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Strengthening the WAEMU Regional Fiscal Framework

Antonio C. David, Alexandre Nguyen-Duong and Hoda Selim

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WORKING PAPER

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Strengthening the WAEMU Regional Fiscal Framework
Prepared by Antonio C. David, Alexandre Nguyen-Duong and Hoda Selim*

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ABSTRACT: This paper assesses the adequacy and effectiveness of the WAEMU fiscal framework along three pillars that have proven to effectively support fiscal discipline in monetary unions—common fiscal rules (including adequacy of numerical ceilings as well as elements of design and enforcement), shared public financial management systems, and coordination mechanisms for decentralized fiscal policies. We undertake a calibration of regional debt and fiscal deficit ceilings taking into account different macroeconomic tradeoffs and risks and conclude that numerical ceilings that prevailed before the suspension of the fiscal rules remain adequate and strike the right balance between growth and fiscal sustainability. The paper also proposes reform options to strengthen the WAEMU regional fiscal surveillance framework, with a view to more effectively supporting fiscal discipline.

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WORKING PAPERS

Strengthening the WAEMU Regional Fiscal Framework

Prepared by Antonio C. David, Alexandre Nguyen-Duong and Hoda Selim ¹

¹ Earlier versions of the paper were presented at an IMF seminar in June 2020 year as well as at the WAEMU Commission in November 2020. The authors are also grateful for comments received from Sebastian Acevedo, Andrew Ceber, James Daniel, Dominique Desruelle, Luc Eyraud, Annalisa Fedelino, Manal Fouad, Vitor Gaspar, Jules Tapsoba, Karla Vasquez and Christophe Waerzeggers, as well as members of the WAEMU Commission, other regional authorities of the WAEMU. The authors also thank Zarina Bentum for excellent research assistance.

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Introduction

The West African Economic and Monetary Union (WAEMU) is one of four currency unions in the world, consisting of eight countries.² It coordinates some regional policies and addresses other common challenges among member countries. The Central Bank of West African States (BCEAO) issues a common currency, the CFA Franc, pegged to the euro, conducts a single regional monetary policy, pools foreign exchange reserves of members, and contributes to the supervision of the financial system of the WAEMU.

Achieving and maintaining fiscal convergence are essential for safeguarding macroeconomic stability and preserving the sustainability and credibility of the fixed exchange rate regime. To this end, a well-designed regional fiscal framework can foster fiscal discipline and improve coordination to prevent member states from running excessive budget deficits. The fiscal stance of one member of the union can indeed impact other members' fiscal positions through various channels, including trade and contagion effects. If member countries do not internalize the impact of their fiscal actions on others, distortions may arise—for instance, the risk premium on regional bond market may rise. These fiscal spillovers can be particularly problematic under a fixed exchange rate, since fiscal indiscipline can deplete international reserves and jeopardize the peg.

In this context, the WAEMU regional surveillance framework, adopted in 1996, aims at ensuring the sustainability of national fiscal policies and their consistency with the common monetary policy (including the fixed exchange rate regime).³ It also envisaged a gradual convergence by member countries to a number of criteria related to macro-fiscal aggregates including the fiscal deficit, public debt, and inflation, among others.

In practice, however, and in spite of reforms, there are some concerns that the regional surveillance framework has not worked as effectively as intended. First, fiscal rules have been weakly enforced over the years thus contributing to weak compliance with the convergence criteria by member states (Féler and Simard, 2019). As a result, repeated fiscal slippages since 1996 led to the successive postponements of the Pact's convergence deadlines. Regional convergence was temporarily achieved at the aggregate level in 2019, but the fiscal framework was suspended in 2020 in the context of the Covid crisis (WAEMU, 2020a). Second, debt has accumulated significantly over the past decade. This trend reflects the accumulation of high fiscal deficits over time, but also the prevalence of debt-creating operations that were not captured by fiscal deficits (Féler and Simard, 2019 and Nguyen-Duong and Selim, 2021). For instance, ad hoc unorthodox procedures and other below-the-line and off-budget operations persisted and often escaped the official scrutiny in national budgets (Imbert and others, 2022 and Versailles, 2018). Third, the framework still lacks formal fiscal-sharing mechanisms, which makes it difficult for countries subject to idiosyncratic shocks (such as the security problems in Burkina Faso, Mali and Niger) to stabilize their economies without support from other members or pressure to loosen the common monetary policy stance.

The Covid crisis and current suspension of the framework provide an opportunity to evaluate the existing fiscal surveillance framework in the WAEMU and rethink some of its components, especially those related to fiscal rules (ceilings, design, enforcement), regional PFM systems and fiscal coordination mechanisms. The WAEMU Commission is currently conducting a review of the framework and the convergence path, with a view of submitting proposals of reform to the WAEMU Council of Ministers in 2022. This revision is taking place amid claims that the fiscal deficit and debt ceilings seem too tight given spending pressures stemming from large development needs. These claims have triggered some discussions on the desirability of revising upwards the current numerical targets for the rules and perhaps change the rules themselves.

² The members of the WAEMU are Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo.

³ A "Growth, Stability, Convergence and Solidarity Pact" adopted in 1996, aimed at ensuring "consistency between national fiscal policies and the common monetary policy" and a "sustainable balance of payment position" through the gradual convergence by member countries to numerical ceilings on the fiscal deficit and debt to GDP ratios.

To contribute to the debate on the fiscal surveillance reform, this paper assesses the adequacy and effectiveness of the WAEMU fiscal framework. The analysis focuses on three main pillars that are considered to be the fiscal foundation of a currency union and have been shown to effectively support fiscal discipline—common fiscal rules (including adequacy of current numerical ceilings and other elements of design and enforcement), shared public financial management systems, and fiscal coordination mechanisms. All currency unions and federations rely these pillars, although in varying degrees.

The paper examines more specifically fiscal rules in the WAEMU. The analysis follows several methods to calibrate regional debt and deficit ceilings to assess whether previous numerical ceilings (in place before the Pact's suspension) remain suitable for the region, taking into account the large development spending needs and the objective of fiscal prudence to preserve fiscal sustainability. The paper expands on previous analysis of the WAEMU fiscal framework conducted in Hitaj (2016), Basdevant and others (2015), Féler and Simard (2019), Eyraud (2019), Nguyen-Duong and Selim (2021), and Bebee and others (2022). The analysis is not comprehensive and focuses on the design and implementation of the most critical fiscal criteria (fiscal and debt rules), leaving aside other important criteria (on taxes and wages) as well as non-fiscal ones (inflation).

