules also incorporate extractive revenues within the constraints, such as by capping non-oil deficit (e.g., Norway), saving a portion of oil revenues (e.g., Timor-Leste), or requiring the government to balance its books assuming average commodity prices (e.g., Chile). There is no one-size-fits-all solution: when designing Ghana's fiscal rule, government officials should carefully consider the country's key economic challenges and opportunities.

Types of fiscal rules

- 1a. **Budget balance rule.** This rule targets the overall fiscal balance, that is, the difference between revenues and expenditures. It is generally set as a percentage of GDP or as a percentage of fiscal revenues.
- 1b. **Structural budget balance rule.** Similar to budget balance rules, but requires adjusting the target depending on commodity prices or economic cycles. It is generally set as a percentage of GDP.
2. **Debt rule.** Sets explicit limits or targets for the level of public debt. It is generally set as a percentage of GDP.
3. **Expenditure rule.** Sets limits on total spending, primary spending (excluding interest on debt), or current spending (excluding capital spending). It can be set in absolute terms, by growth rates, or as a percentage of GDP.
4. **Revenue rule.** Sets ceilings on certain revenue streams, such as natural resource revenues, to be spent in any given year. They can be set in absolute terms, by growth rates, or as a percentage of GDP.

Ghana is a middle-income country. Its economy has been growing at a relatively fast pace, and is well-positioned to attract foreign direct investment. Ghana's 2007 oil find has led to a rapid buildup of the sector. With new fields coming into production, projections show that revenues from oil exploitation will ramp up and could reach about USD 3.2 billion by 2023 (although still only approximately 20 percent of total revenues).⁹ Nevertheless, with increased oil investment and revenues comes growing exposure to the volatility of the sector. Another challenge relates to spending practices. Despite a great need to spend on education, health and infrastructure, Ghana has weak budgeting and public investment planning systems. When the economy was booming in recent years, the government increased rather than decreased its borrowing, and recurrent spending rose much quicker than domestic investment.¹⁰ Therefore, there is a risk that proceeds from an oil boom would end up being largely consumed and not invested.

Based on Ghana's recent experience, we identify three priorities that the rule should address: Restoring fiscal discipline, protecting the country from boom and bust cycles and prioritizing spending on productive domestic investment.

Restoring fiscal discipline

Restoring fiscal discipline is a priority for Ghana today. Since 2010, Ghana's deficit has widened rapidly. (See Figure 1.) This was driven partly by rapid increases in spending, especially on salary increases and fuel subsidies. Frequent in-year

⁹ Ghana Oil and Gas for Inclusive Growth (GOGIG) revenue modeling project, 2015-2019.

¹⁰ Evans, *In Ghana, Fiscal Responsibility Remains Elusive*.

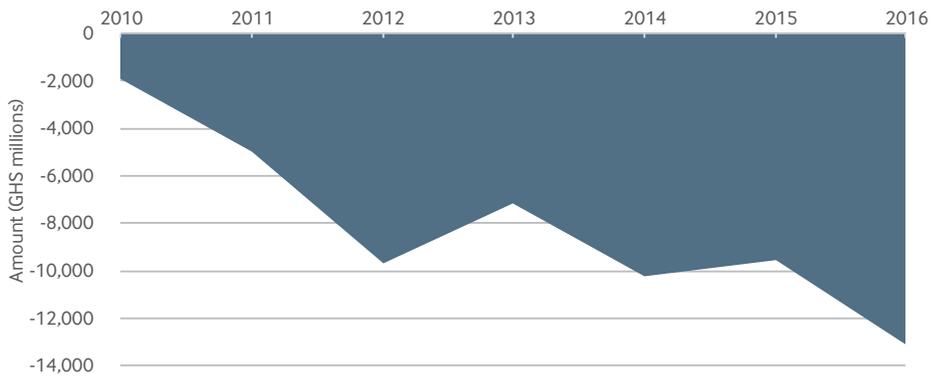


Figure 1. Ghana's fiscal deficit 2010–2016
Source: National budgets (2010-2016)

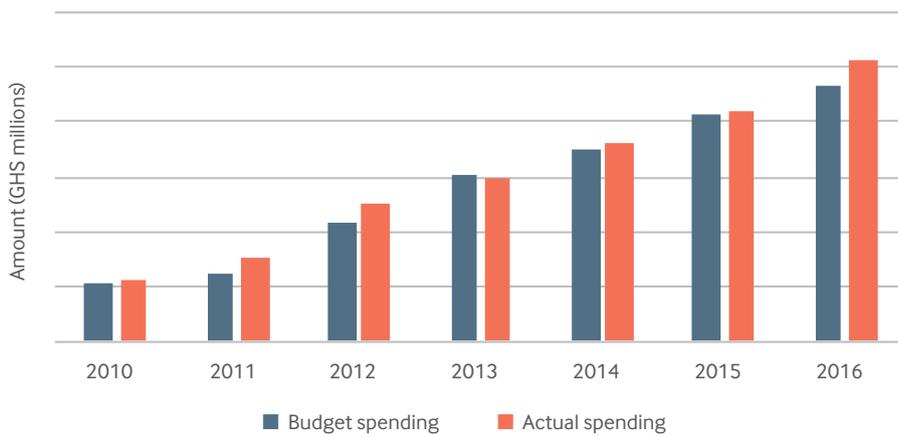


Figure 2. Budgeted versus actual spending 2010–2016
Source: National budgets (2010-2016)

