Chapter 2: MULTILATERAL FISCAL SURVEILLANCE FRAMEWORK
A Generic Roadmap

2.1 Background

COMESA request to the Bank to propose an effective MFSF is made in the context of their program to establish a monetary union. Without that objective, or one to harmonize fiscal policies among that group of countries for other reasons, the need for multilateral surveillance would be mute. In designing an appropriate MFSF, therefore, it is necessary to layout at the beginning what a monetary union is, and the process leading up to the formation and sustainability of the union. This chapter starts with explaining that a monetary union is a fusion of two integration processes: financial integration and real economy integration, and that these processes involve implementation of various macroeconomic and structural policies within a coherent framework over successive stages (degree of intensity) of integration. Fiscal policies are a part, although an essential part, of this framework and thus could not be viewed in isolation. A generic road map is developed to illustrate this fusion of the two integration processes, and possible stages of development, including corresponding policies and institutions needed, on the road towards the monetary union. Following that, the chapter reasons as to why fiscal policy has been particularly singled out by EMU and other existing and aspiring monetary unions, and why they have given prominence to fiscal convergence criteria in their surveillance frameworks. The rest of the chapter then elucidates general considerations relating to MFSF, elaborates its major elements, and emphasizes the importance of robust national public finances management (PFM) as the rock on which MFSF should be built, and hence the importance of national fiscal surveillance to complement the multilateral fiscal surveillance.

2.2 Real Integration plus Financial Integration equals Monetary Union – A Generic Roadmap

2.2.1 Economic viability and sustainability of a monetary union depends upon close integration of members’ economies. Indeed, a monetary union is a fusion of two separate, but consistent, integration processes: financial integration, and real integration. It should be noted that a monetary union is not an objective in itself but an instrument to achieve certain economic (and political) goals. In the case of Africa, these goals include accelerated growth and poverty reduction (MDGs). Each of the two integration processes has to cater to those goals. As indicated in a recent report of the Bank, Financial Sector Integration in Three Regions of Africa (2010), the contribution of regional financial integration comes through four different channels: (i) it provides further powerful stimulus for domestic financial reforms, (ii) it increases the scale of operations and competition, thereby increasing the system’s efficiency and productivity, (iii) it induces foreign direct investment, and (iv) it enables the African financial systems to grow into regional and ultimately global players in financial markets.

2.2.2 Similar contributions also flow from the regional integration of the real sector by providing larger consumer markets, by reducing cross-border transaction costs, by inducing the building of regional infrastructure, by harmonizing tariff and investment policies, and by coordinating fiscal policies. Further, while it is possible that market forces could, and in some cases have, promoted real sector integration (the ASEAN case), in general proactive policies, encompassing a wide set of policies relating to structural, monetary, fiscal and exchange areas, have been needed to foster that integration (EU and African RECs cases). The relative role of these four sets of policies in national policy framework would differ as the integration process progresses, leaving national governments with only structural and fiscal policies to control once the monetary union becomes operational. But, even fiscal policies would need to be based on some commonly agreed principles of sound fiscal policy.
2.2.3. The generic road map suggested below reflects the assertion made earlier that a monetary union is a fusion of two integration processes: regional financial integration (RFI) and regional economic integration (REI). As stated in the Bank Report on RFI, "An ultimate objective of RFI is to facilitate financing of larger real transaction activity among the member countries of the region. In that sense, RFI is a complementary process to trade and services integration among those member countries. However, it is not suggested that there has to be a one-to-one mapping of trade integration and RFI. Instead what is implied is that each process supports the other, and that both processes are mutually dependent: RFI process in the absence of increased intra-regional real transactions will be anemic and contribute only marginally to growth and poverty reduction, while trade integration would be facilitated and accelerated if the financial sectors of member countries were well developed and integrated". Furthermore, RFI by linking the credit and capital markets of member countries would enhance and enlarge channels for monetary policy transmission, thereby enabling the common central bank to conduct its monetary policy more efficiently and across the union as a whole. Hence, there is a need for ensuring that financial integration progresses in tandem with real integration to underpin the viability of an eventual monetary union. This consideration has implications for the design of the surveillance framework. Emphasizing only the financial policies, including fiscal policies, such as an inflation target, budget deficit, and exchange rate stability, may leave unattended the policies needed to advance real integration. On the other hand, focusing on real integration (trade) may ignore policies needed to promote financial integration. The point is that none of the fiscal, exchange rate, or trade policies can be set in isolation and they must be an integral part of a comprehensive and consistent overall macro policy framework. This point should be kept in mind, even though this report, limited by its terms of reference, focuses on the fiscal policy surveillance framework. However, given the assertion below about the importance of having a similar framework for trade integration, a few recommendations are also made in this report in that regard with a view to consolidating regional trade agenda by embedding it with the regional initiative to establish a monetary union.

2.2.4 Balassa (1961) identified five main stages of regional real sector, or economic, integration (REI): Free Trade Area (FTA), Customs Union (CU), Common Market (CM), Economic Union (EU), and Total Economic Integration (TEI). In an FTA, tariffs and quotas on imports from member states are abolished but each member maintains its own tariff and quota regime vis-à-vis imports from non-member countries; in a CU, members abolish non-tariff barriers to imports from other member countries and set up common external tariff (CET) and quota regimes against imports from non-member countries. In a CM, CU members abolish non-trade barriers to trade (in goods and services) among themselves and introduce free intra-regional movement of labor and capital, and when moving to EU, implement significant coordination of national policies and harmonization of relevant national laws. In the final stage of TEI, all relevant economic policies are conducted at the supra-national level by supra-national authorities operating with supra-national institutions and supra-national laws.

2.2.5 The Bank report (2010) on regional financial integration in three sub-regions of Africa also identified five main stages (following the fulfillment of macroeconomic stability as a pre-condition) of regional financial integration: Preparatory, Harmonization, Cooperation, Integration, and Monetary Union. In the first, preparatory stage, the main responsibility falls on domestic policy makers to modernize domestic financial systems especially the payments systems. In the second, harmonization stage, modernization of the financial sector in individual countries would be further extended by the introduction of and compliance with various international standards and practices in the financial sector that would ensure regional harmonization. In the third, cooperation stage of integration, member countries cooperate in effectively implementing agreed convergence criteria that are monitored and evaluated by a regional ministerial council. They also complete the full harmonization process relating to regulatory, supervisory, and accounting procedures began under Stage II, and cooperate in cross-border regulation and supervisory activities. In the fourth, integration stage, will shift the focus of action to the regional level. This stage would be characterized by an effective integration of various financial...
institutions, and of the exercise of regulatory and supervisory functions, including single bank licensing, a single regulatory agency, and increased cross border presence of financial institutions originating in member countries. In the fifth, unification/monetary stage, integration would be characterized by common currency and a common central bank. These stages do not coincide with the five stages of REI and stop short of the final TEI stage of REI. However, the Report did indicate definite mutually supportive relationship between the various stages of REI and RFI. Taking the final, unification/monetary stage of regional financial integration further, and conceptualizing monetary union as a fusion of the REI and RFI processes, a road map towards a monetary union would include policy and institutional steps that need to be taken in both the real and financial sectors in moving towards establishing a monetary union. The remainder of this chapter develops this reasoning and proposes a generic roadmap towards a monetary union that could be used in developing a multilateral surveillance framework specific to the conditions and requirement of a particular REC.

2.2.6 Almost all regional cooperative arrangements aiming at the formation of a monetary union have followed a sequential process between the two types, REI and RFI, of integration. Thus the EMU started with sectoral real integration (coal and steel) and gradually progressed towards economic community and the economic and monetary union. The two CFA currency unions in Africa began with the establishment of a currency union and then proceeded to establish monetary unions (WAEMU and CEMAC) by setting up customs union and other elements of an economic community among their member countries. Other African RECs are following the EMU precedent, establishing FTAs, CU, and EC in sequential order before joining in a monetary union. As a result, most of these arrangements have focused on implementing measures needed to establish either financial integration or real integration to the “benign neglect” of the needed complementary measures in the other area. It is only later, usually in the wake of some crisis (e.g. the Asian financial crisis of the mid-1990s, and the CFAF devaluation in early 1990s) that attention has been paid to the development of the neglected integration, RFI or REI as the case may be.

2.2.7 The past experience with regional integration has also demonstrated that while the establishment of monetary union has involved active multilateral (regional) surveillance of potential member countries’ financial sector developments through the use of convergence criteria as a surveillance tool, the establishment of FTAs or the customs unions, or even economic communities, has not involved any similar surveillance. This may explain why in the present case of African RECs, while formal FTAs have been established, the expected benefits in terms of either a significantly higher intra-regional trade, or improved international competitiveness, or larger FDI inflows have not occurred. This may well be because little attention has been paid to implement the underlying measures at both the domestic and regional levels that are needed to unlock those expected benefits. A plethora of studies have been made, and inter-governmental protocols signed, indicating needed measures and practices and procedures to be followed, but with little follow-up.

2.2.8 The generic roadmap proposed below, consistent with this report’s central proposition that a monetary union is a fusion of real and financial integrations, therefore envisions that the African RECs aspiring to becoming monetary unions also establish a formal multilateral trade surveillance mechanism in parallel with the MFSF to guide the overall integration process. Under this scenario, regional convergence criteria/indicators related to fiscal and trade policies would be prescribed for potential member countries to satisfy, and be monitored regionally, within two separate but consistent and concurrent, multilateral surveillance frameworks: a Multilateral Fiscal Surveillance Framework (MFSF) and a Multilateral Trade Surveillance Framework (MTSF). Underlying this proposal is the idea that fiscal and trade policies are the pivotal policies for ensuring the coherence and sustainability of a monetary union, and for safeguarding the intra-regional competitiveness of member countries.

2.2.9 Based on the above considerations, Table 2.1 below summarizes a generic roadmap towards a monetary union that includes the integration of financial and real sectors. It envisages four hybrid stages, each embracing all or parts of the above-mentioned stages in RFI and REI. It also indicates various sequential policy and institution-building measures that need to be taken to move progressively on that road. During this transition process, greater emphasis is on building a robust PFM system, embedding trade integration with the monetary union agenda and introducing a multilateral fiscal sur-
veillance framework that plays the role of a promoter, policeman, and crisis manager, endowed with appropriate powers and financial resources.