The paper is structured as follows. Section II provides a brief literature review on theoretical underpinnings for fiscal discipline and coordination in currency unions, with a focus on the WAEMU region. Section III gives a background on the WAEMU fiscal surveillance framework including on institutional aspects and implementation track record. Section IV explores issues related to fiscal rules calibration, design, and underlying enforcement mechanisms. Section V provides a brief assessment of the common PFM systems in the WAEMU, while section VI suggests possible reforms to improve fiscal coordination mechanisms in the region. Section VII concludes.

Literature Review: Fiscal Coordination in Currency Unions

A large body of the literature on fiscal coordination in currency unions gained renewed attention first with the creation of the European Monetary Union (EMU) in 1999, then later with the introduction of the Euro in 2002 and finally with the European Crisis in 2010. In a currency union, the common monetary policy ensures the automatic coordination of responses to symmetric shocks (Canzoneri and Gray, 1985). However, this set-up leaves fiscal policy as the only tool available to member states to stabilize their national business cycles when they are in conflict with the common monetary policy and when the free mobility of production factors (labor and capital) is imperfect (Mundell, 1961 and McKinnon, 1963).

To ensure that fiscal policy can effectively deliver this stabilization role, it is generally recommended to achieve a degree of fiscal coordination (including fiscal discipline) among member states of a currency union (De Grauwe, 1992). Such coordination helps prevent member states from running excessive budget deficits, that would undermine the long-term credibility of the common currency. This “deficit bias” tends to occur because countries in a currency union have access to a common pool of resources and may thus have an incentive to overspend or overborrow or to free-ride and shift the fiscal tightening to other members or even the central bank for bail out (Buiter et al., 1993, Kenen 1995 and Chari and Kehoe, 2004). Fiscal coordination is thus necessary to help member states internalize the spillover effects of their behavior on other members and rendering the national fiscal stance consistent with the common monetary policy (Hamada, 1985).

Three Pillars of Fiscal Coordination

The literature proposes three mechanisms to achieve fiscal coordination in federal or county union settings (Eyraud, 2019):

First, a *system of fiscal rules* should be implemented to enforce fiscal prudence, limit the “deficit bias” and facilitate fiscal coordination among member states. Fiscal rules should help prevent member countries from using excessive discretion in formulating and implementing fiscal policy. Fiscal rules can achieve these goals by acting as a commitment device, tying the hands of the government and limiting the use of fiscal discretion (Alesina and Tabellini, 1990; Eyraud and others, 2018), as well as a signaling device that enhances transparency and reveals the preferences and fiscal plans of the government to the public and financial markets (Debrun and Kumar 2007). In addition, by imposing numerical limits, rules may serve as a focal point for politicians, facilitating the formation and stability of political coalitions, and enhancing coordination.

Fiscal rules are more effective in constraining fiscal deficits when some conditions are met (Eyraud and others, 2018). Their design should be well thought through. Poorly designed rules, such as procyclical rules or rules that are not sufficiently precise, can be self-defeating. Moreover, rules are more effective when they are supported by strong enforcement mechanisms. Greater automaticity in enforcement, a more credible set of sanctions and a better monitoring are all measures that would support compliance with fiscal rules.

Second, well-designed fiscal rules need to be complemented with *sound public financial management (PFM) systems*. The latter deals with the regulations and other constraints related to the government’s management of the budget in its various phases—formulation, approval, and execution. It describes a set of processes and procedures that cover all aspects of public expenditure management. Strong PFM systems foster fiscal discipline, including in developing countries. There is empirical evidence that fiscal consolidations are more durable when they are supported by strong institutions (Tsibouris and others, 2006, Kumar and others, 2007 and IMF 2011). A review of past experiences highlights the importance of adopting medium-term expenditure frameworks (MTEFs), which help governments set and meet multi-year priorities and build credibility.

For instance, effective expenditure controls are one PFM tool that ensures that spending is executed in accordance with approved budgets, within authorized limits and in a timely manner (Doe and Pattanayak, 2008). Inadequate controls can cause unsustainable increases in expenditure and unbudgeted liabilities and overall undermine the operation of fiscal policy. This is especially the case if they consistently lead to expenditure overruns, frequent recourse to exceptional spending procedures or supplementary appropriations or significant use of extrabudgetary financing (Corbacho and Ter-Minassian, 2013).

Third, *fiscal coordination mechanisms* should also be put in place. Such mechanisms are common in federal states and currency unions and are necessary to help member states internalize the spillover effects of their behavior on other members and making national fiscal stances consistent with the common monetary policy (Hamada, 1985). Indeed, the fiscal stance of one member of the union can impact other members’ fiscal positions and economic outlook through various channels, including trade, inflation, and contagion effects. For example, a fiscal expansion in one country increases its imports from other member countries. It could also increase domestic prices and lead to a real exchange rate appreciation in the country undertaking the expansion. If there is a significant impact on prices, there may be pressure on the central bank to tighten monetary policy. If member countries do not internalize the impact of their fiscal actions on others, distortions may arise—for instance, the risk premium on regional bond market may rise.

One typical way to achieve coordination is through a framework meant to avoid excessive tax competition among union members. Tax competition to attract or retain firms and wealthy residents may induce neighbors to retaliate and offer even larger tax cuts. This type of competition is suboptimal if it induces a race-to-the-bottom in terms of even larger targeted tax breaks that decrease government revenue without providing a comparative advantage to any jurisdiction (Wilson, 1986).

Other examples of coordination mechanisms entail insurance or fiscal risk-sharing schemes at the union level to address idiosyncratic economic shocks and lower adjustment costs. In this regard, the literature proposes various formal mechanisms focusing on risk pooling across member states. For instance, currency unions could create a “rainy day fund” which would collect permanent contributions from members in exchange for transfers linked to the occurrence of country-level shocks (Allard and others, 2013). A common budget for the currency union could also allow risk sharing through both revenues and spending and thus enable the union to respond to both area-wide and country specific shocks (Allard and others, 2013).

WAEMU-Specific Literature

Looking at these three dimensions, the literature analyzing the effectiveness of rules, PFM arrangements and coordination mechanisms appears less extensive in the WAEMU than for the Euro Area.

