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## **GHANA'S IMF PROGRAM - THE RISK OF FISCAL CONSOLIDATION TO UNCERTAIN PETROLEUM REVENUE AND WEAK FISCAL RULES**

### **Commentary**

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#### **Introduction**

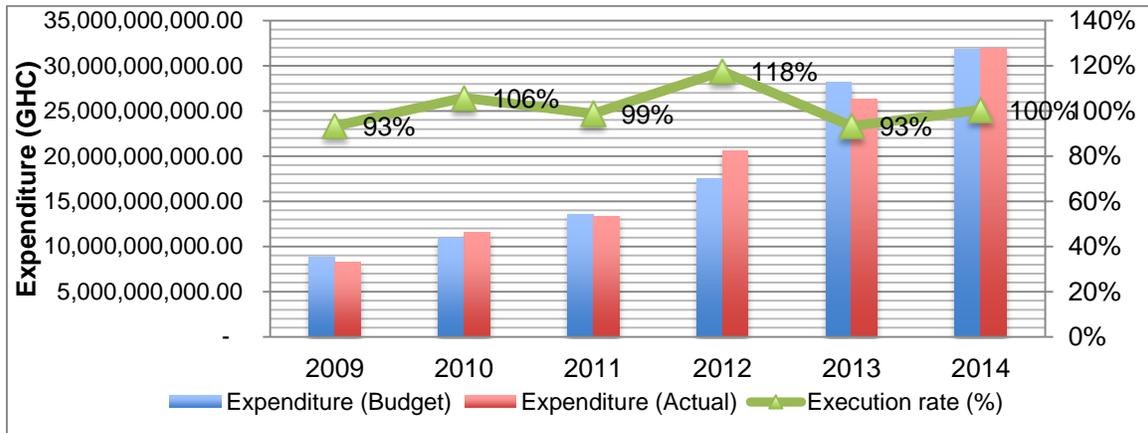
Following macroeconomic challenges resulting from poor fiscal and monetary policy management and their associated effects of large deficits, inflation, higher interest rates, depreciation of the local currency and low economic growth; the Government of Ghana requested a three-year arrangement under the Extended Credit Facility (ECF) covering the period of 2015–17, in an amount of SDR 664.20 million (180 percent of Ghana's quota) to support its new economic reform program. This translates to US\$918 million. The IMF has approved the request and has already started disbursing money to the government. Currently on a mission to Ghana, IMF staff are evaluating Ghana's economic performance and to establish the extent to which the government is complying with the terms of the Facility.

In this commentary, Ghana's poor fiscal management record of the recent past has been examined, the relevance of the IMF program for regaining lost fiscal credibility; and the attainment and sustainability of fiscal consolidation in the face of administrative measures rather than legally binding fiscal and debt rules.

#### **Challenges of Fiscal Management in Ghana**

Ghana over the years has demonstrated higher capacity to spend as reflected in the higher rates of budget execution (See Figure 1 below); implying better levels of absorptive capacity. This also implies on the face value that increasing public spending would have positive impact on the capital base of the economy. But as it is already well known, the bulk of the annual budget is committed to compensation for employees, goods and services, interest payments; with an insignificant proportion for capital spending.