2.2.10 The above categorization of monetary union, and the multilateral fiscal surveillance framework, indicates that the process to achieve the objective of monetary union involves policy and institutional building actions in multiple areas, is a long one and requires careful calibration and sequencing. Thus countries are well advised to keep in focus the multi-dimensional and macroeconomic implications of forming a monetary union, and not to rush into forming a monetary union, or for individual countries to join one, but to go through an intensive preparatory process focused on building robust national PFM systems, and intra-regional harmonization across financial, fiscal, and trade areas. The roadmap must be taken as a first exercise to highlight mutually supportive roles of real, financial, and fiscal and trade policies, and could be further improved through discussions in the COMESA and other fora to make it a more useful tool in assisting other similar attempts at forming monetary unions and instituting fiscal surveillance.

Table 2-1: Monetary Union – A Generic Roadmap towards Fusion of Real and Financial Integration

<table>
<thead>
<tr>
<th>Economic Integration</th>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
<th>Stage 4</th>
<th>Stage 5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Free Trade Area (FTA)</td>
<td>Customs Union (CU)</td>
<td>Economic union (EU)</td>
<td>Monetary Union (MU)</td>
<td>Member states yield sovereignty in monetary policy and currency issue to a common central bank that issues common currency.</td>
</tr>
<tr>
<td></td>
<td>Intra-regional tariffs and quotas on trade in goods abolished</td>
<td>Non-tariff barriers to intra-regional trade removed; Common External Tariff (CET) on trade with non-members</td>
<td>Significant coordination of national economic policies; Harmonization of institutional and legal structures.</td>
<td>Common central bank, and common currency</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>Financial Integration</th>
<th>Pre-condition:</th>
<th>Plus</th>
<th>Stage 1 Preparatory</th>
<th>Stage 2 Harmonization</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Macroeconomic stability.</td>
<td></td>
<td>Member countries begin to modernize financial system by implementing parts of international financial standards, and exchange information among them regarding progress being made,</td>
<td>Member countries to substantially complete modernization of their financial system, and harmonize and link their financial policies, institutions, and rules and regulations.</td>
</tr>
<tr>
<td></td>
<td>Plus</td>
<td></td>
<td></td>
<td></td>
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</table>

**Stage 1 Preparatory**
Member countries begin to modernize financial system by implementing parts of international financial standards, and exchange information among them regarding progress being made.

**Stage 2 Harmonization**
Member countries to substantially complete modernization of their financial system, and harmonize and link their financial policies, institutions, and rules and regulations.
<table>
<thead>
<tr>
<th>Financial Criteria/Benchmarks</th>
<th>Bank soundness, Improve national payment system (RTGS), compliance with BCPs, IAIS, and IAS, remove intra-regional exchange controls, strengthen stock exchange rules and regulations, market based financial system, central bank autonomy, remove barriers to intra-regional banking, develop national credit information systems.</th>
<th>Implement regionally agreed convergence criteria, coordinate monetary and exchange policies</th>
<th>Adapt/modify domestic legislative and regulatory requirements and institutional set-up to conform to the requirements of this stage of RFI, Exchange Rate Mechanism (ERM)</th>
<th>Exchange local currency for the regional common currency, Pool exchange reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Convergence</td>
<td>Top-down budgeting, comprehensiveness of the budget, budget monitoring, MTMEF and MTFF; MTBF, Comprehensive budgetary documents for Parliamentary scrutiny, timely issuance of consolidated financial statements and, if necessary, appropriate corrective action; Multilateral Fiscal Surveillance Framework (MFSF) with pro-active participation of IMF, World Bank, and AfDB.</td>
<td>Budget classification by international standards, MTBE (sectoral), PFM system incorporating at least the minimum required components and other recommendations from the PFM review.</td>
<td>Fully effective medium-term financial system with its four components of macroeconomic, fiscal, budget, and expenditure frameworks.</td>
<td></td>
</tr>
<tr>
<td>Fiscal Criteria/Institutions</td>
<td>Strong centralized budget agency (Min Fin), Budget Unit, Macroeconomic policy unit, budget balance, Single Treasury Account, internal ministry controls, Parliamentary Budget Office, and MPs Committee as “gate-keeper” for budget approval, Independent external audit; Regional Adjustment Fund</td>
<td>Fiscal rules, Budget System Law, regional Investment Code Convergence Program, Fiscal Surveillance Unit (independent or part of macroeconomic unit, Review of Public Finance Management (PFM) system.</td>
<td>Fulfill regional convergence criteria, harmonize statistical and other required information in the interests of an effective MFSF; Activation of “slippages procedure” (ESP)</td>
<td>Continue fulfilling convergence criteria, or, if “slippages”, implement corrective measures. Regional SWAP Facility</td>
</tr>
<tr>
<td>Structural/Trade Benchmarks</td>
<td>Medium-term Trade Integration programs (MDTIP), Improve business environment and regional/global competitiveness Regional trade and transport development plan and facilitation programs</td>
<td>Improve labor market flexibility, Introduce/improve social safety nets Embed trade integration agenda into MFS mechanism Intra-regional Trade Integration index Infrastructure Development Company</td>
<td>Regional procurement system</td>
<td>Trade agenda still subject to multilateral surveillance</td>
</tr>
</tbody>
</table>

WBk/WEF global Competitiveness Index
2.3 Multilateral Fiscal Surveillance Framework (MFSF)

2.3.1 The MFSF provides a regional mechanism for ensuring regional convergence of member countries forming, or joined in, a monetary union. It also provides a forum for discussions among member countries on fiscal developments within a member country and within the union as a whole. The essential elements of such a framework consist of a (Treaty-based) set of fiscal convergence criteria that members must observe, some complementary union-wide rules relating to financing of public deficits or other fiscal requirements, a surveillance body authorized to review member countries’ compliance with convergence criteria and make obligatory recommendations to member countries not in compliance with those criteria, and decide on imposing (Treaty-envisaged) sanctions on a country in case of failure to take corrective steps when recommended by that body.

2.3.2 Fiscal Policies, Fiscal Convergence Criteria, and Fiscal Rules

2.3.2.1 The inclusion of MFSF in a monetary union setup is based on the recognition that fiscal policies, and fiscal convergence, are of paramount importance to the formation and sustainability of a monetary union. It reflects the appreciation of the increased role and impact of fiscal policies not only in the regional context but also at the national levels. The objectives of fiscal policy have expanded beyond its impact on reducing inflation, to promoting stabilization, growth, and (in the case of low- and medium-income countries) poverty reduction. Its assigned role is to ensure financial sustainability via the instrument of fiscal balance, and of promoting growth and poverty reduction via the instruments of fiscal (tax and expenditure) composition. Further, while in the earlier times the impact of fiscal policy was traced through its effects on aggregate demand and public investment, it is now also traced through its effects on private investment and productivity growth. Fiscal policies influence public investment via changes in public sector debt profile, private sector’s expectations, and exchange and interest rates. These also affect poverty profile, which is more directly impacted by the composition and efficiency of public expenditures. Changes in fiscal expenditures also affect the productivity of labor and capital through positive externalities. In addition, credibility of fiscal policies plays a crucial role in influencing private spending.

2.3.2.2 Fiscal policy also affects price development via the money creation effects of budgetary balance and, as elucidated by the fiscal theory of price level (FTPL), by the wealth effects of budgetary balances. This theory argues that a fiscal-dominant (non-Ricardian) regime may emerge when fiscal policy is not sustainable and government bonds are considered as net wealth. These wealth effects could jeopardize price stability, irrespective of central bank’s commitment to price stability and (legal) inability to accommodate government’s financial needs. In this situation it is the fiscal, not the monetary, policy that determines the price level and becomes the nominal anchor. The theory is equivalent to giving the government an ability to choose an equilibrium path of price level. Evidence on inflation and its fiscal determinants in Sub-Saharan African countries seems to suggest that countries with chronic budget deficits have been more prone to fiscal-dominant regimes and high inflation. Evidence also exists that the difference in the relative importance of monetary and fiscal sources of inflation between countries in Sub-Saharan Africa corresponds to differences in the exchange rate regime. The contribution of money growth to inflation in the CFA monetary unions is far less relevant than in countries with floating exchange rate regimes. Further, it demonstrates that fiscal-dominant regimes may emerge even when monetary policy is independent and not accommodative.

2.3.2.3 Recognizing the importance of fiscal policies, all cooperative arrangements aiming for single currency have prescribed fiscal convergence criteria to be attained by potential member countries, and observed by existing member countries. Basically, there are two reasons for prescribing convergence criteria in the context of a monetary union: (i) to prepare potential member countries to join the union and be able to give up the benefits arising from independent monetary and exchange policies, while remaining competitive (economic convergence).
within the union to reap the benefits accruing from being a member of a larger currency union; and (ii) to protect member countries from being exposed to contagion effects of macroeconomic instability or “moral hazard” policies and actions in individual member countries, and ensure sustainability of the union as a whole. The first reason dictates that potential member countries satisfy convergence requirements in areas relevant to a country’s intra-regional competitiveness and, therefore, fulfill convergence criteria that include monetary, exchange rate, and fiscal criteria as conditions for entry. The second reason suggests that countries in a monetary union, having satisfied those criteria and yielded monetary and exchange rate sovereignty to a single central authority, must continue to respect union-wide fiscal convergence criteria which will limit national discretion in the use of fiscal policy and allow an orderly conduct of monetary policy to pursue the (price stability) objectives. The imposition and observance of convergence criteria, by enabling the achievement of a high degree of homogeneity of the economies of member countries, helps avoid asymmetry of shocks.

2.3.2.4 The role and scope of convergence criteria for members seeking to form or enter a monetary union differ from that for countries that are already members of that union. In the former case, the prescribed convergence criteria are comprehensive in nature and coherent in approach in that they encompass monetary, exchange, and fiscal policies, as well as structural policies that must be mutually consistent and supportive of enhancing the entrant country’s homogeneity with the existing members and ensuring the country’s competitiveness within the union once it becomes a member. Once a member, monetary and exchange policies are ceded to the common central bank and convergence criteria to be observed by the members refer only to fiscal policies.