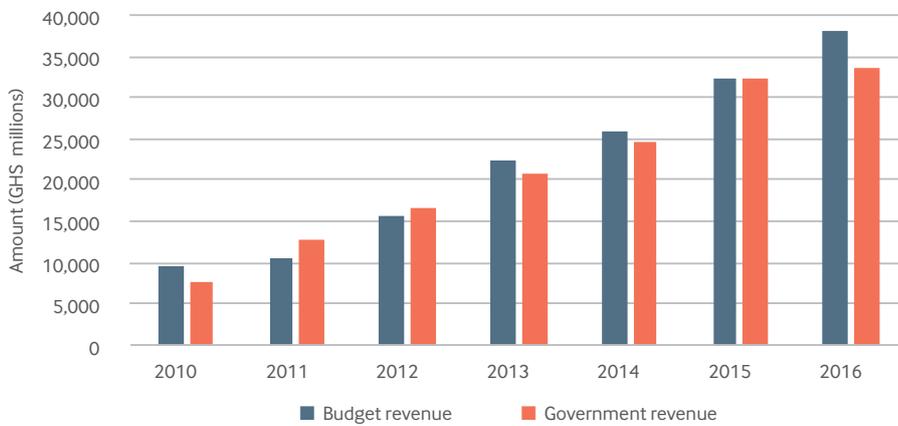


Figure 3. Budgeted versus actual revenue 2010–2016
Source: National budgets (2010-2016)

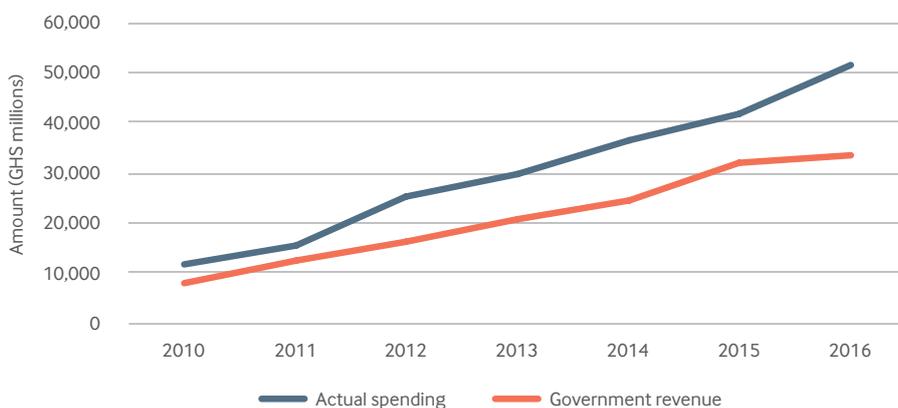


Figure 4. Spending versus revenue 2010–2016
Source: National budgets (2010-2016)

slippages in spending further aggravated this, especially in election years. (See Figure 2.) Over-optimism in revenues also undermined previous efforts to rein in the deficit. (See Figure 3.)

Challenges with Ghana's budgeting practices can, in part, explain the spiraling of the deficit. The PEFA¹¹ assessments of 2006 and 2009 pointed to weaknesses in budget execution and budget oversight that still persist today. In Ghana, budget estimates are often overstated. Typically, revenue estimates are underachieved while expenditure overruns occur. The budget does not classify expenditure line items by function. Unauthorized expenditure has weakened fiscal discipline across several years, as per the auditor general's reports.¹² Challenges also exist with the level of expenditure arrears, managing budget and cash releases, controlling commitments and implementing internal expenditure controls. Problems and delays with accounts reconciliation, in-year budget reporting and annual financial reporting also persist. Parliament (through the Public Accounts Committee) and citizens have exercised only limited oversight of the implementation of legislative and regulatory provisions for public financial management (PFM) in Ghana. These challenges have exacerbated the weaknesses with Ghana's budget execution and oversight.

Increased access to commercial foreign financing, in the form of Eurobonds, has been another damaging factor. The government issued its first Eurobond in 2007, shortly after the Jubilee oil discovery, and made five issuances in total, to the tune of USD 4.5 billion. Today Ghanaian bonds constitute over half of the total African Eurobond market.

Bonds	Coupon	Volume (USD)	Issue	Maturity
2007 – USD 750 million	8.50 %	750	4 October 2007	4 October 2017
2013 – USD 1 billion	7.88%	1000	25 July 2013	7 August 2023
2014 – USD 1 billion	8.13%	1000	11 September 2014	18 January 2026
2015 – USD 1 billion	10.75%	1000	1 September 2015	14 October 2030
2016 – USD 750, million	9.25%	750	8 September 2016	15 September 2022

Table 1. Ghana's Eurobond issuances¹³

Ghana's success in tapping into foreign financial markets can be seen as an achievement, but it came at great costs. The average interests of about 9 percent may be justified if spent on productive investment, but is punitively high to borrow for consumption. Additionally, because the loans were USD-denominated, the rapid depreciation of the cedi increased the costs of repayment considerably. The first of the loans matures this year, so the government now needs to make provisions for its repayment.

Given these circumstances, restoring fiscal sustainability is crucial. But the government's plan to reduce the fiscal deficit from 9.3 percent in 2016 to between 3 and 5 percent by 2018 requires drastic measures. For example, Ghana's statutory and other funds, including those earmarked to the district assemblies common fund, road fund and Ghana education trust fund, have led to rigidities in the budget,¹⁴ and the

11 It measures the extent to which PFM systems, processes and institutions contribute to the achievement of desirable budget outcomes.

12 "Government overspent budget by GHC 4.2 bn last year — Auditor General," GhanaWeb, 15 August 2017, <https://www.ghanaweb.com/GhanaHomePage/business/Government-overspent-budget-by-GHC-4-2-bn-last-year-Auditor-General-569836>.