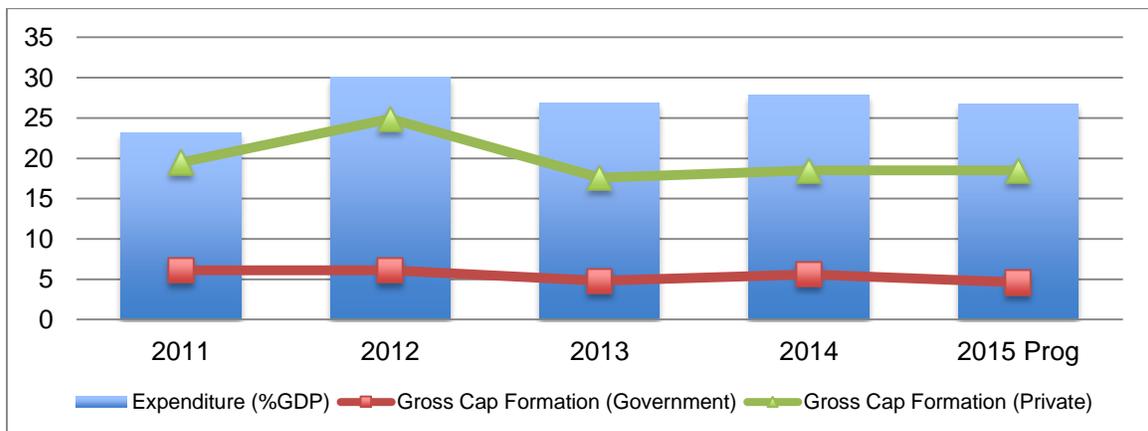
Figure 1: Budget Execution Rate is very high



Source: MOFEP – Fiscal Data

Therefore, higher budget execution rates may not necessarily lead to efficient spending. Efficiency in spending implies that increased spending should lead to equivalent increase or more in capital. This does not appear to be so in Ghana. In spite of the growth in spending over the last few years, gross capital formation has not increased (See Figure 2). Apart from inefficient spending, public capital investment has been declining from an average of 5.2% (2007-2010) to an average of 5.1% (2011-2004).

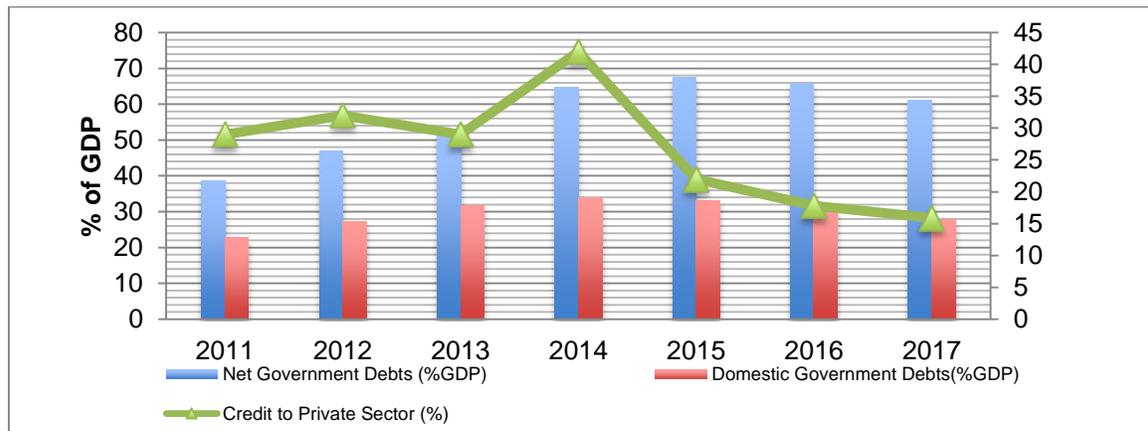
Figure 2: Gross Capital Formation not growing (% of GDP)



Source: Government of Ghana and IMF Estimates

In addition, private capital formation has not grown much due to crowding out effect from excessive public domestic debt. Cost of credit has increased, because the sharp increase in net credit to the government far exceeded the statutory limit of 10 percent of revenue for total Bank of Ghana financing, increasing the perception that the Bank is not independent, as well as questioning the credibility of the inflation-targeting regime (IMF, 2013)<sup>1</sup>. Banks' lucrative investments in government securities have reduced their incentives to actively seek lending opportunities to the private sector (Ibid). Whilst private credit grew strongly in 2014, this occurred from a low base. Credit to the private sector is projected to decline from 42% in 2014 to 16% (IMF, 2015)<sup>2</sup>.