2.3.2.5 From a country point of view, efforts to meet the convergence criteria can also lead to the identification of specific reforms and policy changes. For example, a convergence criterion regarding public wages (as in WAEMU framework) could reveal the need for not only wage restraint but also for a comprehensive civil service reform in the context of a framework for centralized wage negotiations and medium-term labor contract framework (Lundgren, 2010). It could also lead to a further analysis as to the overall performance of the civil service, and therefore specific national fiscal rules to guide that reform. Inclusion of such rules could also encourage a greater focus on institution building and social implications of the integration process and thus make the eventual integration of economies sustainable, and attract greater support for the union.

2.3.2.6 The experience with fiscal rules has demonstrated that a rules-based fiscal policy results in better fiscal performance. As a consequence, there is now recognition that currency unions should be supported by rule-based frameworks at country levels, and fiscal rules have become more common in recent years, with their adoption increasing from only a few countries in 1990s to about 80 countries in 2009 (IMF, 2009).

2.3.2.7 Fiscal rules can be defined as institutional mechanisms placing durable constraints on fiscal discretion through numerical limits on budgetary aggregates. In general, fiscal rules are a broader concept than fiscal anchors because they include institutional mechanisms to commit to anchors, and they are often enshrined in the law. To make the rules more effective, institutional reforms often follow, such as the enactment of fiscal responsibility legislation or creation of separate non-partisan fiscal councils.

2.3.2.8 Fiscal rules must satisfy two basic objectives; credibility, and flexibility. In the African case, they must also satisfy a third objective: socio-economic (growth, macroeconomic stability, and poverty reduction). The

10 The above reasoning was best summarized by Peter B. Kenen in his intervention at an IMF seminar when he noted that the criteria are devised “to require that the national governments do the hard work of achieving macroeconomic stability and sustainability before monetary union begins so that the common central bank could start to work in a benign environment and escape the onus of imposing the hardships required to create that environment”. This last observation also implies that careful attention needs to be paid to the quantification of those criteria. For example, convergence among countries may be achieved, and countries remain competitive among themselves within the monetary union, at a high level of inflation if all member countries stabilize at that level. However, this will not be a “benign environment” and will make the task of monetary authorities difficult, as well as bring about exchange rate instability.

11 However, in the case of these and other similar structural issues, this report advocates fiscal rules at national level, rather than convergence criteria at the regional level.
choice of fiscal rules is guided by considerations such as (i) the type of shocks the economy is exposed to; (ii) the state of public finances and the budgetary process; (iii) the structure and quality of fiscal institutions; (iv) the relative policy priorities; and (v) the exchange rate regime. Kopitz and Symansky (1998) suggest four principles to guide a country’s choice: a rule should be (i) simple, well-defined, and relatively easy to monitor; (ii) flexible, to accommodate shocks, allow the operation of automatic stabilizers, and thus avoid pro-cyclical fiscal policy; (iii) transparent, so as not to give rise to distortions and unsavory accounting practices; and (iv) internally consistent and enforceable. An OECD survey highlighted six aspects of fiscal rules prevalent across regions: type of fiscal rules adopted, the basis (primary law or executive decision, international agreement) underlying any fiscal rule, the monitoring authority of any fiscal rule, coverage across government operations, and coverage across years. The extent to which political commitment and data are available also affects the statutory base and the coverage of the fiscal rule.

2.3.2.9 Fiscal rules generally include some variants of budget balance rules, public debt rules, expenditure rules, and revenue rules. The primary goal is to promote fiscal sustainability of member countries and, by implication, the sustainability of the monetary union. Different rules comply in different degrees with this objective. To that effect, countries (and monetary unions) adopt a multiplicity of rules rather than a single rule. As fiscal rules are intended to achieve some medium-term goals, they are generally to be set in the context of medium-term framework of public finance management. To be effective, fiscal rules should be underpinned by a robust institutional system capable of ensuring their implementation and monitoring. Moreover, experience suggests that fiscal rules should not be introduced in an excessively uncertain economic environment when reliable economic projections and forecasting are virtually impossible, but rather after some degree of fiscal consolidation and macroeconomic stability has been achieved.

2.3.3 A Priori Elements of MFSF for African RECs

2.3.3.1 Any effective MFSF must be calibrated to the special circumstances of the region to which it is to be applied. While exhibiting many economic and financial features common in the rest of the world, African RECs also have some unique characteristics that have implications for the surveillance mechanism. Unlike member countries of EMU, African countries are generally low-income countries, have limited export base, trade mostly with non-African countries with little intra-regional trade, possess limited financial and technical resources which makes them aid-dependent. Their infrastructure is underdeveloped, resulting in market inflexibilities, and their financial systems are narrow and shallow, inhibiting their productivity and competitiveness. Although many amongst them have made significant progress towards achieving macroeconomic stability and positive per capita growth rates, further progress is needed in these directions to meet the MDG targets, increase employment, and reduce poverty. These countries also have a history of setting up various targets, programs, and organizations aimed at fostering regional integration that have seen little follow up in terms of implementation.

2.3.3.2 In view of the above, a few à priori elements could be considered for inclusion within the multilateral surveillance framework for a successful march towards a monetary union: enhanced national ownership; variable speed and variable geometry approach on the roadmap towards the monetary union; social safety nets; combination of promotional, preventive, and restorative (crisis management) roles of multilateral surveillance, gradually increasing intensity of multilateral surveillance pari passu with increasing integration, and a pro-active and cooperative role of multilateral institutions (IMF, World Bank, and AfDB) in promotional, surveillance, and crisis management domains:

(i) Enhanced national ownership: Multilateral surveillance implies that countries are committed to making progress towards the attainment of regionally agreed convergence criteria by implementing appropriate fiscal and other policies and programs. National ownership, or buy-in, of those policies and programs is an essential precondition for their successful implementation, especially as it is likely to affect all the sections of population in the short and the long term. It should reflect not only an active support for the monetary union’s objectives, and willing assumption of the responsibility for the policies, by the authorities of member countries, but also a broader support from the member country’s parliament, civil society, and other stakeholders. These preconditions could be
satisfied if the regionally agreed convergence criteria (which will form the basis of the member countries’ national convergence programs) are approved by each member country’s Parliament, and are given wide publicity for public record and discussions.

(ii) **Variable speed and variable geometry approach:** The circumstances and ability of potential member countries of any REC will differ, and not all countries may realistically be able, or be willing, to reach the convergence criteria within the same time period dictated by the agreed target date for the establishment of the monetary union. Countries should, therefore be allowed to determine their own time path and fiscal route to fulfill the criteria for entry into the union; this approach would be consistent with the current practices of COMESA.

(iii) **Social safety nets:** Joining a regional arrangement such as an FTA, Customs Union, or a Monetary Union will generate various social costs of adjustment to the requirements of those arrangements. Given the low income levels in potential member countries, some provision needs to be made to meet those costs, especially as they relate to the vulnerable sections of the society. In the longer run, the establishment of such social programs could also improve the mobility of labor, and thus bring about some flexibility in the labor markets.

(iv) **Characteristics of the surveillance framework:** One of the functions of the surveillance is to discipline member countries in their fiscal behavior and to impose sanctions in case of non-compliance, following agreed procedures regarding excess deficit resolution. However, in a transition to setting up a monetary union, the surveillance framework should not include sanctions for non-compliance with the convergence criteria, except to postpone entry into the Union until the criteria are satisfied, and conditioning the use of any regional funds (as proposed below) to meet the adjustment or infrastructure investment costs of integration. Instead, it would be desirable that the framework operates as an “enabler”, assisting and inducing countries to implement their convergence program on a steady path. Thus, during the progress on the roadmap, the role of the multilateral surveillance mechanism should be one of a promoter rather than of a policeman. It can discharge this role by identifying policy formulation and implementation, weaknesses/gaps in individual countries, and mobilizing financial and technical assistance to address them, and to help meet the adjustment and investment costs to member countries of implementing appropriate measures during the transition period.

(v) **Inadequate financial and human resources:** The African REC member countries, in general, do not possess adequate resources, financial or human, to perform effectively the promotional or surveillance role in the context of multilateral surveillance. Hence, they may consider exploring assistance from their development partners, including the EU, IMF, AfDB, and the World Bank. The chances of obtaining such assistance would be enhanced, and the surveillance system would be more robust, were these institutions invited to take a more pro-active participatory role in the surveillance mechanism. It may be recalled that at present the IMF conducts regional surveillance in the form of annual assessment of policies pursued under currency unions, and multilateral consultations for systemic countries or issues of multilateral or regional importance. More recently, it has also agreed to a G-20 request to assess economic policies of G-20 countries under the new G-20 Mutual Assessment Program with a view to ensuring that policies pursued by G-20 countries are collectively consistent with the objective of a strong, sustainable, and balanced growth for the global economy. In that role the Fund provides analytical (quantitative and qualitative) and technical support, where appropriate. In a similar vein, the IMF could be requested to assess convergence policies of member countries of RECs actively engaged in forming a monetary union to ensure that policies pursued by them are collectively consistent with the objective of forming a sustainable monetary union.

2.3.4 Foundations of MFSF: Macro models, and National Public Finance Management (PFM) Systems

2.3.4.1 Macro Models

2.3.4.1.1 The effectiveness of MFSF is as strong as the fiscal management in the member country with the
weakest system of PFM. It is important, therefore, that in the process towards the formation of a monetary union, MFSF should pay special attention to the PFM systems in potential member countries and include mechanisms to improve and strengthen them with a view to ensuring that at entry point member countries possess a minimum standard of efficient PFM system in the interests of convergence and sustainability of the union. At the national level, the objectives of PFM include fiscal discipline, fiscal control, efficient resource allocation, and cost-effective service delivery. The achievement of these objectives can be traced through following related key indicators, such as budget balance, debt stock, public arrears, budget outcomes as compared to budget estimates, expenditure composition, quality-adjusted service deliveries, etc. When a country improves its PFM system, and thereby its capacity to pursue the main objectives, this should lead to improvements and changes in these fiscal indicators over time. However, fiscal developments are related to many different factors and there may be significant time lags between the introduction of institutional changes and subsequent improvements in fiscal indicators.