13 Data from CBonds.com.

14 *Fiscal Rigidities and their Effects in Ghana*, Institute for Fiscal Studies, 2017, <http://ifsghana.org/httpifsghana-orgwp-content/uploads201702policy-brief-3-fiscal-rigidities-and-their-effects-in-ghana-pdf/>

government has now instituted efforts to cap related payments.¹⁵ But if the government wanted to achieve this level of fiscal deficit through spending reduction alone, it would need to cut spending by 11.69 to 17.13 percent over the 2017 Medium Term Expenditure Framework. Cutting government spending by such a significant amount over two years could hurt Ghana's development priorities, which need significant and sustainable funding to spur economic growth in the long run. Of course, the deficit could also be cut in areas where money is less well spent, or by raising additional revenues, but there is a risk that drastic cuts predominantly affect domestic investment, because they are easier to implement both practically and politically.

Managing volatility

Ghana has gone through yet another boom and bust cycle, which culminated in the 2015 IMF program. Such cycles are typical across developing countries, especially those heavily reliant on exporting primary commodities.¹⁶ This volatility makes it difficult to plan government revenues and, consequently, spending. For example, commodity price booms lead to significant revenue increases, which pose a temptation to increase government spending, sometimes through borrowing, to supplement the budget. On the other hand, a crash in commodity prices often forces governments to cut spending to finance their budgets. Repeated patterns of increasing spending during economic booms and decreasing spending during economic recessions is called pro-cyclical spending. Chile provides an example of how this can be avoided. (See Figure 5.)¹⁷

Ghana, on the other hand, was unable to avoid the pitfalls of pro-cyclical government spending and has experienced significant volatility. (See Figure 6.) Oil prices may have induced some of the recent turbulence, but Ghana does not export much more petroleum than it imports. Ghana's dependence on cocoa and gold can partially explain volatility. In addition, dependence on global and regional economic trends also play a major role in explaining volatility. However, volatility can also be self-inflicted by failing to keep spending at bay when there is a rapid growth in revenue.

Chile's adherence to a counter-cyclical fiscal policy

Chile followed a pattern of pro-cyclical fiscal policy until 2001, when the government introduced a structural balance rule. Since then, it has been a success story in terms of adhering to counter-cyclical fiscal policy. The government started saving windfall revenues from the copper price boom for a rainy day, and resisted the temptation to spend more when revenues exceeded set targets. By 2008, when copper prices had reached USD 800 per tonne (or quadrupled in price compared to 2001), it had amassed 5 percent of GDP in savings. Though the decision was unpopular at the time, in 2009, when Chile faced severe effects of the global financial crises, the government was able to respond with a sharp increase in spending. This helped keep critical expenditure at existing levels to reduce the effects of the global financial crises on economic growth. Had the government increased spending during the copper price boom, the global financial crises would have damaged the Chilean economy.

In Chile, restraints on government spending are drafted in law. There is a structural balance rule which defines the acceptable deficit. In the event of a "permanent" economic boom, government is allowed to spend increased revenues. If the economic boom is short-lived, however, government is obligated by law to save the excess revenues.

15 "Parliament to pass Bill to cap statutory funds at 25%," Citifmonline.com, 28 March 2017, <http://citifmonline.com/2017/03/28/parliament-to-pass-bill-to-cap-statutory-funds-at-25/>.

16 Miklos Koren and Silvana Tenreyro, "Volatility and Development," *The Quarterly Journal of Economics* (2007).

17 Cespedes, Parrado, and Velasco, "Fiscal rules and the management of natural resource revenues: The case of Chile" *Annual Review of Resource Economics* (2014) 105-132.

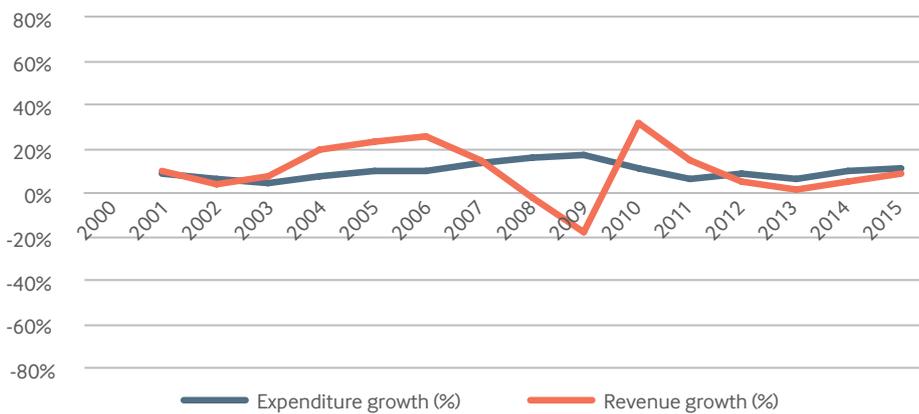


Figure 5. Historic volatility of government budget in Chile¹⁸

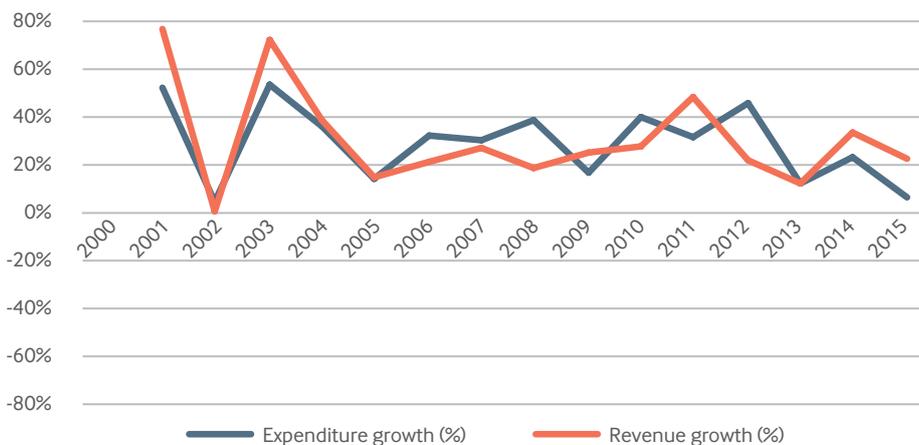


Figure 6. Historic volatility of government budget in Ghana

With two new oil fields now in production (TEN and Sankofa), and gradual recovery of previous investment costs, oil revenues are forecasted to increase.¹⁹ This means that oil revenues may ramp up to compose 10 to 20 percent of all government revenues. The higher band of the range would only just place Ghana's budget in the category of oil-dependent by international standards.²⁰ Hence, decoupling all revenues—not just oil revenues—from spending is key.