**Figure 3: Credit to the private sector declining**



Source: Government of Ghana and IMF Projections

The lower levels of capital accumulation in spite of growing public spending exposes inefficiencies in spending, resulting from weak public financial management systems, poor quality of procurements, project implementation delays and cost overruns. The effects on economic growth are well known. These concerns perhaps underlie the significance of the structural and financial reforms contained in the IMF Program.

Another reflection of low productivity in the Ghanaian economy is expressed in the consistent “positive” output gap recorded over the years due in part to the electricity shortage. By “positive” output gap, it means higher potential output of the economy over actual output, indicating slowdown in economic activity. It is therefore not surprising that Government revenues have not been rising as expected. The consistent “positive” output gap has translated into expansionary public spending against lower inflows, thus raising

<sup>1</sup> IMF, Ghana Article IV Consultations, IMF Country Report No. 13/187, June 2013.

<sup>2</sup> IMF, Ghana - Request For A Three-Year Arrangement Under The Extended Credit Facility Staff Report; Press Release; And Statement By The Executive Director For Ghana, IMF Country Report No. 15/103, April 2015.

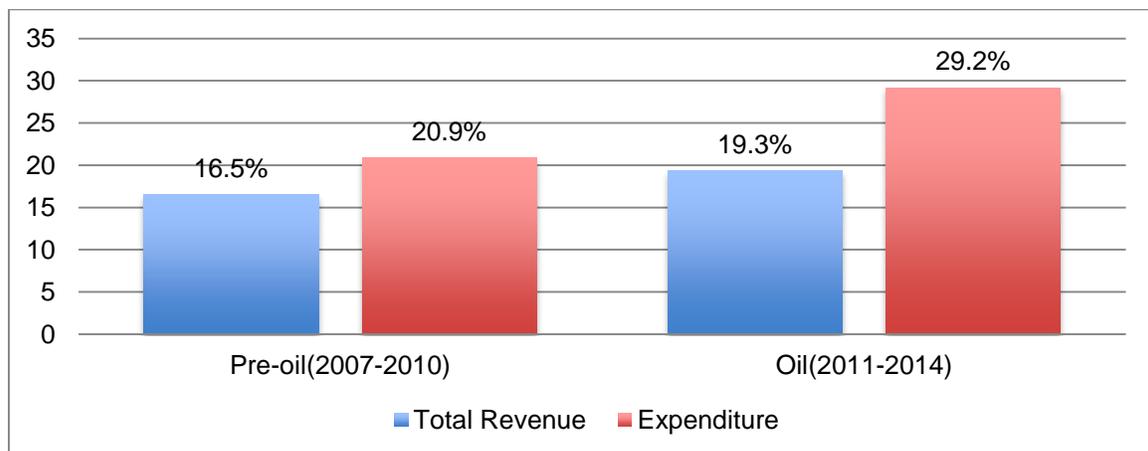
both actual inflation and inflation expectations (IMF, 2013).

Expectedly, the IMF program anticipates “a gradual shift of public expenditure from current to capital spending supported by the channeling of new oil and gas revenues into productive investment to develop proper infrastructure and reliable power generation, as well as reform of State-Owned-Enterprises (SOEs)”. However, this growth strategy hinged on expected oil and gas revenues should be taken with cautious optimism because of the volatility and uncertainty of these revenues.

The commencement of commercial oil production deepened government’s pro-cyclical behavior consistent with Ghana’s rule for managing petroleum revenues. Fact is, projection of the benchmark petroleum revenue, a percentage of which is allocated to the annual budget (the Annual Budget Funding Amount or ABFA)<sup>3</sup>, is based on a 7-year moving average of crude oil prices. Whilst this formula is expected to smoothen revenues, it in part assumes a pro-cyclical posture because consistent boom periods in the computation projects higher ABFA. This in addition to increased debts servicing accounted for the large public expenditure (29% of GDP) during the oil production period (2011-2014) compared to the pre-oil period (20.9%) (See Figure 4).