2.3.4.1.2. The above objectives could be achieved by encouraging countries to formulate their budgetary policies within a comprehensive medium term financial management framework, comprising a set of four separate frameworks: a medium-term macroeconomic framework (MTMEF), a medium-term fiscal framework (MTFF), a medium-term budget framework (MTBF), and a medium-term expenditure framework (MTEF). The formulation of such a financial framework involves various (sequential) steps, as follows:

(i) Formulating a medium-term macroeconomic framework (MTMEF) reflecting the government’s objectives in terms of growth, savings and investment, current account deficit, and external reserves;

(ii) Defining end-period major objectives for public finance management and identifying and quantifying corresponding fiscal indicators and their time path over the medium-term leading to the formulation of the medium-term fiscal framework (MTFF) that should be consistent with, and derived from, the MTMEF;

(iii) Deriving the implications for taxation, expenditure and debt-management policies and formulating the medium-term budget framework (MTBF); and

(iv) Sectoral examination of major expenditure categories leading to the formulation of the medium-term expenditure framework (MTEF), within the overall expenditure ceilings derived from the MTBF, aimed at aligning the expenditure categories to sectoral objectives and improving their cost-effectiveness.

2.3.4.1.3 The medium-term macroeconomic framework quantifies objectives for growth, price inflation, and external reserves. Based on specific country data, the implications of these objectives are then translated, on the basis of existing policies, into consumption, savings and investment, imports, exports, and current account balance. This exercise may involve subsequent simulations under different policy scenarios (and perhaps the growth and price objectives) if the stated objectives turn out to be mutually inconsistent, until a consistent scenario emerges. This exercise may also lead to a re-examination of the assumptions lying behind the growth targets. The resulting macroeconomic framework then forms the basis for developing the other three components, MTFF, MTBF, and MTEF, of the medium-term financial management framework.

2.3.4.1.4. The medium-term fiscal framework incorporates a quantitative statement of the government’s fiscal objectives and policies, comprising revenues and expenditures, and overall financing. It is a means to assure that the targeted path of fiscal aggregates (revenue, expenditure, and public debt) is consistent with the medium-term fiscal viability, macroeconomic stability, and reduced vulnerability to shocks. Fiscal balance is the pri-

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13 R.J. Bhatia, Establishing Multilateral Fiscal Surveillance Framework for COMESA Region (The Experience from Other Regions), Presentation to the joint COMESA/AFDB Workshop, Mauritius 2009.
14 Developing economies are also subject to various exogenous risks mainly connected with weather, terms of trade, and capital flows. Greater fiscal transparency, including a well-specified medium-term fiscal framework, can curtail fiscal risks by reducing asymmetric information, thereby limiting moral hazard and adverse selection. Fiscal vulnerability, however, goes beyond these exogenous shocks. Underlying weaknesses may be present that may at sometime prevent government from achieving its fiscal objectives, and such weaknesses may limit a government’s ability to respond to future fiscal policy challenges, such as external shocks. From a macroeconomic
The primary objective of the MTFF. The focus of this framework has to be the central government budget. The definition of central government should be broad, and include all activities conducted by it and on its behalf. A basic criterion constraining medium-term fiscal targets within MTFF is that they satisfy ex ante liquidity and solvency constraints. The former demands that the government must be able to meet its financial obligations at any time without resorting to debt default or other emergency measures. Thus, the government needs to maintain an adequate level of liquid assets. The second constraint requires that today’s government debt be matched by an excess of future primary surpluses over primary deficits in present value terms, implying that the growth rate of debt cannot be higher than the interest rate.

2.3.4.1.5 By aligning fiscal strategy to the fiscal convergence targets of its regional group and their implementation timetable, such a framework could facilitate a country’s progress towards realizing those criteria and facilitate conducting multilateral fiscal surveillance. It could also help in identifying institutional weaknesses and the needed multi-year institutional reforms and capacity building.

2.3.4.1.6 The MTFF, in turn, is the necessary building block for developing the MTBF and MTEF, which together enable a comprehensive assessment of public revenues and expenditures. The MTBF provides a framework of future revenue accruals and expenditure outlays. It enables a closer look at the taxation and other revenue raising measures and institutions with a view to determining their efficacy and possible areas of improvement. Revenue estimates have to be based on several considerations: GDP growth and its composition by expenditure categories, taxation structure (direct and indirect taxes, and other revenues), tax elasticity and buoyancy, and new policy measures (taxation measures, tax administration, privatization receipts, etc.). Total tax revenues may be estimated on the basis of past-observed relationship between GDP and tax receipts, further checked by estimates of broad categories of tax receipts, as well as the estimated revenues from any new tax measures. Such a framework provides an opportunity to make a comprehensive review of the taxation structure (e.g. between direct and indirect taxes, and the progressivity of the tax system), especially if new taxation measures are required to reach the budget target.

2.3.4.1.7 As concerns expenditures, an efficient financial management system implies that governments have a clear vision as to what is to be achieved, adequately reflecting national development policies and (in the regional integration context) regional strategies, quantifying outcomes, and analyzing costs. While the MTFF gives estimates of the overall expenditure envelope, governments must prioritize expenditure areas and resources to be allocated to those areas within the medium-term framework. The MTEF enables the government to look at the composition of expenditures and examine their performance management (through the introduction of performance objectives and corresponding indicators), their relation to the overall economic and social objectives of the government, and institutions and regulations relating to those expenditures.

2.3.4.1.8 Ideally, a multilateral fiscal surveillance mechanism in the context of regional monetary union should be based on the availability of all the four components of the medium-term financial management system. However, their development requires substantial resources in terms of data availability, data analysis, and human capacity that could only be built over a longer period of time and, in the case of African RECs, with substantial technical assistance from development partner countries and institutions. In pragmatic terms, therefore, the proposed MFSF envisages the development of these four components in stages, linked to the above-identified stages on the roadmap to a monetary union, but according MTMEF and MTFF the higher priority.

2.3.4.2 Public Finance Management System (PFM)

2.3.4.2.1 Budget is the central instrument of macroeconomic policy in African countries where monetization
of the economy is still limited or when sovereignty over monetary policy is devolved to an independent central bank. In the regional contest, fiscal policies and outcomes in member countries have implications for the sustainability of the monetary union. There is a vast theoretical and empirical literature that leads to the conclusion that there is close (positive) relationship between the scope and efficacy of budget institutions (visible face of PFM) and fiscal performance. As such, an effective MFSF should concentrate on ensuring that member countries possess a robust PFM system with a view to interpreting fiscal developments correctly and enforcing convergence process appropriately.

2.3.4.2.2 Budget institutions refer to the structures, formal and informal rules, and procedures governing the various phases of the budgetary process: formation, approval, implementation, and audit. Sound budget institutions are vital for a country’s ability to design and implement effective fiscal policies. Various studies (PEFA, OBI, CABRI initiative on African budget practices and procedures, IMF/World Bank’s CPIA) have been made to measure the quality of budget policies and institutions by identifying specific components related to the different stages of budgetary process and their individual and collective impact on the effectiveness of budgetary policies. From these studies, it is possible to select the more important components, prioritize among them, and design a PFM system adapted to the circumstances of individual countries that would meet the needs of a MFSF in a monetary union. The aim would be to identify institutional gaps in each member country by reference to a minimum (lowest common factor) standard of PFM that must exist in each member country, and corresponding domestic reform measures and technical and other assistance needs that the country concerned and MFSF could address. Based on such studies, a minimum acceptable PFM system in each country (see Table 2-2 below) should encompass the following elements under different stages of the budgetary process:

Table 2-2: Public Finance Management System
(Minimum Desirable Characteristics)

<table>
<thead>
<tr>
<th>Budget formulation and planning:</th>
</tr>
</thead>
<tbody>
<tr>
<td>➔ “Top-down” budgeting and strong centralized agency (usually the ministry of finance) responsible for preparing the budget proposals;</td>
</tr>
<tr>
<td>➔ Comprehensiveness of the budget (current and capital budget, contingent liabilities, aid and debt receipts and expenditures);</td>
</tr>
<tr>
<td>➔ Budget classification system consistent with international standards/</td>
</tr>
<tr>
<td>➔ Fiscal rules limiting discretionary authority of the budget agency;</td>
</tr>
<tr>
<td>➔ Medium-term macroeconomic and fiscal context to guide annual budgeting exercise (Medium-Term Macroeconomic Framework – MTMEF, and Medium-Term Fiscal Framework – MTFF, plus sectoral Medium-Term Expenditure Framework – MTEF);</td>
</tr>
<tr>
<td>➔ Consistency between debt management policies and other macroeconomic policies;</td>
</tr>
<tr>
<td>➔ Inclusion of cyclical and ‘risk’ factors.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Budget approval:</th>
</tr>
</thead>
<tbody>
<tr>
<td>➔ Clear timeline for the submission and approval of annual budget proposals;</td>
</tr>
<tr>
<td>➔ Submission by the Government a comprehensive set of documents supplementing the budget proposals to enable legislature to scrutinize budget proposals;</td>
</tr>
<tr>
<td>➔ Limited powers of legislature to amend the overall revenue or expenditure ceilings proposed by the Government.</td>
</tr>
</tbody>
</table>

2.3.4.2.3 An essential prerequisite of sound PFM is that the budget is comprehensive in the sense that it includes all the financial operations of the Government (or at least of the central government). Thus, both the current and capital budget should be included under one budget, and aid and debt, as well as other off-budget items (including contingent), must be captured in the budget. Such a comprehensive sweep of the budget would facilitate coordinating fiscal policies within a macroeconomic policy framework and enable assessment of the sustainability of fiscal policies over the short- and medium term.