On the issue of fiscal rules, most of the WAEMU related literature focuses on assessing their design and other aspects of the fiscal surveillance framework. Overall, compliance with the convergence criteria has been considered to be weak. To remedy this, several authors argued for simpler rules and more effective enforcement mechanisms (Nguyen-Duong and Selim, 2021 and Basdevant and others, 2015). Others showed that the deficit rule adopted in the 1990s contributed to procyclical fiscal policy (through public spending) especially in the absence of proper fiscal sharing mechanisms (Guillaumont and Tapsoba, 2009, Coulibaly, 2015 and Dessus and others, 2013). From this perspective, Dessus and others (2013) explored alternative fiscal rules that could allow further cyclical flexibility and thus give more weights for considerations of sustained growth in the WAMEU.

Nevertheless, formal analyses of the adequacy of the fiscal ceilings have been scarce. Basdevant and others (2015) recommended based on WAEMU countries debt sustainability exercises reducing the 70 percent debt ratio ceiling to 50 percent with a view of limiting the risk of debt distress. More recently, Bebee and others (2022) provided a quantitative analysis of medium-term regional debt and deficit ceilings based on econometric estimates and a structural model.

In addition, on PFM issues, the literature emphasizes the need for better PFM systems to instill more discipline in budget execution in the region. The focus should be on controlling the sources of debt accumulation more effectively, especially below the line and off-budget operations (Imbert and others, 2022; Nguyen-Duong and Selim, 2021; Féler and Simard, 2019; Versailles, 2018 and Hitaj 2016). Other papers have examined the uneven implementation of PFM directives across member states (Assemien, 2008, Imbert, 2014 Sarr, 2014 and Bonherbe, 2016).

Finally, out of the limited work focusing on risk-sharing mechanisms in the WAEMU, the following recommendations stand-out: (i) improving national tax harmonization to enhance the effectiveness of the WAEMU Commission’s surveillance functions (World Bank, 2019), and (ii) establishing centralized risk-sharing mechanisms and enhancing financial integration within the union to smooth asymmetric shocks and increase the scope for countercyclical fiscal policy (Dessus and others, 2013; Basdevant and others 2015).

Background: The WAEMU System of Fiscal Rules

Shortly after the unsustainable national fiscal policies that led to the 1994 devaluation of the CFA Franc, member states signed the WAEMU Treaty which added elements of deeper economic integration to the monetary union that was already established in 1962.⁴ The Treaty also aimed at reinforcing fiscal discipline and coordination among WAEMU member countries as well as ensuring the consistency of their national fiscal policies with the common monetary policy. To this end, member states adopted a “Growth, Stability, Convergence and Solidarity Pact”. The Pact prescribed ceilings on main macro-fiscal aggregates to be observed by member countries by a specific deadline. To ensure their compliance with the convergence criteria, the regional fiscal surveillance framework (formally adopted in 1996) was also established and so was the WAEMU Commission. The latter, representing the overall interests of the community, was mandated with the task of regional fiscal surveillance.

As part of the convergence efforts, the WAEMU members were also expected to coordinate national fiscal policies through additional means. First, member countries would begin harmonizing budget laws and procedures, including budget and accounting laws as well as laws governing public accounting, budget transparency, and the chart of accounts. Second, they would work on reducing excessive disparities in the structure and amount of their national tax policies (Kireyev, 2016). These last two elements will be discussed in sections V and VI respectively.

This section reviews the main institutional arrangements of the WAEMU fiscal rules framework and how they evolved over time. It also assesses compliance with the convergence criteria by member states.

The Initial Pact: 1996-2015

In 1994, member states embarked for the first time on a gradual convergence path towards eight rules, also known as “criteria”. First-order convergence criteria included ceilings on the fiscal deficit and debt to GDP ratios and on CPI inflation, as well as a prohibition to accumulate arrears (Kireyev, 2016). The deficit rule was based on the basic fiscal balance (defined as the fiscal balance excluding grants and externally financed capital expenditure). Moreover, against a background of over-indebtedness in the mid-1990s’s (with debt ratios significantly above 70 percent of GDP in all member states), the debt ceiling was set at 70 percent of GDP. Second-order convergence criteria included ceilings on wages and salaries, floors on tax revenue and investment-expenditure-to-revenue ratios and limits on current account deficits (Kireyev, 2016). Under the convergence rules, any excessive deficit should be eliminated, and budget policies must respect a common discipline of supporting multiyear efforts toward fiscal consolidation and improving the structure of public revenue and expenditures.

Advancement towards regional convergence was disappointing until 2015. In fact, despite some fiscal consolidation efforts in the very early years, repeated breaches in both the deficit and debt ceilings were observed in the majority of WAEMU countries since 1998 and more so between 2001 and 2012 (Hitaj, 2016 and Doré and Masson, 2002). By 2015, several countries remained noncompliant with the key criterion of the fiscal deficit and regional convergence was far from achieved.

⁴ In 1994, the Union included Benin, Burkina Faso, Côte d’Ivoire, Mali, Niger, Senegal, and Togo. In 1997, Guinea-Bissau became the eighth and last member to join the Union.

Doré and Masson (2002) showed that fiscal slippages were not entirely caused by exogenous factors such as terms of trade deterioration or unfavorable cyclical factors but also by the lack of fiscal discipline in member states. In fact, assessments conducted in the mid-2010s indicated that slippages resulted from three main sources.

First, the system of rules was considered excessively complex. It included too many criteria, some of which, were difficult to understand, implement and monitor (Basdevant and others, 2015). In particular, the basic fiscal balance, which excluded foreign-financed capital expenditure, was insufficiently linked to public debt dynamics, especially as substantial debt accumulation stemmed from externally financed spending (Hitaj, 2016 and Coulibaly, 2015). Second, in the absence of fiscal sharing mechanisms that would allow the region to address asymmetric shocks, the fiscal deficit rule was associated with procyclical characteristics with member countries often being forced to adjust through public spending (Guillaumont and Tapsoba, 2009, Coulibaly, 2015 and Dessus and others, 2013). More importantly, such adjustments were found to be asymmetric in relation to the economic cycle, implying that public spending contracted more in recessions than it expanded in booms (Dessus and others, 2013). Third, the monitoring and enforcement mechanisms of the rules proved of limited effectiveness in ensuring compliance.