The climax of government’s expansionary fiscal policy was in 2012 during the general elections, which saw large twin deficits, arising from excessive spending including extra-budgetary spending. The dilemma here is that, with expected increases in petroleum revenues, government spending is likely to be influenced by high expectations, rather than by efficient spending.

**Figure 4: Expenditure grew faster than Revenue in the oil era (% of GDP)**



Source: IMF Estimates

<sup>3</sup> ABFA is the proportion of the estimated benchmark petroleum revenue allocated to the annual budget of the government. The Petroleum Revenue Management Act 2011 (Act 815) provides that up to 70% of the benchmark revenue should be transferred to the budget.

As a result of fiscal indiscipline, the IMF program focuses more on regaining fiscal credibility by proposing a number of reforms including structural reforms to strengthen public finances and fiscal discipline; and financial sector reforms to strengthen the monetary policy framework and safeguard financial sector stability.

These reforms no doubt will re-establish fiscal credibility. However, there is the risk of poor enforcement of these reforms given that previous reforms were never fully implemented. The extent to which these reforms will affect fiscal consolidation is also in doubt, given that the measures aimed at fiscal consolidation are inadequate and are not expressed in very strong legal terms required for a fiscally indiscipline environment. At best, the measures are largely administrative which can be ignored with ease once the program is over in 2017. More serious is the fact that future fiscal consolidation rests with oil revenues and grants, which are both volatile, uncertain and unsustainable.

### **Fiscal Consolidation Measures**

The program aims to turn the primary balance (on a commitment basis) from a deficit of 3.5% in 2014 into a surplus of 0.9% of GDP in 2015 and 3.2% of GDP in 2017. If the government is to improve on its fiscal outlook, there must be serious efforts at improving on tax collection and controlling public spending but this requires serious austerity measures and improved institutional quality to achieve. This is also consistent with recommendations made by the World Bank to the Government, asking it to raise tax collection, reduce expenditures and ensure that expenditure cuts do not fall disproportionately on public investments in order to protect wages, salaries and other important recurrent cost (World Bank, 2009)<sup>4</sup>.

The revenue and expenditure measures taken by government as contained in the program seek to raise tax revenues and control expenditure. They include:

- a. Revenue measures (about 2 percent of GDP in 2015) include:
  - i. Special Petroleum Tax of 17.5 percent);
  - ii. VAT on fee-based financial services and a 5 percent flat rate on real estate; and
  - iii. Extension of the special import levy of 1-2 percent and the National Fiscal Stabilization Levy

Government has already introduced the special petroleum tax and VAT on fee-based financial services, which are generating substantial revenues for the state.

- b. Expenditure measures (savings of about 2 percentage points of GDP in 2015):

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<sup>4</sup> World Bank (2009c), Ghana: 2009 External Review of Public Financial Management, Report No. 47639-GH, Washington D.C.

- i. Limit the nominal increase in the total wage bill to 10 percent
- ii. Eliminate subsidies for utilities and petroleum products, i.e., strict implementation of tariff and price adjustment mechanisms and using part of the resulting fiscal space to safeguard social and other priority spending (LEAP)
- iii. Clear outstanding stock of arrears over the coming three years
- iv. Reduce expenditures on goods and services,
- v. Scaling back domestically financed non-priority capital expenditures, as well as transfers to other government agencies.

These are intended to reduce fiscal deficits significantly particularly the primary balance. However, the medium term effects of these measures cannot be fully evaluated, given that most of the measures are administrative, and are not binding except to fulfill IMF conditions. In fact, the program endorses legislative reforms in the Bank of Ghana Act, Banks and Specialized Deposit-Taking Institutions Bill, Deposit Insurance Bill and the Petroleum Revenue Management Act (PRMA).

However, the more important Fiscal Responsibility legislation has been reduced into “revising existing Public Financial Management (PFM) legal frameworks to accommodate provisions on fiscal responsibility and debt management”. This fell short of a bold decision to backing the formulation and implementation of a comprehensive set of fiscal and debt rules for managing the fiscal policy. Given that government has consistently argued that it has fiscal rules (which do not exist), one is tempted to doubt if it will establish any strong rules to inject discipline and statutory restrictions on excessive spending and borrowing, once the program is completed.