2.3.4.2.4 Under the top-down budgeting arrangement, a central budgeting authority, generally the Ministry of Finance, under the supervision of the Cabinet, is given the authority to set the main budgetary aggregates, ensuring compliance with budget laws and ensuring control of budgetary expenditures. The recommendation favoring the top-down budget formulation is based on the findings of several studies that conclude that such an approach avoids the “deficit bias” in budget formulation arising from the common pool phenomenon and the agency phenomenon and results in better fiscal discipline. “A binding top-down decision on the aggregate spending level and the sectoral or ministerial allocations on the onset of the budget process promote fiscal discipline during budget preparation. This reduces the room for special interest pressures to enlarge the budget envelope.” The arrangement also limits, or precludes, at the budget approval stage any incentive for the legislature to promote spending for their narrow parochial interests. The top-down approach specifies limits on individual ministries level, with sufficient level of disaggregation, to avoid funds being misappropriated or diverted to purposes other than those authorized in the budget.

2.3.4.2.5 Notwithstanding the limit on its power to revise the government’s aggregate budget proposals, the Legislature plays a crucial role in the public finance management system. It is the place where the Government’s proposals are scrutinized and approved. Such a role demands that the legislative body possess adequate technical capacity to analyze and approve the proposals. Discussions on the budget by the legislature are in public domain and, therefore, lend the legitimacy of transparency to the budgetary process. A timely and comprehensive oversight and approval by the legislature also ensures political support for the budgetary policies and appropriations.
2.3.4.2.6 Internal and external audits of government expenditures put appropriate discipline on the spending ministries to respect budgetary limits. A robust system of accounting, based on internationally accepted principles, facilitates monitoring, and enhances the credibility, of government operations. In the MFSF framework, it facilitates regional surveillance and coordination of fiscal policies.

2.3.4.2.7 Transparency in government finances “implies openness about policy intentions, formulation, and implementation” (OECD), providing to public information in a reliable, timely, and understandable manner. Kopitz and Craig define fiscal transparency as openness towards the public at large about government structure and finances, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities. Several studies find that fiscal transparency is associated with improved fiscal discipline, better credit ratings, and reduced corruption. Fiscal transparency is one of the areas that the IMF’s Executive Board endorsed in a list of 12 areas for standard assessment in Reports on Observation of Standards and Codes (ROSCs) for the Code of Good Practices on Fiscal Transparency. M. Hameed (2008) found that two aspects of fiscal transparency, namely fiscal risk disclosure and medium-term budgeting frameworks, were significantly related to market credibility, fiscal discipline, and corruption.

2.4 Current Status of African PFM Systems

2.4.1 Based on a survey of 26 African countries, a CABRI report (2008) provides the following assessment of budgetary practices and procedures in Africa:

- The beginning of annual budget process varies between four and eleven months (the median being eight months) prior to the beginning of the relevant fiscal year;

- A majority of countries follow some form of top-down approach in budget formulation, which may partly be due to the existence of clear fiscal rules stipulated in regional treaties;

- A significant number of countries do not include multi-year estimates in the budget documents submitted to parliaments, while others do it with different levels of detail. Multi-year expenditure targets are much more widespread in both these groups;

- Use of budgeting frameworks in Africa is considered a useful instrument to instill fiscal discipline but their implementation faces obstacles such as weak capacity, unpredictable aid flows, as well as different legal and administrative traditions;

- African legislatures have, on average, inadequate institutional capacity for financial scrutiny, and countries with Westminster heritage tend to have weaker legislative bodies;

- Budget execution and expenditure controls are generally weak in the countries surveyed, as evidenced by the extensive use of supplementary budgets, overspending, and reallocation of expenditures;

- Most countries have made efforts to improve transparency, with the average index of transparency estimated at 0.59 (low 0, high 1). The information provided includes macroeconomic assumptions, budget policies, fiscal policy objectives for the medium-term, etc. Audit reports are also published;

- The coverage of off-budget spending, on average, seems to be better at earlier stages of budget process than during reporting on execution;

2.4.2 The CABRI report concludes as follows: “The results also identify a number of areas where there are significant challenges that African countries are facing. The need to increase transparency and address the issue of budget spending is one area. In many cases, country responses reveal the lack of availability and comprehensiveness of budget information, which in turn can have a severe impact on accountability and ‘challenge function’ in the budget process, but also undermine coherence and coordination in policy-making. Aid management and the quality of medium-term projections are some other areas that deserve some attention…. Finally, issues related to the solidity of budget execution and audit procedures show room for improvement.”

2.5 Two Levels of Fiscal Surveillance – National and Multilateral

2.5.1. The proposal in this report envisages two levels of fiscal surveillance: one at the regional level and other at the national level. The components of the regional mechanism would include: convergence criteria (scope and quantification), regional policy guidelines, financial and technical assistance provisions, monitoring framework for analysis and assessment of the status of economic convergence, and institutional mechanism. As a counterpart to the regional mechanism, the surveillance framework at the national level would include the following components: national ownership of convergence criteria, medium-term convergence program, fiscal rules and benchmark indicators, a fiscal responsibility Act, PFM assessments, and institutional mechanism.

2.5.2 Regional components

2.5.2.1 Convergence criteria

2.5.2.1.1 These criteria are used by existing monetary unions, and RECs aspiring to establish monetary unions, to assess the progress being made by countries towards economic and financial integration, and form the basis of multilateral surveillance of member countries policies in their respective regional arrangements. Given the importance of fiscal policies, a preponderance of these criteria relate to the fiscal area. A survey of such criteria in EMU and African monetary unions and RECs yielded the following list of convergence criteria (“primary” and “secondary”) to be satisfied by member countries:

- **Fiscal convergence criteria**: Budget balance, Public debt, Domestic and external arrears, Public wage bill, Government revenue, Government expenditure, Public investment and Central bank credit to government;

- **Non-fiscal convergence criteria**: Inflation, GDP growth, National savings, Real interest rates, Basel core principles, Current account balance, and stable exchange rate

2.5.2.1.2 Of course, not all the convergence criteria are included in any single regional arrangement, but, generally speaking, fiscal criteria dominate the surveillance framework. However, it is also the case that many arrangements, especially in the African RECs, also include many non-fiscal criteria (either primary or secondary). In selecting appropriate criteria for multilateral surveillance, the primary objectives of such surveillance must be borne in mind, i.e. ensuring the stability and sustainability of the union, and maintaining fiscal sustainability and intra-union competitiveness of individual member countries. All other objectives, such as the growth rate, national savings rate, or even current account balance of member countries should be left to the discretion of national authorities to pursue in the context of their national development programs via the mechanism of national fiscal rules. This approach will limit the number of convergence criteria to be monitored at the regional level and focus them on the above-mentioned two objectives. It will also permit choosing criteria that are transparent and easy to control and monitor, the other desirable features mentioned earlier.

2.5.2.2 Fiscal policy objectives and fiscal indicators:

2.5.2.2.1 Mr. Iossifov and his co-authors\(^\text{19}\) note that a government’s fiscal policy reflects a mix of objectives, which are affected differently by fiscal policy. Thus, to assess the impact of fiscal policy, a range of fiscal indicators are needed. Referring to Blanchard (1990), they indicate several aspects of fiscal policy for which indicators would be useful:

- **Policy changes**: To account for changes in the fiscal position (spending, taxes, transfers) due to discretionary changes in policy, rather than due to the economic environment.

- **Sustainability**: To assess whether the current fiscal position can be sustained without exploding public debt.

- **Impact on aggregate demand**: To determine how the fiscal position would affect aggregate demand in the short and medium term, i.e. in other words, to assess whether fiscal policy is acting as catalyst or restraint on domestic saving and investment.

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2.5.2.2.2 Given these different aspects of fiscal policy, they propose a few guiding principles for selecting appropriate indicators:

- simplest formulation as possible consistent with the measurement objective, which would facilitate their calculation and interpretation;
- positive rather than normative economic principles, leaving it to the user to make judgments about the broader economic environment in a particular country;
- similar definitions and concepts when used for cross-country comparisons; and
- as few projections as feasible.

2.5.2.2.3 Which convergence criteria will best serve those objectives? A recent IMF (Fiscal Affairs Department) paper\(^\text{20}\) examined how different rules comply with the objective of promoting fiscal sustainability, and provides the following observations:

**i. Overall budget balance (BB)** is obviously the one figure that summarizes the overall fiscal position of the government and may be considered an appropriate criterion to choose for fiscal surveillance. It is also most closely linked to the debt ratio, is easy to monitor, and is within the control of the budgetary authority, except for interest payments, external grants, and (export) commodity related revenues. However, it lacks cyclical flexibility and could constrain much needed public investment in infrastructure for meeting poverty-reduction outlays. Accordingly, various variants of budget balance have been proposed; e.g. primary balance (excludes interest payments thereby providing more controllability, but weakens the link to debt sustainability since increased interest payments, say due to increase in interest rates, will increase overall budget deficit and debt burden but will not require adjustment), BB excluding foreign grants (but then what about expenditures financed by those grants), BB excluding foreign grants and foreign financed investment (same problem as in BB excluding grants and will not capture the overall stance- expansionary or deflationary-of fiscal policy needed for fiscal surveillance), non-commodity balance (exclude revenue from commodity, including oil, exports (but thereby limits the scope of fiscal surveillance and may lead to undisciplined overall fiscal behavior in times of commodity booms).

The explicit exclusion of certain budget items, either on the revenue side or the expenditure side, raises various conceptual and analytical issues that may go against the principle of simplicity, easy understandability, and transparency. Moreover, except in the case of oil exporting countries, cyclical variations in revenues for African countries are generally relatively small and should be manageable with appropriate fiscal rules (e.g. a reserve fund) at the national level. “Policy guidelines” that are proposed (see below) to be issued at the regional level to guide national fiscal policies can also make a similar recommendation for relevant countries to follow. The justification for excluding grants or foreign-financed expenditures from BB is much less as these receipts have counterpart expenditure and, therefore, almost automatically stabilize overall balance. Thus, the convergence criterion relating to budget balance should be comprehensive, including all government revenues and expenditures. This will also make it possible to relate government budgetary proposals directly with the medium-term macroeconomic framework, with its component frameworks referred to above.