The Revised Criteria and Convergence Phase: 2015-2019

The weak compliance with the convergence criteria prompted successive postponements of the 1994 Pact's deadline. In this context, the Conference of the WAEMU Heads of States (considered the WAEMU's highest governing body) adopted in 2015 a revised surveillance framework with a revised set of criteria to ensure convergence (Table 1).⁵ Member countries were expected to progress more effectively towards the convergence criteria and to achieve this objective by a new deadline set for end-2019. If, by this date, a least half of WAEMU's member countries accounting for at least 65 percent of the regional GDP had not yet sustainably met all first-order criteria, the convergence phase could be extended by one year. The 2015 revised Pact stipulated also that the region would begin a stability phase only when the observance of the first order convergence criteria (as just described in relation to critical mass of member states) is considered "durable", meaning that the convergence had been maintained for two years and is expected to hold for another two future years

Table 1. WAEMU Convergence Criteria Adopted in 2015

First-order criteria of the convergence phase	Ceiling/Floor
Overall fiscal balance (including grants) to nominal GDP	≥ -3 percent
Average consumer price inflation per year	≤ 3 percent
Total public debt to nominal GDP	≤ 70 percent
Second-order criteria of the convergence phase	Ceiling/Floor
Wages and salaries to tax revenue	≤ 35 percent
Tax revenue to nominal GDP	≥ 20 percent

Source: Compiled by staff based on information from the Additional Act no. 01/2015/ CCEG/UEMOA.

⁵ Additional Act no. 01/2015/CCEG/UEMOA.

The 2015 reform introduced also changes to address the weaknesses of the previous framework. A simplification of the fiscal rules framework involved amending the definition of the main fiscal rule to be measured by the overall fiscal balance and, reducing the number of criteria from 8 to 6 (as a result of dropping criteria on arrears, current account, and public investment). The system of rules retained the debt ceiling at 70 percent of GDP, even though all WAEMU countries benefited since the late 1990's from substantial debt relief in the context of the HIPC debt initiative, with Côte d'Ivoire being the last country to reach the HIPC completion point in 2012 (Hitaj, 2016). Finally, the reform also required the gradual reduction of arrears towards their complete elimination by 2019.

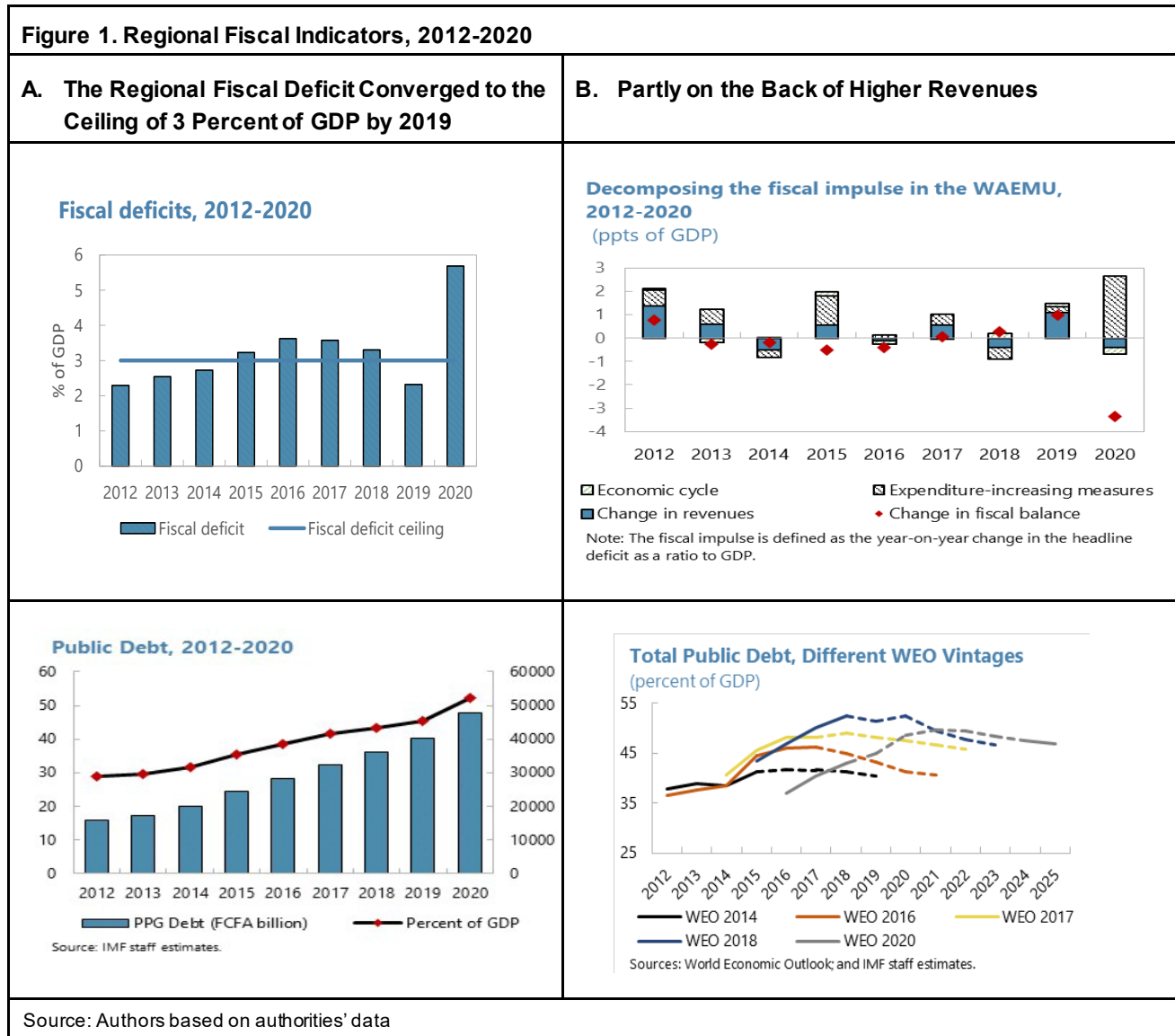
Overall, the region *temporarily* observed the primary regional convergence criteria at end-2019. According to the assessment of the WAEMU Commission (WAEMU, 2019), the first-order convergence criteria were met at the regional (aggregate) level at end-2019 but not at the level of each individual country. All WAEMU countries except Guinea-Bissau and Senegal met all the first order criteria.