### **Fiscal Consolidation and Volatility of Petroleum Revenue**

Petroleum revenue has contributed to reducing the higher primary balance recorded over the oil production period. From a pre-oil average of (-1.8%of GDP), the primary balance increased to (-5% of GDP). This includes the positive effect of petroleum revenue financing. Excluding petroleum revenues (1.9% of GDP), the non-oil primary balance deteriorated to (-6.9% of GDP). The significance of this is that with increased petroleum revenues from the TEN and Sankofa Fields, petroleum revenues could provide the relief for fiscal consolidation in the near term if production is increased substantially.

**Table 1: Primary Budget Balance improved with oil revenues but not sufficient to balance the budget**

<b>Primary Balance</b>	<b>Pre-Oil (2007-2010)</b>	<b>Oil (2011-2014)</b>	<b>Petroleum Revenues</b>
Overall balance (%GDP)	-4.4	-9.9	1.9
Primary balance (%GDP)	-1.8	-5	1.9
Non-oil primary balance (% GDP)	-1.8	-6.9	0

Source: IMF Estimates

The IMF program acknowledges the role petroleum revenue could play in balancing the government budget by providing for instance that petroleum revenue will be a major component on the financing side of the program primary fiscal balance; that the deficit ceilings for 2015–17 will be adjusted for excesses and shortfalls in petroleum revenue and program loans and grants; and that a Debt Service (Sinking Fund) Account will be established from petroleum revenue.

It is already well known that production of oil and gas is expected to increase over the next two years. However, as already stated, the uncertainty about crude oil prices and the litigation on the TEN project puts the fiscal targets under serious threat, unless there is significant buffer in the Ghana Stabilization Fund, which for the 2015 fiscal year, has already been committed following the price crash in 2015. This in part has compelled government to consider amendments to the PRMA to give the Minister of Finance more discretionary power to revise the benchmark revenue when there is material evidence that petroleum prices and/or output targets will not be achieved. Although the proposed amendments will further entrench pro-cyclical spending of petroleum revenues exposing public spending to boom-bust cycles, the IMF has approved them.

Putting the proposed amendments into proper perspective, one wonders how they could adequately address the volatility effects of oil prices and production. These amendments by far remain unnecessary, considering that the inadequacy of the reserve in the GSF to cushion the budget against revenue shortfall is to blame for the current situation. Under the PRMA, the Minister has exercised its discretion in setting maximum caps on the GSF, which so far have been done through arbitrary processes. For example, government set the cap at \$250 million in 2012, this allowed the deployment of \$305.7 million, being excess revenue over the cap, for debt service and establishing the contingency fund by end of September 2014. Thus, government's policy on the use of the GSF shifted from the counter-cyclical objective to reducing the borrowing cost premium, hence, exposing the budget further to cyclical effects. Based on the projected ABFA, the caps on the GSF varied from one year to another (see Table 2).

**Table 2: Illustration of the size of the stabilization buffer in the GSF (US\$)**

Item	Unit	2014	2015 (Q1)	2015 (Year End)	2016
Projected ABFA	US\$	409,072,778	721,818,314	721,818,314	874,878,604
Cap	US\$	250,000,000	300,000,000	400,000,000	400,000,000
Buffer in GSF	%	61%	42%	55%	46%

Source: Government and Author's Computations

This implies that as the projection of ABFA increased, the size of the cap proportionately decreased, reducing the size of the revenue buffer in the GSF against spending shortfalls. It is therefore important for government to formulate a rule that ensures a balance

between debt repayment and the need to keep significant reserves against petroleum revenue shortfalls to ensure that it is on the consolidation path. The effect of oil induced revenue shortfall in Ghana has already led to costly adjustments threatening to completely deplete the GSF. Cabinet has approved adjustment to the primary balance by GHC1,265 million to mitigate the impact of lower oil prices and keep total public debt accumulation as approved in the 2015 budget. This exposes the risk of fiscal consolidation to insufficient and arbitrary setting of the GSF cap.