**ii. Debt rules** set an explicit limit or target for public debt. The convergence of the debt-to-GDP ratio is generally considered the appropriate criterion for fiscal solvency because it ensures that the inter-temporal budget constraint of the government is met (if the interest rate on public debt exceeds the GDP growth rate) and, in any case, because GDP represents the pool of resources over which the government can potentially have claims to service the debt. This type of rule, when expressed as a percentage of GDP, is, by definition, regarded as the most effective in terms of ensuring convergence to a debt target. However, it does not provide sufficient guidance for fiscal policy when debt is well below its ceiling (as is the case with most African countries that have benefitted from the HIPCs and other debt relief

initiatives). Just as the BB does not provide sufficient guideline for debt management policy, the debt ratio does not provide guideline for fiscal policy.

African countries have benefitted from the HIPC initiative of the IMF and the World Bank, and debt sustainability will remain a major concern in those countries, as well as for the monetary union. Generally, debt ratios are quantified in relation to GDP. However, it may be more useful if in the case of African RECs the debt ratio is related to government revenue. This should be the case for many reasons: (i) unlike in developed countries, a government’s ability to raise tax revenues in Africa is rather limited and increases in GDP do not necessarily translate themselves in increased government revenues even when (efficient) tax efforts are made; (ii) projections of tax revenues are generally less unreliable than those of GDP; (iii) government revenues are a more immediate indicator of the government’s ability to service debt than GDP and, therefore, may be a better criterion for purposes of multilateral surveillance; and more importantly (iv) unlike as the GDP ratio it will provide sufficient guideline for debt management even for countries that received debt relief.

The latest IMF/World Bank analysis of debt sustainability uses policy-dependent external debt-burden thresholds because the debt levels that Low Income Countries (LICs) can sustain are influenced by the quality of their policies and institutions. These debt-burden thresholds are not to be seen as rigid ceilings but as guideposts for informing debt sustainability assessments. Policy performance is measured by the Country Policy and Institutional Assessment (CPIA) index, compiled annually and jointly by the World Bank and the IMF. The DSF divides countries into three performance categories: strong, medium, and poor. Their respective external debt burden thresholds are then (for 2008) 30, 40, and 50% of GDP, or 200, 250, and 300 of government revenue. These threshold ratios do not include domestic public debt, which must be included in the debt ratio convergence criterion for purposes of MFSF. As a proportion of government revenue, therefore, the thresholds for overall debt will be smaller than the above limits, particularly if domestic debt is significant and rising. There is also some evidence that rising domestic debt increases the likelihood of external debt distress, and therefore should reduce the external debt threshold also.

iii. Expenditure rules usually set permanent limits on total, primary, or current spending in absolute terms, growth rates, or in percentage of GDP. As such, these rules are not linked directly to the debt sustainability objective since they do not constrain the revenue side. Similarly, revenue rules set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing a tax burden. These rules are also not directly linked to the control of public debt, as they do not constrain spending. Hence, these rules are not relevant to multilateral fiscal surveillance mechanism. They can provide, however, an operational fiscal rule tool at the national level to trigger the required fiscal consolidation consistent with sustainability when they are in the context of regional debt and budget balance convergence criteria.

Fiscal rules/convergence criteria have different implications for the way fiscal policy responds to shocks. With regard to output shocks, overall balance or debt rules typically provide the lowest degree of cyclical flexibility. A cyclically adjusted or structural balance rule allows the full operation of automatic stabilizers, though it does not provide room for discretionary fiscal stimulus.

iv. A cyclically adjusted balance captures the change in fiscal policy not related to the effects of the economic cycle on the budget. The structural balance, in addition, controls for additional one-off factors and other non-discretionary changes in the budget unrelated to the cycle. While these rules specify an annual target, an “over-the-cycle” rule requires the attainment of a nominal budget balance on average over the cycle.

Rules defined “over the cycle” provide room for both discretionary and cyclical adjustments. Expenditure rules are consistent with cyclical and discretionary reductions in tax revenues, but they do not normally permit discretionary expenditure stimulus. Revenue rules do not generally account for the operation of automatic stabilizers on the revenue side in a downturn (or in an upturn for revenue ceilings). As automatic stabilizers are stronger on the revenue side, these rules per se tend to result in pro-cyclical fiscal policy. In addition to output shocks, budgets can be significantly affected by interest rate and exchange rate movements through changes in debt service; primary balance rules do not require full adjustment to them. Table 2-3 below summarizes the effects of various indicators:
Table 2-3: Properties of Different Types of Fiscal Rules Against Key Objectives 1/

<table>
<thead>
<tr>
<th>Type of fiscal rule</th>
<th>Debt sustainability</th>
<th>Economic stabilization</th>
<th>Government size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall balance</td>
<td>++</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Primary balance</td>
<td>+</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Cyclically adjusted balance</td>
<td>++</td>
<td>++</td>
<td>0</td>
</tr>
<tr>
<td>Balanced budget over the cycle</td>
<td>+++</td>
<td>+++</td>
<td>0</td>
</tr>
<tr>
<td>Public debt-to-GDP ratio</td>
<td>+++</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure</td>
<td>+</td>
<td>++</td>
<td>++</td>
</tr>
<tr>
<td>Revenue</td>
<td>-</td>
<td>-</td>
<td>++</td>
</tr>
<tr>
<td>Revenue ceilings</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Revenue floors</td>
<td>+</td>
<td>++</td>
<td>-</td>
</tr>
<tr>
<td>Limits on revenue windfalls</td>
<td>+</td>
<td>++</td>
<td>++</td>
</tr>
</tbody>
</table>

1/ Positive signs (+) indicate stronger property, negative signs (-) indicate weaker property, zeros (0) indicate neutral property with regard to objective.

Source: IMF (FAD) Fiscal Rules – Anchoring Expectations for Sustainable Public Finances, December 2009

2.6. Technical and financial assistance

2.6.1 Moving into a monetary union has both costs and benefits. In the case of EMU, and even in the cases of single currency and single central bank in the two CFA zones prior to the setting up of formal WAEMU and CEMAC, benefits from the monetary union were both immediate and apparent, while the potential costs were distant and invisible. Countries joining the EMU foresaw immediate benefits in terms of reduced costs of public borrowing by virtue of the German DM as the anchor (in the period of run-up to the EMU), and in reduced interest costs on public borrowing due to the implicit link to the German Bund, and increased credibility and sustainability of macroeconomic policies of the union. The CFA zone countries benefited from the French guarantee of the convertibility of the CFAF and the existence of the Operations Account with the French Treasury, as well as other development assistance from France. In the proposed regional monetary unions among members of African RECs, on the other hand, possible benefits from monetary union are likely to be distant and invisible while the costs are immediate and apparent. This is mainly because among them there is no available “anchor” country or anchor currency to link to, or explicit and unlimited support of a major country, from which other countries joining the proposed monetary union could reap similar benefits. At the same time, costs from the loss of sovereignty in monetary and exchange policies, and pursuing restrained fiscal policies and opening markets to potential competitors in the region and losing fiscal revenues from import duties, are immediate and evident. In addition, countries would need resources for needed improvements and strengthening of national PFM systems (domestic capacity), and intra-regional infrastructure investments. The transition framework towards the monetary union should therefore be so designed as to make available some immediate benefits accruing to potential member countries to offset, or at least to minimize, the costs of integration and meet investment and capacity building requirements.

2.6.2 Such assistance should be a prominent feature of the regional surveillance mechanism. To help meet these costs, RECs may consider the setting up of two regional funds: an Adjustment Fund, and an Intra-regional Infrastructure and Integration Fund. The Adjustment Fund will address the social costs of integration and technical assistance requirements in the PFM and legal sectors in member countries, while the Infrastructure Fund will support the development of cross-border projects such as the transport and economic corridors, and economic zones and growth triangles. The former
fund should provide “grant” assistance while the latter may operate on commercial basis and seek private and public resources, including resources from development partners and institutions. The timing of these two funds should be spread out, with the Adjustment Fund being set up and becoming active during the formation of FTAs and CUs, and the Infrastructure Fund after a substantial number of potential member countries have effectively entered the FTA and the Customs Union is planned to be launched.

2.7 The Monitoring Mechanism

2.7.1. Institutional

2.7.1.1 It is generally recognized that the proper functioning of a monetary union requires a well-developed system of fiscal surveillance. In the case of EU and EMU, for example, a comprehensive system of coordination procedures has been defined and is used as an umbrella term. It encompasses an entire spectrum of interactions among policy actors, including monetary and fiscal actors and the European Commission as representative of the common interest.21 The range of methods used includes, among others, the EU-ECOFIN Council’s annual issues of the Broad Economic Policy Guidelines (BEPGs) that present, in an integrated manner, broad recommendations for policy actors on macroeconomic and structural policies and provide a yardstick for ex-post assessment in the context of multilateral surveillance. “Overall, and in very broad terms, the more obvious and direct spillovers are, the more compelling the case for relatively strong forms of co-ordination. Thus, the degree and the mechanisms for co-ordination differ according to how convincing the economic rationale for co-ordination is in the particular policy area.”22 In the case of the EMU where the degree of interdependence is significantly intense, therefore, the mechanism is designed as a “firewall” system to prevent unpleasant spillovers by preventing un-union wide policies at national levels (see Chapter 3 for details).

2.7.1.2 In the Asian region, where the financial crisis of mid-1990s highlighted the region’s (especially the ASEAN region’s) growing interdependence, the symmetry of external shocks, and regional contagion, take the form of (1) information exchange and surveillance procedures establish independent surveillance units, (2) resource pooling and sharing, and (3) coordination of macroeconomic and exchange rate policies23 (see Chapter 3 for details). The cooperation has evolved in an “ascending form of intensity”, involving progressively increasing constraints and surveillance, on the amount of discretion that individual countries can exercise in the design of their macroeconomic policies. The ASEAN experience so far has not included resort to convergence criteria for enhancing cooperation/integration, though this may change as the region moves towards establishing an economic community.