- The regional fiscal deficit was estimated by the Commission at 2.5 percent of GDP at end-2019. Fiscal consolidation was backloaded with fiscal slippages occurring in 2016 and 2017 then gaining momentum since 2018 due mainly to better revenue mobilization (figures 1a and 1b).
- Public debt remained below the ceiling of 70 percent of GDP but did not decline towards 40 percent of GDP as was expected back in 2015. In fact, the debt ratio increased by about almost 17 percentage points of GDP between end-2012 and end-2019 to about 45 percent of GDP even though the deficit declined (figures 2a and 2b).⁶
- CPI inflation had also converged to the regional criterion and was estimated at -0.7 percent.

As for the two second-order criteria, neither of them was met at the regional level by end-2019 (WAEMU, 2019). Only Senegal and Mali met the criterion on wages and salaries, according to the Commission. Notwithstanding enhanced efforts in revenue mobilization in 2019, all countries breached the revenue criterion.

Even though regional convergence was temporarily observed at end-2019, pre-requisites for the stability phase were not yet met. Indeed, the Union needed to sustain convergence in 2020 in order to begin the stability phase. However, with the onset of the COVID-19 crisis, a Declaration of the WAEMU Heads of States in April 2020 suspended the Pact for Convergence, Stability, Growth and Solidarity (including the system of the fiscal rules) among its member-countries to allow them an accommodative response to the shock. This suspension voided all existing considerations for convergence and stability with an ongoing exercise to introduce new reforms later this year.

⁶ A rebasing of national accounts in most WAEMU countries expanded the nominal GDP and contributed to lower debt ratios.



Reforming the System of Fiscal Rules in WAEMU

The ongoing review by the WAEMU Commission of the fiscal framework provides an opportunity to evaluate its effectiveness and rethink some of its components. Some aspects could be assessed in relation to (i) the adequacy of system of the fiscal rules including the previous ceilings (for debt at 70 percent of GDP and for the deficit at 3 percent of GDP) in their ability to continue to deliver long-term fiscal sustainability (ii) some design aspects and whether there is merit in changing again the definition of the deficit rule or introducing alternative rules, and (iii) the effectiveness enforcement mechanisms of fiscal rules.

To undertake this assessment, the following section is divided into three main parts. The first section calibrates the regional fiscal ceilings (for both the debt and deficit rules) in order to assess whether they remain

suitable. The second and third parts analyze respectively fiscal rules design and underlying enforcement mechanisms in the WAEMU framework.

Fiscal Rules Calibration

To assess a fiscal framework, it is generally convenient to separate between two types of targets: the medium-term fiscal anchor and the operational rule (see definition in IMF, 2018a). The fiscal anchor is linked to the final objective of fiscal policy. The anchor is often the debt-to-GDP ratio, which provides a guide for medium-term fiscal expectations and creates an upper limit for repeated fiscal slippages. In practice, a threshold for the debt anchor can be calibrated to ensure long-term fiscal sustainability. In turn, the operational rule relies on short-term fiscal aggregates that are under the direct control of policy makers and have a close and predictable link to debt dynamics. The most common operational rule is a budget balance rule, but an expenditure rule would also fulfill the same criteria. The following sections assess both numerical rules (debt and fiscal) of the WAEMU fiscal framework in a sequential manner. First, the calibration of the debt ceiling is considered, which in turn serves as a basis to obtain an estimate of the adequate level of the debt anchor. Subsequently, this debt anchor will serve as a guide to calibrate the ceiling for the budget balance rule.

Step 1: Calibration of the Debt Ceiling

There is an inherent trade-off in the calibration of the debt ceiling for the WAEMU. On the one hand, the level must not be set too high so that it increases vulnerability to shocks, undermines market confidence, and leads to fiscal distress. On the other hand, the debt limit should not be set too low so as to prevent much-needed debt-financed spending on infrastructure and other development needs to meet SDG goals.

In this section, we consider two main approaches to calibrate the debt ceiling in the region. The first approach is based on precautionary considerations, following the sequential methodology presented in Eyraud et al. (2018) to obtain an estimate of the “safe debt” level, which would be compatible with economic resilience and market confidence. The second approach places emphasis on economic growth considerations and the objective of providing space for borrowing to finance large development spending.

Approach 1: The “Safe” Debt Approach to Calibrating the Debt Ceiling

The “safe” debt level is defined as the debt-to-GDP ratio that ensures that debt dynamics remain under control even if adverse economic shocks occur. The approach is based on two main principles. Firstly, we assume that there is a point beyond which debt dynamics can spiral out of control, which we call a maximum debt limit. The second principle is that the fiscal framework should aim at keeping debt well below this limit. Because countries are vulnerable to significant macroeconomic and fiscal shocks, including changes in market sentiment, there must be a sufficient safety margin between the debt anchor and the debt limit.

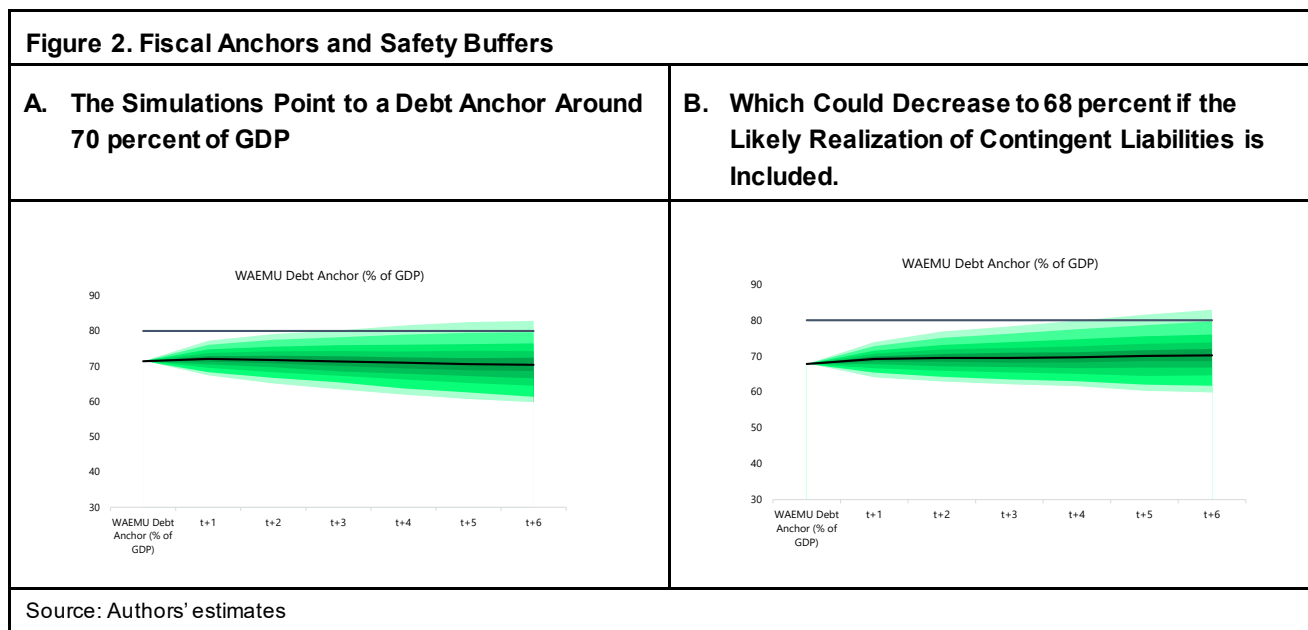
In that context, the debt anchor is computed in three stages: (i) first, an estimate of the maximum debt limit is obtained; (ii) then, we proceed to estimate the required safety margin; (iii) and finally the debt anchor is inferred as the debt limit minus the safety margin. More specifically, the required safety margin is estimated through stochastic simulations. To do so, we estimate the distribution of macroeconomic and fiscal shocks faced by the country in the past. Subsequently, we simulate future debt trajectories under these shocks over a 6-year horizon. This creates a fan chart of debt realizations, which allows us to calibrate the debt anchor and calculate the probability that public debt would exceed the maximum debt limit in the medium-term.