The proposed fiscal rule, which sets out a deficit target as a percentage of GDP, is pro-cyclical in nature. This means that when the economy is performing strongly, resulting in faster GDP growth, the government can allow expenditures to increase. In case of economic slowdowns, when revenues dip and GDP growth slows down, the government will be forced to cut spending. This will exacerbate boom-bust cycles.

18 Author's graph, data from IMF World Economic Outlook Database.

19 GOGIG's Ghana oil revenue modeling project estimates that Ghana's revenue from oil production will increase significantly when associated development costs from TEN and Offshore Cape Three Points fields have been recovered from 2017 onward. Oil revenues are estimated to reach as much as USD 3.2 billion by 2023.

20 The IMF puts the threshold at 20 percent. See *Fiscal Frameworks for Resource Rich Developing Countries*, IMF, 2012, <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Fiscal-Frameworks-for-Resource-Rich-Developing-Countries-25902>.

Prioritizing effective domestic investment

Ghana needs to address critical gaps in funding for education, health and infrastructure to develop and diversify its economy. Some countries that have similarly high domestic investment needs, such as Botswana in the 1980s, have opted to cap recurrent expenditures with their fiscal rules, rather than all expenditures.

Mineral revenues and social programs in Botswana

Botswana's fiscal framework sets out to spend mineral revenues on assets that can continue to generate income for the country even after natural resources have been depleted. This means that recurrent sources finance recurrent spending. Mineral revenues finance education, infrastructure and health in Botswana. In ensuring compliance with this principle, Botswana uses the Sustainable Budget Index (SBI). The SBI is defined as the ratio of non-investment spending to non-mineral revenues. An SBI value of less than one means that the government is either saving mineral revenue or spending it on public investment, while non-mineral (recurrent) sources are financing recurrent spending—a system that is interpreted as sustainable.

One of the objectives of the Petroleum Revenue Management Act is to ensure that oil receipts primarily fund domestic investment. The government earmarked 70 percent of budgeted oil revenues toward priority development projects. This rule, however, has proven ineffective, as oil revenues are fungible: the benefits of a measure to use petroleum revenues for priority projects was offset by a decision to decrease the share of allocation capital projects received from the budget. (See Figure 7.) Nevertheless, the government should not lose sight of its aims.

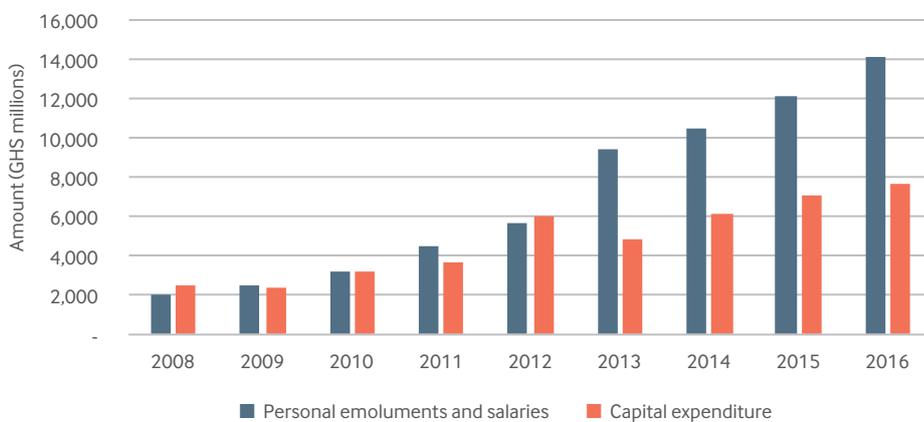


Figure 7. Wages and salaries versus capital expenditure in Ghana's budget²¹

On the other hand, public investments do not easily translate into commensurate additions to physical capital in Ghana. Public investment remains weak for a number of reasons. For instance, project appraisals and selections often face challenges, leading to delays in execution when projects are finally selected. The disbursement of a USD 3 billion Chinese loan is an example: spending challenges and delays in execution resulted in penalty costs, forcing the government to renegotiate the facility to USD 1.5 billion.

21 Presentation by Samuel Bekoe, "Underlying Causes of Ghana's Fiscal Challenges," Technical Meeting on Fiscal Responsibility in Ghana, September 2017; using MoFEP data.