The reliance on expected petroleum revenue for consolidating fiscal targets further shows Ghana's vulnerability to fiscal slips. If the Government was forced to review its 2015 budget due to shortfalls in petroleum revenue, although Ghana is not an oil depending country, then the expected fiscal consolidation may not be realized as dependence on oil revenue increases. This therefore raises the question as to whether future adjustments may not be too expensive for the economy. Government is therefore likely to resort to more borrowing in spite of the ceilings on non-concessional debts under the program. The negative implications of the debt ceilings for undermining fiscal consolidation when oil revenue fails in the medium term are predictable.

### **Some Proposals**

The government has a number of options in formulating comprehensive fiscal rules for long-term fiscal consolidation some of which are proposed as follows.

- a. Government needs to shift from pro-cyclical spending to counter-cyclical spending. This requires a strong stabilization mechanism to support the budget during periods of low economic activity.
- b. Government must introduce a legal framework on a comprehensive set of fiscal rules – budget balance rules, expenditure growth rules and debt rules, and must have the discipline to follow the rules. Some proposals for the introduction of new fiscal rules will be helpful.
  - i. Government should fully integrate petroleum revenues into the fiscal policy rather than its current structure as earmarked funds for selected sectors and for financing the Ghana Infrastructure Investment Fund (GIIF). Given that government short to medium term target is to have a primary surplus of 0.9 percent of GDP in 2015 and 3.2 percent of GDP in 2017, a fiscal rule that requires non-oil primary balance deficit at 1% of trend GDP is appropriate. Where there are surpluses, they can be saved to build government assets. This removes the pro-cyclicality in the fiscal policy and ensures accelerated accumulation of government assets.
  - ii. Government should seek to reduce its debts and free up revenues used for interest payments to finance capital expenditure. The development of a debt management strategy and its approval by cabinet to guide borrowing is a weak prescription. Further, the ceiling imposed on non-concessional debt by

the IMF program is good but unsustainable without a legal effect. To check excessive borrowing, Government must further formulate and implement a debt rule based on the solvency ratio or liquidity ratio, two important indicators of debt sustainability.

- iii. To ensure that the GSF plays its role as fiscal stabilizer, Government should remove the arbitrariness in setting the maximum cap on the GSF, and ensure that there it balances its debt repayment commitments with the need to have a strong buffer against bad times. A strong proposal for setting the GSF cap is to put it at not less than 50% of ABFA or an alternative proportion of GDP. This rule ensures that in the event of a shortfall in petroleum revenue by 20% to 40% of ABFA, there will be sufficient reserves to finance it and restore budget balance.

## Conclusions

Although the central theme of the program is fiscal consolidation, it recognizes the role of regaining fiscal credibility as necessary conditions for achieving consolidation. Fiscal credibility is important as it ensures investor confidence in the economy and introduces discipline in fiscal management. This accounts for the many monitoring and surveillance requirements including the institution of administrative measures for achieving credibility. However, fiscal consolidation remains a difficult target with the largely administrative measures. It requires strong rules enshrined in law to ensure both fiscal credibility and consolidation, and to help address the often too much fiscal discretion that often pushes fiscal policy making to the gallery. The rules should be a combination of budget balance rules, expenditure rules and debt rules. Although a limited window, it is expected that by December 2015, Cabinet would approve amendments to public financial management legal frameworks to accommodate provisions on fiscal responsibility including debt management; and government is encouraged to use this opportunity to introduce strong fiscal and debt rules as well as sanctions for non-compliance. Also worrying is the focus on future oil and gas revenue and grants for achieving fiscal consolidation. Revenues from these sources are volatile and uncertain. A stronger rebound in oil prices over the medium term, remains highly uncertain considering that global demand for oil is not rising as fast as anticipated.