Appendix 1 presents the details of the steps followed to obtain estimates of the maximum debt limit for the region using two different approaches based on the concepts of “fiscal fatigue” and preservation of debt servicing capacity, respectively. The results indicate that a debt limit of around 80 percent of GDP for the WAEMU seems appropriate.

Once a maximum debt limit for the region has been computed, the required safety margin or buffer can be estimated. The buffer should reflect two factors: i) the history of macroeconomic shocks for countries in the region, ii) contingent liabilities, estimated at 3 percent of GDP every 6-years based on the evidence discussed in Bova et al. (2019).

Macroeconomic and fiscal shocks facing WAEMU countries are derived from a multivariate normal distribution based on annual data at the regional level for key macroeconomic and fiscal variables (namely, real GDP growth, the primary balance, real interest rates and the real exchange rate). These shocks are subsequently used to perform simulations of future debt trajectories based on the standard debt dynamics equation and a fiscal reaction function. The resulting debt paths are presented in a fan chart (see Figures 2a and 2b and figure 3). Each trajectory represents the evolution of debt under a certain shock scenario. The debt anchor is the initial point of the different simulations presented below and it is calibrated, so that the fan chart stays below the maximum debt limit over a 6-year horizon with a high probability.

The simulations point to a debt anchor of around 70 percent of GDP if policymakers are willing to accept a 10 percent probability of breaching the maximum debt limit in the medium-term (Figure 2a). Therefore, an anchor of around 70 percent of GDP is the “safe” level of debt that ensures that countries in the region can withstand negative shocks without breaching the maximum debt limit (assumed to be 80 percent of GDP) by the 6th year with very high probability.

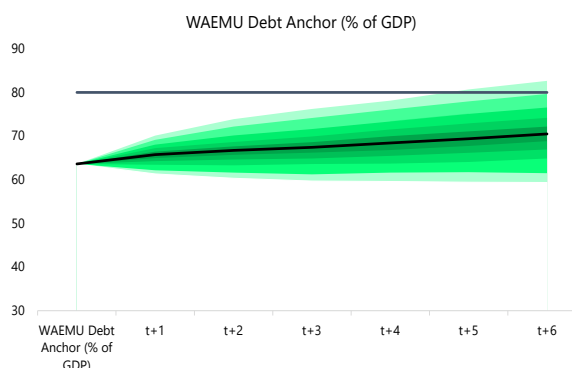


The anchor would decrease modestly if one accounts for the possible realization of contingent liabilities (see Figure 2b). In fact, certain types of transactions may lead to a disconnect between the evolution of deficits and debt in the standard debt dynamics equation levels (the so-called stock flow adjustments). These include the likely realization of contingent liabilities (arising from the recapitalization of a bank or state-owned enterprise, for example); off budget operations; or other large operations in financial assets. Bova et al. (2019) based on a comprehensive dataset of contingent liability realizations in advanced and emerging markets for the period 1990–2014 find that on average a country would be expected to have experienced a contingent liability realization every 12 years or so with a fiscal cost of 6.1 percent of GDP per episode. In the context of our simulations, if we consider that the expected realization of contingent liabilities is 3 percent of GDP over 6 years, the implied debt anchor would be 68 percent of GDP.

Overall, the analysis suggests a debt anchor of around 70 percent of GDP, but there is uncertainty around that level. This corresponds to a debt limit of 80 percent of GDP minus a safety buffer of 10 percent of GDP, deemed appropriate for the region given the history of shocks and expected realization of contingent liabilities. Nevertheless, it is important to bear in mind that the size of the safety buffer was estimated based on historical information.

Going forward, there might be important risks and structural trends that would call for a wider safety margin, such as for example monetary policy normalization in Advanced Economies pushing up global interest rates. Robustness checks show that a 100 basis points increase in interest rates relative to recent levels would increase the size to the buffer to over 16 percent of GDP, bringing the debt anchor below 65 percent of GDP if a debt limit of 80 percent of GDP is considered (see Figure 3). Nonetheless, there is also uncertainty about some elements of the calculation of the debt limit, which may support a higher debt limit than 80 percent of GDP. For example, if efforts to mobilize additional domestic revenues materialize and the revenues excluding grants to GDP ratio increase from 14.8 to 16 percent of GDP, the debt limit would be revised upward to 95 percent of GDP, keeping other things equal.

Figure 3. Fiscal Anchors and Safety Buffers: Calibration with Higher Interest Rates



Source: Authors' estimates.

Approach 2: Growth-Maximizing Debt Level

Another approach to determine the appropriate debt anchor attempts to estimate a debt ratio that maximizes growth. We use a theoretical model constructed by Checherita-Westphal and others (2014) to derive the level of public sector debt beyond which debt starts to have a negative effect on growth, even when considering the positive effect of public investment (financed through additional debt) on GDP. In this framework, the optimal debt-to-GDP ratio depends on the output elasticity of the public capital stock (that is, how additional public capital translates to higher GDP levels).