Country name	Sub indexes				Overall score
	Appraisal	Selection	Implementation	Evaluation	
South Africa	4.0	4.0	2.8	3.3	3.5
Brazil	3.0	2.8	3.3	3.3	3.1
Colombia	4.0	2.8	2.1	3.3	3.1
Tunisia	2.8	3.2	3.2	2.7	3.0
Thailand	2.8	2.0	3.3	3.3	2.9
Peru	2.8	3.6	2.7	1.3	2.6
Bolivia	2.8	2.0	2.9	2.0	2.4
Armenia	0.5	3.2	3.2	2.7	2.4
Kazakhstan	3.0	2.0	2.5	2.0	2.4
Botswana	3.0	2.4	2.0	2.0	2.4
Moldova	2.7	2.8	2.5	1.3	2.3
Rwanda	2.5	2.0	3.2	1.3	2.3
Jordan	2.2	2.8	2.5	1.3	2.2
Mali	3.2	2.4	1.7	1.3	2.2
Afghanistan	2.7	2.8	1.6	1.3	2.1
Burkina Faso	1.2	3.2	2.0	2.0	2.1
Belarus	1.8	1.6	2.8	2.0	2.1
Bangladesh	2.8	1.6	1.7	2.0	2.0
Serbia	2.5	2.0	2.1	1.3	2.0
Madagascar	2.5	1.6	1.7	2.0	2.0
Ukraine	2.0	2.0	1.7	2.0	1.9
FYR Macedonia	1.2	2.4	2.1	2.0	1.9
Lesotho	2.8	2.0	0.8	2.0	1.9
Turkey	1.0	3.2	2.0	1.3	1.9
Côte d'Ivoire	3.5	1.2	1.5	1.3	1.9
Zambia	1.5	2.8	1.9	1.3	1.9
Ghana	1.3	2.4	2.4	1.3	1.9
Malawi	2.3	1.6	2.1	1.3	1.8
Philippines	2.3	1.6	2.1	1.3	1.8
Namibia	0.5	2.8	1.6	2.3	1.8

Table 2. Ghana's score on the Public Investment Management Index²²

Table 2 shows IMF country scores and rankings in 2012 for public investment efficiency with regards to project appraisal, selection, management and evaluation. A score of four indicates the highest level of efficiency for a country's public investments in any of the four project stages. Ghana's scores of 1.33 for both project appraisal and evaluation are relatively lower than other countries, showing inherent weaknesses in these areas.

Implementing a rule that focuses on maintaining a 3 to 5 percent deficit may not be optimal for Ghana's long-term priorities. It will result in rapid deficit reduction, but will not address challenges linked to volatility and the need to prioritize effective domestic investment. Modifications and additions to the rules would help incorporate these complementary goals.

²² Dabla-Norris, Brumby, Kyobe, Mills, and Papageorgiou, *Investing in Public Investment: An Index of Public Investment Efficiency* (IMF, Washington, DC, 2011), <https://www.imf.org/external/pubs/ft/wp/2011/wp1137.pdf>.

2. A GOOD FISCAL RULE SHOULD BE SIMPLE, BUT COMPREHENSIVE

International experience shows that fiscal rules are best kept simple.²³ When fiscal rules are simple, oversight actors (including parliamentarians, policy experts, investors and concerned citizens) can more easily monitor them. Simple rules also help prevent confusion or manipulation by government officials when they report on their adherence to the rule. If the general public understands the fiscal rules in place and their long-term benefits, it helps governments contain expenditure demands from the public and focus on ensuring fiscal discipline.

Ghana's proposed fiscal rule is very simple and its target, the deficit, has been defined clearly and reported widely. This means any violation of the rules will become apparent. But there is still some risk of the government circumventing the rule. As of now, there is no clarity about which government levels and entities will be involved in the fiscal rule. The minister of finance's frequent tabling of supplementary budgets could potentially enable circumvention of the fiscal rule, as supplementary budgets often contain proposals for increasing aggregate expenditure. Given that Ghana's fiscal rule caps the fiscal deficit but not debt, it is possible for government entities to increase borrowing, which may be backed by government guarantees. This will all add to the public debt, as a state guarantee makes the government liable for repaying loans in the event of default. Capturing all government levels and entities into the fiscal rule's implementation will help ensure accountability in administering the rule.

Nigeria provides a cautionary example. The Fiscal Responsibility Act capped the fiscal deficit at 3 percent of GDP at the federal level, but implementation at the state level has been mixed.²⁴ This is especially problematic in Nigeria where much of public spending occurs at the state level. Another cautionary example is Mongolia, where the Development Bank of Mongolia (DBM) borrowed heavily using a guarantee from the state and used those funds for quasi-fiscal activities. The arrangement enabled an extra 8 percent of GDP in capital spending off-budget. The DBM's state-guaranteed borrowing did not add to deficit—the target of the fiscal rule—until many years later, in 2016, the government had to step in as the DBM could not pay back its loans. On the other hand, Mexico's fiscal responsibility law provides a good example of comprehensiveness, as its balanced budget rule applies to central government, financial and non-financial decentralized agencies, and public enterprises.

In Ghana, state-owned companies have borrowed heavily. One such company, Ghana Gas, borrowed USD 3 billion from the China Development Bank in 2011. Ghana Gas planned to repay the loan by selling 13,000 barrels of crude oil per day up to 2027. In effect, the loan used Ghana's future resource revenues as collateral. The loan did not directly increase the deficit at the time, hence the proposed fiscal rule would not have capped it. Similarly, the mid-year policy review of the 2017 budget showed that by the end of 2016, total arrears amounted to GHS 7 billion.²⁵

This, and similar practices, present clear risks to budget sustainability. Hence, capping the deficit alone will not suffice. Fiscal rules should also protect against risks associated with off-budget borrowing, supplementary budgets and arrear accumulation.

23 G. Kopits and S. Symansky. 1998 *Fiscal Policy Rules*. IMF Occasional Paper, 162.

24 Vanessa Ushie, "Implementing the Fiscal Responsibility Act at the State Level in Nigeria," CSEA Working Paper, 2010, <http://www.cseaafrica.org/directdownload/CSEA%20Working%20Paper%204.pdf>.