2.7.1.3 The present surveillance frameworks in African RECs have more or less replicated the EMU model (see Chapter 3). It should be noted, however, that in the case of African RECs, the current degree of interdependence is minimal and the spillover effects of national policies on other members are likely to be below a significant level. The regional monitoring, therefore, does not have to create a fire-wall, and instead needs to promote that interdependence through harmonization of member countries’ policies, strengthening their capacities to formulate and implement appropriate policies, and furthering real economic (trade) and financial integration of their economies. In that sense, the multilateral “surveillance” framework in the African situation should correspond more to the Asian cooperative mechanism than the EMU framework. However, unlike in Asia, the African RECs have set up the establishment of monetary union as a specific objective and thus, like in the EMU, should provide for monitoring and enforcement mechanism to promote appropriate convergence in fiscal and other relevant domains. In this latter aspect, the EMU surveillance mechanism for the entry of new members is relevant, except that in the EMU case, individual countries aspiring to enter the EMU had to negotiate bilaterally with an already established monetary union under established (“aqui”) policies and procedures; whereas in the case of the African RECs, there has to be a cooperative approach where potential member countries attempt to cooperate to reach the goal of establishing monetary union under

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21 Coordination of economic policies in the EU: A presentation of key features of the main procedures by Directorate-General for Economic and Financial Affairs, Euro Papers, No. 45, July 2002.
22 Ibid. However, it may be noted that the term employed is “coordination” and not “surveillance”.
23 P. Rana, Monetary and Financial Cooperation in East Asia and Economic Integration in Asia: Trends and Policies.
only one set of “conditions” in the form of fulfilling the convergence criteria.

2.7.1.4 The above consideration would suggest that the multilateral surveillance framework in the case of African RECs should be an amalgam of the EMU and Asian frameworks. The “firewall” aspect will be represented by the prescription of binding convergence criteria, especially in the fiscal field, and the issuance of non-binding policy guidelines, while the cooperative aspect would be served by replicating Asian type of cooperation in the form of information exchange and integration-related severity of surveillance, coordination of macroeconomic, exchange, and trade policies, and sharing a common pool for financial and technical resources, fed by internal and external resources, for mutual support to prepare for entry into an eventual monetary union.

2.7.1.5 The initial focus of multilateral fiscal surveillance would therefore be much more on assistance-oriented cooperation and coordination through the prescription of (nationally designed) medium-term benchmarks and indicators consistent in terms of targets of the agreed regional convergence criteria but in different time periods reflecting individual country circumstances, and operationalizing the above-mentioned funds. The focus would gradually shift to increasing degree of surveillance, as in the Asian case, demanding specific policy implementation by member countries underpinned by a system of inducements and sanctions, appropriate to the degree of interdependence achieved among member countries.

2.7.1.6 The institutional structure for implementing MFSF at the regional levels should be simple, consisting of as few bodies as possible, with clearly defined functions that are not overlapping among different bodies but in totality encompassing all the tasks that need to be accomplished to ensure effective surveillance. In the case of African RECs in their transition to a monetary union, the institutional structure should also reflect the promotional, policeman, and crisis management aspects of multilateral surveillance. As an optimal minimum, the institutional structure should include the Authority of Heads of State and Government, Regional Secretariat, a Convergence Council (Ministerial), Committees of Ministers of Finance, of Governors of Central Banks, and of Ministers of Trade, a Central Statistical Secretariat, and financial/technical assistance bodies to support member states in the realization of their respective national convergence programs. Consideration should also be given to inviting the IMF, the World Bank, and the African Development Bank to take a pro-active role in both the financing of technical and financial assistance funds in the region, and in the multilateral surveillance exercises.

2.7.2 Statistics

Effective fiscal surveillance cannot be exercised in the absence of appropriate union-wide fiscal statistics. It will be necessary, therefore, that statistical preparations for developing and collecting fiscal data is undertaken simultaneously with the launching of the MFSF. This function could be currently assigned to the REC Secretariat concerned that may set up a special Fiscal Unit (see Chapter 5). This would involve not only the strengthening and appropriately equipping the responsible body, but also taking similar actions at the national statistical agency level as well as cooperation and coordination among them. Further, there needs to be a clear allocation of tasks to avoid wasted effort and unnecessary burden on reporting agencies. Given the limited human capacity both at the regional and national levels, statistical compilation should initially be confined to provide only what may be considered to be the bare minimum for effective fiscal surveillance. Fortunately, the IMF has an extensive set of publications and a statistical data framework that could be used to quickly bring about fiscal data harmonization and reporting.

2.7.3 National components of MFSF

2.7.3.1 The primary emphasis of MFSF during the transitional phase towards a monetary union has to be on securing ownership by member countries of the objective of joining the monetary union and of the obligation to meet the regionally prescribed convergence criteria, and ensuring that countries accordingly follow policies to meet those obligations. This requires actions along three lines: transparency and public discussions of the goal of the monetary union and obligations involved, a Medium-Term Fiscal Framework, and a robust public finance management (PFM) system.

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2.7.3.2 African governments have the tendency to enter into various cooperative arrangements that are often overlapping and, sometime, contradictory. The current issue of multiple REC membership by individual countries is a case in point. As a result, there is little follow up on many of those agreements. It is important, therefore, to ensure that any agreed MFSF, consistent with the present objective of monetary union, does not meet that fate and that the Framework is fully owned, not only by the political leaders, but by the countries’ parliaments and legislatures, as well as by the civil society and other stakeholders. In the interests of transparency and promoting public discussion, therefore, the governments could communicate to their respective parliaments/legislatures the agreed set of convergence criteria for discussions and approval, and also provide opportunities for discussion by the civil society. Additionally, a small task force in the Ministry of Finance should be charged to “educate” appropriate parts of civil service that would be engaged in implementing the required policies.

2.7.3.3 Convergence criteria agreed at the regional level are supposed to ensure the sustainability of the union as a single area, and not necessarily that of individual member countries who are expected to be responsible for ensuring their own sustainability and meeting their other economic and social goals within the constraints of single union-wide monetary and exchange rate policies. Similarly, the regional time-line for fulfilling the convergence criteria may not be optimal from a country’s point of view. This makes it necessary that individual countries set their own fiscal rules and time-path for meeting the regional criteria, and enter into the monetary union when they are ready. These rules and time-path should be reflected in the countries’ Medium-Term Fiscal Framework, which would constitute the country’s (rolling) convergence program for joining the monetary union.

2.7.3.4. Following the “variable geometry” and “variable speed” approach to membership does not mean that the relevant RECs adopt a “benign neglect” attitude towards those members convergence programs. Instead, all members should be required to submit annually their programs, and developments under those programs, for assessment (compliance/consistency) under the MFS mechanism. The assessment procedures could be similar to those adopted by EMU to prepare Candidate Countries and potential Candidate Countries for their reporting obligations, called the Pre-accession Fiscal Surveillance Procedure that includes the Pre-Accession Economic Program (see Chapter 3 for details). This system could be adapted to the circumstances and requirements of African RECs, and include, for example an assessment of capacity and other gaps and make recommendations as to how those gaps could be filled. Furthermore, this assessment should also include progress being made by each country in the trade integration area as discussed in this report elsewhere.

2.7.3.5 The convergence programs of member countries will be bound by the commitments regarding the convergence criteria. In the fiscal field, these criteria will demand limits on the extent of the budget deficit and on public debt. As mentioned earlier, these national limits (fiscal rules), however, need to be more stringent than the regional criteria in order to leave the countries some fiscal space to meet cyclical and other unanticipated shocks/risks. The national limits will normally be expressed in the form of fiscal rules to be observed by the government in proposing and getting parliamentary approval of the budget estimates.

2.7.3.6 As mentioned earlier, fiscal rules are most effective once a country has achieved a reasonable degree of macroeconomic stability, and need to have a medium- to long-term longevity. The IMF experience with stabilization programs has demonstrated the effectiveness of annual specific credit criteria, such as limits on the increase in net domestic assets (NDA) of the banking system, and net credit to government, as effective performance criteria during the period when countries are implementing a stabilization program. Once stabilization is achieved, the use of fiscal rules to maintain fiscal sustainability becomes the desirable fiscal policy tool. In the case of Tanzania, for example, Kim and Saito recommend that Tanzania replace its long-standing zero net domestic financing (NDF) guide by a set of “diamond” fiscal rules comprising a fiscal anchor (PV of gross public debt) and three complementary benchmarks: (i) a limit on net domestic...
financing in a single year, (ii) a limit on non-concessional external borrowing; and (iii) a limit on the change in the ratio of spending to GDP. They point out that there is increasing need for Tanzania to consider shifting from annual NDF targeting to a rule-based medium-term fiscal policy framework (MTFPF). An MTFPF could (i) provide more flexibility for countercyclical policy; (ii) help define the fiscal space available for more infrastructure spending; and (iii) facilitate regional convergence and economic integration (e.g., the EAC monetary union). In practice fiscal policy is anchored on a variety of budgetary anchors, the more typical ones being the budget balance, and debt ratios. Any complementary rules or indicators should be instituted in the light of specific country requirements and objectives (such as poverty reduction which may necessitate an expenditure rule, or growth which may require a public investment rule, ratio of non-discretionary spending to indicate the degree of flexibility in budget formulation).

2.7.3.7 The crucial importance of an effective PFM system, and its minimum desirable features, for conducting fiscal policies were emphasized in the earlier section. In that context, it is important that the Ministry of finance has a strong macroeconomic pillar to produce macroeconomic projections, and a strong budget pillar to generate and guide the budgetary cycle. In addition, the parliament should possess the capacity to assess budget proposals of the government for which it should have an independent Budget Office, and a strong Finance Committee of MPs as a gatekeeper. A strong and independent audit office, as well as effective procedures for internal audit at line ministries level, will round up an effective PFM set up. In the course of developing and implementing the PFM, the authorities would also be able to identify institutional and other weaknesses, which could be addressed in the regional context of multilateral surveillance. Identifying institutional weaknesses and providing technical assistance to address those weaknesses will enable countries to develop, in due course, the other two components (MTBF, and MTEF) of the medium-term financial framework to further improve PFM that could underpin a robust MFSF.

2.7.3.8. Several governments, both in developed and emerging market countries have adopted formal medium-term fiscal frameworks to guide fiscal management and adopted fiscal responsibility acts to enforce PFM systems. New Zealand and Australia were among the first countries to reform their PFM, with New Zealand enacting the Fiscal Responsibility Act in 1994 that expounded five principles (relating to debt, fiscal balance, government’s net worth, fiscal risks, and predictability and stability of tax revenues) of responsible fiscal management that Governments are required to follow and publicly assess their fiscal policies against those principles. Should the Government depart from these principles, the Minister of Finance has to specify reasons for departure, the approach to be taken to return to the principles and the period of time this is expected to take.