More specifically, the level of public sector debt level that maximizes output growth is derived in an infinite horizon model with flexible prices and wages with a production function that includes labor (L); private capital (K); and public capital (K_g). Output is given by the production function below, where α is the output elasticity of the public capital stock:

$$Y = L^\gamma K^{1-\gamma} (K_g/K)^\alpha$$

Assuming that public debt is used exclusively for public capital financing (“golden rule”), the optimal debt to GDP ratio (D^*) is given by the following expression and depends crucially on the output elasticity of the public capital stock (α).

$$D^* = (\alpha/(1-\alpha)^2)^{1-\alpha}$$

We use data from the Penn-World Tables version 10.0 (Feenstra and others, 2016) and from the IMF’s Investment and Capital Stock Dataset to estimate the parameter α for WAEMU countries with pooled data over the period 1960-2015. We follow Checherita-Westphal and others (2014) and use two different specifications. In the first model, output and labor are expressed as a share of the private capital stock. In the second model variables are expressed in per capita terms (except for the ratio of public capital to private capital). We also consider specifications in which a deterministic trend is included. The results are presented in Table 2.

All regressions yield point estimates for α of around 0.31, which would imply an optimal debt to GDP ratio target of about 74 percent. Considering a 90 percent confidence interval around the point estimate (i.e., an upper bound of 0.34 and a lower bound of 0.28), would yield optimal debt to GDP ratios ranging from 65 percent to 84 percent.

Table 2. Estimates of Output Elasticity of Public Capital

	(1) ln(Y/K)	(2) ln(Y/L)	(3) ln(Y/K)	(4) ln(Y/L)
ln(Kg/K)	0.312*** [0.016]	0.312*** [0.016]	0.307*** [0.016]	0.307*** [0.016]
ln(L/K)	0.366*** [0.021]		0.377*** [0.021]	
ln(K/L)		0.634*** [0.021]		0.623*** [0.021]
Trend			0.003*** [0.001]	0.003*** [0.001]
Constant	0.380*** [0.016]	0.380*** [0.016]	0.273*** [0.041]	0.273*** [0.041]
Observations	480	480	480	480
R-squared	0.738	0.659	0.743	0.664

Standard errors in brackets. *** p<0.01, ** p<0.05, * p<0.1

Source: Authors' estimates.

Overall, the analysis presented in this section would indicate that changing the debt ceiling presently embedded in the fiscal framework does not seem to be warranted. The 70 percent of GDP ceiling for the region is appropriate and strikes the right balance between fiscal prudence and growth considerations.⁷

Step 2: Setting the Deficit Ceiling

Turning to the operational rule, the WAEMU framework includes a rule capping the (nominal headline) overall deficit below 3 percent of GDP as part of the convergence criteria (Box 1).⁸ It is possible to obtain the overall deficit (OB) that would make debt converge to a desired level in the absence of shocks by using the standard relationship linking debt as a share of GDP (D) and nominal GDP growth (θ):

$$OB = ((-\theta)/(1 + \theta))D$$

Assuming that potential medium-term real growth ranges between 5 to 6 percent for countries in the region in line with current IMF projections and taking the BCEAO's objective of an inflation rate of 2 percent (+/- 1 percent band), would yield an estimate of nominal potential growth rate of between 6 and 9 percent. This implies that the 3 percent of GDP ceiling embedded in the current framework would stabilize debt between 40 to 50 percent of GDP, which is close to current debt levels for several countries in the WAEMU.

Naturally, modestly higher deficits may be compatible with a higher debt ceiling. A 4 percent deficit ceiling would stabilize debt at around 70 percent of GDP, if a nominal growth rate of 6 percent is assumed.

⁷ For a discussion on the pros and cons of having differentiated fiscal rules including ceilings, see section B below.

⁸ Article 7 of Additional Act no. 01/2015/CM/UEMOA.

Considering a nominal growth rate of 8 percent, a 4 percent of GDP deficit would stabilize debt at 54 percent of GDP.

However, an increase in the deficit ceiling may be associated with several risks.⁹ First, the shift to a 4 percent of GDP fiscal deficit ceiling would likely increase the deficit path in the region. In fact, international experience with deficit ceilings suggests that they tend to become a “focal” point with countries converging to the ceiling over time (from initial levels above and below it). This would have important macroeconomic implications that need to be taken into account when considering a revision of the deficit target.

Second, from the point of view of external stability, permanently wider fiscal deficits could have implications for the sustainability of the currency peg in the WAEMU, given that they would likely constitute a net drain on international reserves. Larger deficits would have a direct impact on reserves through higher imports, but could also have adverse effects on competitiveness through real exchange rate appreciation.

Third, wider deficits will affect the absorptive capacity of the regional market and lead to crowding-out effects. At least part of the wider fiscal deficits would likely need to be accommodated by the regional market. Given the lack of liquidity in the regional market for sovereign bonds (IMF 2021), additional borrowing requirements could create financial pressures, particularly if banks (by far the most important players in the market) cannot accommodate them. This could result in a tightening of financial conditions and crowding-out of financing for the private sector. Overall, the analysis does not support a significant revision of fiscal rule targets in the WAEMU.

Fiscal Rules Design

Under the stability phase, the 2015 reform had considered the possibility of shifting to a structural deficit rule in replacement of the 3 percent of GDP nominal deficit ceiling. A specific methodology has not yet been specified to make this concept operational. This section explores different fiscal rules to assess whether there is merit in changing again the definition of the deficit rule or introducing alternative rules,

Well-designed rules can help build and preserve fiscal space. But not all rules are born equal. Some rule designs perform better than others when it comes to containing the deficit bias. Rules need to ensure fiscal sustainability and economic stabilization and also need to show efficacy—that is: be simple, have clear operational guidance¹⁰, be resilient and be easy to monitor and enforce (IMF, 2018b).

The first option for the WAEMU is to retain the nominal deficit ceiling. International experience with such rules is mixed. On the one hand, such rules are easy to communicate to the public, and can be effective in preserving debt sustainability since the overall budget balance is closely linked to debt dynamics. They are also easy to compute, monitor and enforce because they are not subject to adjustments or to the exclusion of specific items. On the other hand, they often lead to a procyclical fiscal stance and, perhaps more importantly, a drift of public debt. This is because they force policy makers to offset a cyclical decline in revenues in bad times but cannot prevent countries from spending windfall revenues in good times (Blanchard and Giavazzi, 2004).