25 Republic of Ghana, *Mid-Year Fiscal Policy Review of the 2017 Budget Statement and Economic Policy*, 2017, <http://www.mofep.gov.gh/sites/default/files/budget/The%20Mid-Year%20Fiscal%20Policy%20Review%20of%20the%202017%20Budget%20Statement%20and%20Economic%20Policy.pdf>.

3. A GOOD FISCAL RULE PROVIDES WELL-DEFINED ESCAPE CLAUSES

Escape clauses allow for the temporary suspension of fiscal rules in case of large shocks. This is a good thing: no numerical rule can be flexible enough to adequately respond to extraordinary spending needs.

In Chile, the 2009 economic crisis and 2010 earthquake and tsunami caused economic damage worth around 4.2 percent of GDP. The response to the crisis clearly required much greater spending than what the country's fiscal rule allowed. A temporary invocation of the escape clause allowed the government to deal with urgent spending needs before reverting to the rule.

A more problematic practice occurred in Mexico, where the government repeatedly invoked the escape clause because of low economic growth, including in 2010, 2011 and 2012, while saving very little during good times.²⁶ This eventually led to the rule's revision in 2015 as debt continued to increase.

Escape clauses are desirable in fiscal rules. However, it is important to ensure that they can't be triggered in normal times.

For example, a government could trigger the escape clause in case of natural catastrophes or a sharp decline in short-term economic activity, as Uganda's PFM Act 2015 provides for. (See below Box.) Proceeding with caution is important, however, as Uganda's law allows for invoking the clause in case of any other significant unforeseen event that cannot be funded under the PFM Act. This adds ambiguity and can easily be misinterpreted to provoke a departure from the rule in normal times.

Uganda's escape clause

Section 7(1) of Uganda's PFM Act 2015 provides the circumstances in which deviation may occur due to *force majeure* and be approved by parliament.

These circumstances are:

- (i) A natural disaster
- (ii) An unanticipated severe economic shock
- (iii) Any other significant unforeseen event that cannot be funded under the PFM Act 2015 or using prudent fiscal policy mechanisms

Note: The minister is required to publish reasons for deviations in the national gazette.

Tanzania's fiscal rule provides for temporary departures from compliance when the government plans a major strategic investment that requires its partial or complete suspension.²⁷

These are clear examples of fiscal rules with escape clauses which could easily be invoked in normal times. Excessively subjective escape clauses should be avoided because they leave too much room for discretion.

Inappropriately designed escape clauses could reduce fiscal discipline in the economy and undermine the rule's credibility, undoing the gains from efforts to restore fiscal discipline in Ghana.

26 International Monetary Fund, "Mexico : Selected Issues," November 2013, <http://www.banxico.org.mx/publicaciones-y-discursos/publicaciones/imf-article-iv/%7B9545A575-20DB-5609-5718-61F59B902DC3%7D.pdf>.

27 The United Republic of Tanzania. *The Oil and Gas Revenues Management Act (2015)*, <http://parliament.go.tz/polis/uploads/bills/1447070761-A%20BILL%20GAS%20REVENUE-DODOMA%2015%20june.pdf>.

4. A GOOD FISCAL RULE REQUIRES TRANSPARENCY AND STRONG OVERSIGHT

Fiscal rules are only useful insofar as people hold governments accountable for following them. Where there is no mechanism to monitor and review compliance, it is easier for government officials to manipulate the rules, or for policy-makers to ignore them.

In Ghana's own experience of implementing the Petroleum Revenue Management Act (PRMA), the government has circumvented certain provisions on a number of occasions to suit changing economic situations. The government established the Ghana Stabilisation Fund (GSF) to help with its objective to smooth expenditure over the business cycle by acting as a buffer during revenue shortfalls. In the recent past, although Ghana faced economic challenges, consistently lowering the cap on the stabilization fund limited its ability to serve its purpose. The current cap on the fund is USD 100 million, which is woefully inadequate to cushion budget shortfalls that could occur in case of a large shock to the economy. The Public Interest and Accountability Committee (PIAC) was established to oversee the PRMA's implementation, but has faced funding challenges in the recent past, in addition to other challenges that often delay its reports.

Several examples abound from other countries that demonstrate interference with set fiscal rules. In Mongolia, for instance, a number of situations have arisen where fiscal targets set in the fiscal stability law have been missed. The Fiscal Stability Law, effective from 2013, originally set a threshold for a budget deficit of 2 percent of GDP and 40 percent for debt. The government missed these targets repeatedly, but went on to amend the rules in the Fiscal Stability Law four times over four years, while government debt rose to about 92 percent of GDP—well above limits set in the law.

In drafting a good fiscal responsibility law, legitimacy is key. A strong independent oversight body should oversee fiscal rules, such as the Parliamentary Budget Office or an independent fiscal council. Research has shown that countries with independent monitoring bodies are more likely to comply with fiscal rules and consequently have lower public debt.²⁸ Fiscal councils have served as watchdogs over fiscal rule implementation in a number of countries, including Chile, and have ensured the sustainability of the rules themselves by regularly publishing budget forecasts and monitoring the implementation of the fiscal rules against the actual budget turnout, to keep citizens informed.²⁹

Transparency is the other key ingredient for effective oversight. The 2015 Open Budget Index showed that Ghana provides little information and limits public participation in the budget process.³⁰ In addition, limited legislative oversight exists for the national budget. The lack of comprehensive information, citizen participation and legislative oversight in the budget process raises a risk that government will not thoroughly comply with the fiscal rule.

Strengthening budget transparency and mandating a body with oversight will provide a strong basis for entrenching the fiscal rule. In order to make the budget

28 Wolf Heinrich Reuter. *When and why do countries break their national fiscal rules?*, German Council of Economic Experts, April 2016.

29 *The Fiscal Rule in Chile: A Teaching Case Study (Mock Up)*, <https://www.odi.org/sites/odi.org.uk/files/odi-assets/events-documents/2712.pdf>.