2.7.3.9. The IMF, the World Bank and other development partners have also helped developing countries, including many in Africa, in devising PFM frameworks to enable them to reform their public finance management. Many among them, including countries like India, Brazil, and Nigeria have enshrined these systems in the equivalent of fiscal responsibility acts to enforce their effectiveness. Table 2-4 summarizes the main features of Brazil’s budget law as an illustration of these practices:

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<tr>
<th>Table 2-4: Main features of Brazil’s fiscal responsibility law (FRL)</th>
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<tr>
<td>The FRL is a comprehensive law, whose features include:</td>
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<tr>
<td>➤ Detailed provisions for budget preparation and execution.</td>
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<td>➤ Numerical limits for some fiscal indicators (e.g., the ratio of net public debt to net revenues; and the ratio of personnel expenditures to net revenues).</td>
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<td>➤ Provisions to restrict expenditure commitments in the final year of government.</td>
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<td>➤ Limits on the borrowing activities of sub-national governments.</td>
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<tr>
<td>➤ Transparent fiscal reporting. The government must present: multiyear fiscal targets; targets for the primary balance and public debt for the following three fiscal years; a description of fiscal risks with an assessment of contingent fiscal liabilities.</td>
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<tr>
<td>➤ Strong sanctions for non-compliance (the FRL is accompanied by a Fiscal Crimes Law).</td>
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Source: Lienert and Israel (2010)
2.7.3.10 A recent publication by the IMF (FAD) staff from which the above Brazilian illustration is reproduced, provides an excellent review of current practices relating to Budget System Laws (BSL) and recommendations on how those laws may be formulated. The following paragraphs reproduce some relevant observations and recommendations:

A BSL is “the formal expression of rules that govern budgetary decisions made by the legislature and the executive. The objectives of the formal rules are to specify what budgetary processes are prescribed in law, who is responsible, and when key budgetary steps should be taken. The BSL should be a tool that enables the authorities to achieve their desired policy objectives.”

“In particular, the BSL should provide the framework for achieving five aims of a well-functioning public financial management (PFM) system: (i) attaining short-term macro fiscal stability and medium-term fiscal sustainability; (ii) enhancing the allocation of budgetary resources; (iii) improving the efficiency of spending; (iv) ensuring that cash is managed optimally; and (v) improving the quality of budget information presented to parliament and the public.”

“A diagnostic review of a country’s budget system, its fiscal institutions, and decision-making processes may be a necessary first step before changes to the BSL can be proposed to address specific issues of the PFM system. Each country’s specific institutional, legal, and cultural features need to be considered prior to drafting amendments to an existing BSL or preparing a new BSL to cover specific aspects of budget processes.”

2.7.3.11 On the basis of their survey of BSL practices in various countries, Lienert and Fainboim have listed the principles shown in Table 2-5 that could guide the reform of domestic BSL.

### Table 2-5: Sound Principles for a Budget System Law (BSL)

<table>
<thead>
<tr>
<th>Overarching Principle</th>
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<tr>
<td>1. Authoritativeness: Decision-making authority is specified clearly in the BSL. The executive prepares a draft annual budget law and supporting documents such as a fiscal policy strategy paper and a medium-term macro-fiscal framework; the legislature approves the annual budget, possibly after amendments; no expenditure can be made without approval of the legislature; the executive implements the annual budget and provides reports on implementation. It also has the authority to close and open public bank accounts. The authority to modify the approved budget law is specified in the BSL.</td>
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<th>Classical Principles</th>
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<tr>
<td>2. Annual basis: Budget authority is for a 12-month period. Exceptions are specified in the BSL, including multiyear appropriations and end-year carryovers. The annual budget law is enacted prior to the year to which it refers. All transactions are estimated for their one-year effect.</td>
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<th>Comprehensiveness:</th>
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<td>3. The “universe” (e.g., central government) is specified clearly. All revenues and expenditures are included in the budget on a gross basis. Expenditures are not offset by revenues: the BSL specifies any exceptions. Extra budgetary funds are minimal, being established by law. Contingency funds are included in the budget law. Tax expenditures and quasi-fiscal activities are reported.</td>
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<th>Unity:</th>
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<td>4. The budget presents, and the legislature approves, all receipts and payments in the same annual budget law. For expenditures, there is no “dual” budget system that splits current and development (or capital) transactions (this is best implemented if there is also unity of budget administration – one central budget authority). For revenues, there is an option between (i) approving all new revenue measures in the annual budget law or (ii) approving revenue measures only in laws other than the annual appropriations laws (the principle of exclusivity, which may be included in the BSL).</td>
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<tr>
<th>Specificity:</th>
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<tr>
<td>5. Common pooling (or fungibility) of revenues: All resources are channelled into one common fund.</td>
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<th>Specificity:</th>
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<tr>
<td>6. Revenues and expenditures are approved with some detail in the budget estimates. Authorized spending is intended for particular purposes (inputs or programs/outputs).</td>
</tr>
</tbody>
</table>

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I. Lienert and I. Fainboim, Reforming Budget System Laws, 2010
Balance:

7. Budget payments are balanced by receipts (accounting balance, cash basis). Budget expenses are balanced by budget revenues and financing (accrual basis). “Balance” is well defined and may be subject to legal limitations.

Modern Principles

Accountability:

8. The executive must account to the legislature for how it has met its responsibilities at least twice a year. An independent external audit body reports at least annually to the legislature on budget execution and annual government accounts. Within the executive, the accountability of budget managers is clearly defined.

Transparency:

9. The roles of public bodies are clear. Timely and regular financial and nonfinancial information on the budget is publicly available. The terms used in the BSL are clearly defined.

Stability:

10. Short-term policy stability: anchoring commitments to achieve targets for revenues, total expenditures, fiscal balance or public debt, specified in the context of a regularly updated medium-term budget framework. Medium-term fiscal sustainability is also another important aspect of stability.

Performance:

11. The expected and recent past results (outputs and/or outcomes) of budget programs are reported in the budget document.

2.7.3.12 Many countries in Southern and Eastern Europe have utilized BSL frameworks to meet relevant criteria for accession to EMU. Their experience suggests that African countries aiming to form monetary union and ensuring appropriate PFM systems could follow a similar pattern: strengthening their PFM systems and underpinning their effectiveness and enhancing their ownership by reforming existing, or enacting new, Budget System Laws.

2.8 Trade issues

2.8.1 The generic institutional structure for surveillance suggested above included the establishment of a Committee of Trade Ministers that should follow and encourage trade integration as an integral part of MFSF. This inclusion follows from the findings, referred to in the earlier part of this report, that member countries’ incentive for implementing fiscal convergence criteria is directly related to the degree of trade integration within the region. Almost all African countries are now members of one or more FTAs, but in almost all these cases results in terms of either increased intraregional trade or increased investment and competitiveness have been disappointing. It is necessary, therefore, to embed the trade agenda in the fiscal surveillance framework with the view to operationalizing it with the same urgency as the fiscal convergence agenda proposed above. The immediate objective of this approach would be to remove barriers and facilitate intra-regional trade, and to improve the business climate in each REC to encourage domestic investment and FDI flows and improve competitiveness. Parallel with the MFSF, it is proposed that the RECs aiming to form a monetary union should also introduce a regional surveillance framework for trade integration based on regional benchmarks to be achieved by member countries through the development and implementation of national programs for regional trade integration, incorporating those benchmarks. As with the fiscal program, the trade program would also be implemented at variable speeds in different countries depending upon their individual circumstances and timetable for joining the monetary union.

2.8.2 The Multilateral Trade Surveillance Framework (MTSF) should aim at (1) improving intra-regional connectivity through trade and transport development; (ii) improving business environment in member countries; and (iii) improving global competitiveness of member countries. To that effect, regional efforts would be directed at coordinated improvement of transport infrastructure and trade facilitation, including harmonized cross-border regulations, procedures, and standards to reduce transport costs and time for transiting goods and people. The experience in the development and implementation of the Transport and Trade Development Strategy of the CAREC region in Central Asia may be a good example to follow here. The transport development part of the strategy aims at reforming three pillars: infrastructure, management, and technology. Trade facilitation refers to “the simplification and harmonization of international trade procedures, including the activities, practices, and formalities involved in collecting, presenting, communicating, and processing data and other information required in the movement of goods in international trade” (WTO). The main objective of trade facilitation is to reduce transaction costs and time by improving administrative
efficiency and simplifying, standardizing and harmonizing trade procedures. Some of the measures that CAREC has expounded include improving border cross points (infrastructure upgrades and modernization of border cross points), and a single window to file declarations and manifests.

2.8.3 Trade integration efforts could also go beyond just the transport and trade facilitation policies and include the development of **Special Economic Zones** in individual member countries (the Chinese experience), and **Growth Triangles** (such as the Greater Mekong Sub-region Asian Development Bank-supported project) that aim at developing adjacent regions across borders of two or more countries. These projects involve applying immediately the trade and investment liberalization practices that characterize common markets, and administrative autonomy from the member countries’ central administration.

2.8.4 The MTSF would involve setting up regional policies and goals in transport development (e.g. transport corridors) and trade facilitation (e.g. identification and removal of non-tariff barriers) and ask member countries to formulate and implement medium-term programs to improve business environment and national productivity and competitiveness. The latter programs could be linked to the regional trade integration index (see Chapter 4 below), World Bank’s Index of Doing Business, and the joint World Economic Forum and World Bank Global Competitive Index to assess their progress. The national programs would aim at specified improvement in their respective standing in these indices over a time period of a country’s own choosing depending upon its circumstances and willingness to undertake the necessary reforms. These indices would form the basis of multilateral surveillance (in conjunction with MFSF), and help address the coordination problem at the regional level and accelerate regional integration if embedded with the monetary union agenda. The overall program could be supported, financially and technically, by the resources of the above-proposed regional integration fund, supplemented by loan and grant resources from the development partners (e.g. aid for trade funds), and participation of the private sector.