30 International Budget Partnership, "Ghana: Open Budget Survey Document Availability Tracker," <http://www.internationalbudget.org/opening-budgets/open-budget-initiative/open-budget-survey/country-info/?country=gh>.

process more transparent, the government needs to publish all relevant budget information (for example a pre-budget statement and the enacted budget) in a comprehensive format that citizens can easily understand. The executive's budget proposal should provide more information on expenditure classifications over the past and current medium-term expenditure framework. The government should also publish quarterly reports on the implementation of the national budget for public scrutiny as per the Public Financial Management Act (2016). In addition, the annual budget performance reports should provide details on planned revenues and expenditure (as contained in government macroeconomic forecasts), versus actual revenue and expenditure turnouts. This information will prove crucial to monitoring performance against the fiscal rule.

In addition to instituting an oversight body, it is important to consider punitive measures for arbitrary departures from the fiscal rule. The 2016 Public Financial Management Act makes provisions for applicable sanctions for unauthorized spending and commitments. These could be strictly applied. To complement these, the relevant parliamentary committee could also hold hearings for ministers of finance who supervise arbitrary departures from set fiscal rules.

5. A GOOD FISCAL RULE SHOULD BUILD ON EXISTING INSTITUTIONS AND ON NATIONAL CONSENSUS

International experience shows that having strong consensus behind fiscal rules helps them work. Norway's fiscal rule enjoys extensive political support. In 1990, Norway's political parties jointly committed to a fiscal rule that caps oil revenue spending at 4 percent of the expected value of its sovereign wealth fund.³¹

Experience from other countries also shows that when the government handles forecasts of sensitive variables in the budget process, predictions tend to be overly optimistic.³² Many countries benefit from the expertise of specialized civil society organizations, academics, economic and financial experts, and other professional bodies in successfully conceptualizing and implementing their fiscal rules.

Hence, having consensus behind the rule and tasking a capable and independent body to monitor compliance is key. However, there are budget implications for establishing a new fiscal council, recruiting independent experts and providing adequate resources for the staff to execute their mandate. One way of reducing the costs of establishing a fiscal council is to build existing staff capacity in Ghana's parliament, building on its research department and the new Scrutiny Office, established under the Parliamentary Service Act. The Scrutiny Office aims to provide objective and independent analysis on all policy initiatives and proposals that are brought to parliament for approval, including analysis of the national budget and government policies and programs. However, the Scrutiny Office needs a stronger staff and system to deliver effectively on its mandate.

31 Andrew Bauer and David Mihalyi, "How to Prepare for a Commodity Price Shock," IMF Public Financial Management blog, 23 July 2015, <http://blog-pfm.imf.org/pfmblog/2015/07/-why-werent-governments-better-prepared-for-the-commodity-price-crash.html>.

32 Jeffrey A. Frankel, "A Solution to Fiscal Procyclicality: The Structural Budget Institutions Pioneered by Chile," Central Bank of Chile Working Paper N° 604, January 2011.

The oversight body monitoring a fiscal rule should conduct independent analysis evaluating the risks to implementing the rule. These should address the issues this brief identifies, including scrutinizing revenue projections, effects of commodity price volatility and risks from off-budget borrowing. Additionally, it should review and evaluate the legitimacy of invoking the escape clause in different situations and the credibility of subsequent plans for restoring fiscal discipline.

Ghana could also benefit from the experience and expertise of civil society organizations and academics and other professionals focusing on budget reform and fiscal issues. PIAC, for instance, has consistently raised the need for government to situate petroleum revenue management within a well-coordinated public financial management system. For the fiscal rule to gain legitimacy and for it to have a better chance of successful implementation, government needs to engage the public on Ghana's options based on its current fiscal situation and stage of development.

Red metal in Chile

Copper constitutes around 50-60 percent of Chile's exports. Therefore, the country's budget is hugely dependent on the volatility of the price of copper. In Chile, there is independent forecasting of trend-levels of GDP growth and commodity prices. Chile's projections on the copper price and the long-term GDP trend are thus delegated to two independent committees. The forecast for the GDP trend is done indirectly according to IMF guidelines. Experts provide their five-year forecasts for both the GDP trend and the expected deviation of GDP from the trend in a report presented to government. To assure transparency and avoid discretion, the medium-term price of copper is obtained through a committee of experts from the mining, the academic and the financial sectors using information provided by the Chilean Copper Commission regarding consumption, production, costs, inventories and prices. The data and the estimates are detailed explicitly in a report to government.

Parliament, which represents citizens and will ultimately pass the fiscal rules into law, is well-placed for discussions with Ministry of Finance officials on the various options for a fiscal rule. The Parliamentary Budget Office is responsible for research on budget related issues and could assist with building the capacity of parliamentarians on issues concerning fiscal rules and their implementation in different contexts. The Scrutiny Office and Research Department of Parliament could hold sessions with Ministry of Finance officials to discuss the merits and demerits of different fiscal rules, based on evidence from international experience. Such discussions can help officials make more informed choices that are best suited to Ghana's economic growth and development goals.

RECOMMENDATIONS

Ghana's upcoming fiscal responsibility law presents a unique opportunity to reform Ghana's public financial management and put measures in place to make the national budget more credible and ensure fiscal discipline. An all-encompassing, realistic, achievable fiscal rule will go a long way to instill investor confidence in the Ghanaian economy and set the scene for accelerated economic growth.

Based on this paper's analysis of Ghana's policy priorities, historic performance and international experience, we present the following recommendations to government and lawmakers to improve the effectiveness of Ghana's fiscal rule:³³

- 1 Review whether it is realistic to reach a 3–5 percent deficit target by next year without cutting into pro-poor or developmental spending.
- 2 Avoid a pro-cyclical approach by setting a 4 percent structural deficit target, one that would allow a larger deficit in bad years while ensuring strict compliance with the rule in good years. Chile and Norway are using similar structural balanced budget rules.
- 3 Set an additional rule that caps the growth rate of recurrent expenditures. This would ensure that the government uses revenue windfalls for investment rather than increasing consumption and wages. Peru and Tanzania are using similar recurrent expenditure caps.
- 4 Make it difficult to circumvent the deficit target by setting limits to arrear accumulation and off-budget borrowing by various public entities. Most importantly, this should cover loans that state-owned companies take on for non-commercial activities. In Mexico, for example, a budget balance rule ensures limited borrowing by the national petroleum company.
- 5 Include an escape clause for major shocks. A temporary suspension of the fiscal rule should be conditional upon a limited range of well-defined events. The escape clause should also include specifications for publishing deviations from the rule and a public plan on measures for putting the economy back on the path to recovery.
- 6 Make a two-thirds majority vote in parliament necessary for invoking the escape clause. This will allow for consensus around the invocation of the clause, as well ensuring that the government follows recovery provisions after invoking the clause.
- 7 Make a two-thirds majority vote in parliament necessary to enact the fiscal rule, in order to build legitimacy and consensus. In addition, leaders of all political parties in Ghana should in principle agree with the kind of rule adopted and commit to its successful implementation in their various different capacities. This will increase the likelihood of continued compliance with the rule.
- 8 Strengthen budget transparency based on recommendations from the 2015 Open Budget Survey. These include publishing all relevant budget information (for example a pre-budget statement and the enacted budget) in a comprehensive format that citizens can easily understand, providing more information on expenditure classifications over the past and current medium-term expenditure

³³ Appendix A provides a short overview of fiscal rules across selected countries that this brief references.

frameworks in the executive's budget proposal, and publishing detailed annual budget performance reports with information on macroeconomic projections versus actual budget turnouts.

- 9 Institute punitive measures for non-compliance and arbitrary departures from the fiscal rule in any given financial year. Provisions for sanctions in the 2016 Public Financial Management Act present a good starting point for instituting punitive measures.³⁴ The government must, however, enforce these punitive measures. In addition, any minister of finance who supervises such arbitrary departures should face hearings with the Finance and Public Accounts Committees of Parliament.
- 10 Task an independent body with reviewing compliance with the fiscal rules. This body should carry out its own analysis to evaluate risks and credibility of government plans for fiscal consolidation. This does not need to be a new institution: The Scrutiny Office that the Parliamentary Service Act recently established is mandated to provide objective and independent analysis on all policy initiatives and proposals that are brought to parliament for approval.
- 11 Ensure that the selection of the head of the independent body tasked with producing independent forecasts is apolitical and based on the candidate's technical expertise, qualifications and work experience. The head of the independent body should have a guaranteed tenure of office and should not be subject to arbitrary removal.

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34 Public Financial Management Act 2016, <http://www.mofep.gov.gh/sites/default/files/reports/PUBLIC%20FINANCIAL%20MANAGT.%20%20ACT%2C%202016.pdf>.

APPENDIX A. SELECTED COUNTRIES AND FISCAL RULES IMPLEMENTED

Country	Type of fiscal rule	Fiscal rule target	Coverage	Independent implementation monitoring body	Escape clause?
Botswana	Budget balance, expenditure, debt	Limit on foreign debt (20 percent of GDP), on expenditure (40 percent of GDP); balanced budget over National Development Plan period	Central government	No	No
Chile	Budget balance rule	Achieve zero structural balance deficit by 2018	Central government	Yes, Advisory Fiscal Council (five members)	No
Kenya	Debt rule, revenue rule	Debt to GDP ratio in NPV terms to be below 45 percent; revenue to be maintained at 21–22 percent of GDP	Central government	No, but there is a Parliamentary Budget Office	No
Mauritius	Debt rule	Debt cannot exceed 60 percent of GDP	General government	No	Yes
Mexico	Budget balance rule, expenditure rule	Requires maintaining balanced budget; structural current spending (SCS) cannot grow faster than 2 percent	Central government and key state-owned enterprises in energy sector	Yes, Centre for Public Finance Studies (65 staff members)	Yes for budget balance, no for expenditure rule
Mongolia	Budget balance, expenditure rule, debt rule	Structural deficit cannot exceed 2 percent of GDP; public debt cannot exceed 40 percent of GDP; expenditure growth limited to non-mineral GDP growth	Central government	No, but the government is currently establishing a fiscal council	Yes
Nigeria	Budget balance	Fiscal deficit cannot exceed 3 percent of GDP	Central government	No	No
Norway	Budget balance rule	Non-oil structural deficit cannot exceed 4 percent	Central government	No	No
Peru	Budget balance, expenditure rule, debt rule	Structural deficit cannot exceed 1 percent of GDP; non-financial public sector debt cannot exceed 30 percent of GDP; recurrent expenditure growth limited to 4 percent of GDP in real terms	Central government for budget balance and expenditure; general government for debt rule	Yes, Consejo Fiscal (13 members)	Yes, except for debt rule
Tanzania	Budget balance, expenditure rule	Non-gas fiscal deficit below 3 percent of GDP; recurrent expenditure growth limited to nominal GDP growth	Central government	No	Yes
Uganda	Fiscal deficit, debt rule	Fiscal deficit below 3 percent of GDP; public debt below 50 percent of GDP	Central government	No, but there is a Parliamentary Budget Office (21 members)	Yes

Source: IMF Fiscal Rules database, IMF Fiscal Council database, 2017 Resource Governance Index research

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