To address the procyclicality problem, alternative operational rules could be considered but they tend to be less attractive than a nominal deficit rule. A first option is a cyclically-adjusted balance rule which imposes limits on the overall balance, correcting for the effects of business fluctuations on revenue and expenditure (Fedelino, Horton and Ivanova, 2009). Cyclically-adjusted balances are commonly measured in relation to an estimate of

⁹ The quantitative simulation of macroeconomic scenarios that incorporate these considerations goes beyond the scope of this paper. For further analysis, see Bebee and others (2022).

¹⁰ Operational guidance refers to the possibility to translate the rule into clear guidance in the annual budget process. Resilience refers to the desirability that rules should be in place for a sustained period to build credibility and should not be easily abandoned after a shock (IMF, 2018a).

potential output, which helps account for what the fiscal balance would be if the output gap were closed. Cyclically-adjusted rules have many advantages including better stabilization of the path of expenditure and a countercyclical ability since they do not force governments to cut spending during downturns. However, their monitoring and enforcement are challenging owing to technical issues and difficulties in computing timely and reliable estimates of the output gap.¹¹

A second option, also envisaged by WAEMU legislations during the stability phase, is a shift to a structural balance rule (SBR). The latter is an extension of the cyclically-adjusted rules but in addition to correcting for the effects of the business cycle, they also correct for revenue and spending for one-off fiscal measures and other economic cycles such as those related to commodity or asset prices. One advantage of SBRs is that they can provide greater economic stabilization than cyclically-adjusted balance rules, especially as they could prevent countries from spending one-off revenues or revenues related to an asset price boom, thus reducing the volatility of spending. Yet, in practice, SBRs, like CABs, have had a poor track record (see for example, Tereanu, Tuladhar, and Simone. 2014). The main reason is that countries tended to overestimate potential output and underestimate the output gap; therefore, SBRs tend to allow excessive spending. In addition, these rules can be complicated to implement—even more so than cyclically-adjusted balance rules and especially in developing and emerging economies, where it is difficult to measure the business cycle due to supply shocks and catch-up processes.

A third option is to introduce an expenditure rule, which sets limits on total, primary or current spending (measured in real or nominal terms). Expenditure rules have been typically set in terms of levels or growth rates (and occasionally in percent of GDP), with a time horizon that typically ranges from three to five years (Lledó and others, 2017). Such rules are generally easier to understand, monitor, and enforce, because they target a part of the budget that policy makers control most directly and that is visible and well known to the public. As a result, expenditure rules tend to have higher compliance rates than other rules (Cordes and others 2015). This rule can also contribute to achieve a broadly similar degree of macroeconomic stabilization with a smaller deficit bias (by constraining spending during temporary economic booms, when windfall revenue receipts are high and nominal deficit limits are easy to comply with (Eyraud and others, 2018). Nevertheless, an important drawback of expenditure rules is that, unless they take into account possible revenue measures, they may discourage revenue mobilization, which is a central policy objective for developing countries.

Based on the arguments discussed previously, it appears that on balance, a rule focusing on the nominal headline deficit appears to be the most appropriate for the WAEMU given that its advantages outweigh its drawbacks. However, a related and natural question is whether the fiscal framework should depart from the current model where rules are uniform across all countries and introduce some differentiation, for example for commodity exporters versus importers, for example. The differentiation could be motivated by the fact that WAEMU countries have different capacity to repay debt and different initial conditions. Recently, some proposals have been made in this direction in the context of the Euro Area (Martin, Pisani-Ferry, and Ragot, 2021).

Nevertheless, it is important to bear in mind that such differentiation across countries could be complex to implement. In fact, there is little historical precedent to rules differentiation within a currency union. Differentiation of rules would probably make fiscal coordination and monitoring more complex than under the current framework. Moreover, in the context of WAEMU member states, it may be difficult to calibrate country-specific debt ceilings due to a number of constraints, not least data availability. For instance, when estimating the debt limit, it could be difficult to ascertain how maximum primary balances and interest-growth differentials under stress vary across countries.

¹¹ For more information on cyclically adjusted rules, see IMF (2018b).

Fiscal Rules Enforcement

To make rules more effective and enhance compliance, specific enforcement mechanisms need to be in place, such as: (i) an independent entity monitoring the rule; (ii) escape clauses for authorized deviations from the rule; (iii) correction mechanisms as well as sanctions for unauthorized deviations. The rest of the section examines these institutions in greater detail.

Rule Monitoring

Under the WAEMU framework, the Commission monitors compliance with the rules through the multilateral surveillance mechanism. For this purpose, it issues decisions specifying the types of information required for surveillance. Members on a regular basis transmit it to the Commission, including statistical data and information related to economic policy measures. It publishes two reports per year, which are examined in June and December by the Council of Ministers. The reports discuss the convergence of economic policies and their consistency with the Union's monetary policy. The June report assesses members' macroeconomic performance, including with respect to the first-order and second-order convergence criteria for the preceding year, and on this basis reviews macroeconomic objectives for the current year. The December report focuses on the budget law and on forward looking five-year convergence plans that member countries must submit by end-October at the latest.

During the first convergence plans (1996-2014), the role of the WAEMU Commission in effective fiscal surveillance seemed relatively weak. In fact, despite repeated breaches, financial sanctions were never imposed. In addition, the WAEMU Commission encountered difficulties in collecting information (especially on arrears) (Hitaj, 2016). With the 2015 reform, actions were taken to strengthen the enforcement mechanisms through enhancing the administrative capacity of the WAEMU commission and encouraging voluntary compliance through outreach missions to member states.

However, there is still scope for reforms that ensure better compliance from member states with fiscal rules. Going forward, it could be beneficial to strengthen the independent enforcer role of the WAEMU Commission, but this would require an increase in its capacity and a rebalancing of power vis-à-vis the Council of Ministers. This would likely require amending the WAEMU Treaty, which may be long and complex process. It is worth noting that issues related to enforcement powers have been, to some extent, addressed in the European Union by changing the voting rule system and adopting a reverse qualified majority voting rule, which gives more power to the European Commission in imposing sanctions in relation to economic governance issues. Under this procedure, a European Commission recommendation is deemed adopted unless the Council decides by qualified majority to reject the recommendation within a given deadline that starts to run from the adoption of such a recommendation by the Commission.

Escape Clauses (in Case of Authorized Deviations)

According to international best practices, fiscal rules should be sufficiently flexible to manage unexpected and extraordinary economic or other large shocks (Eyraud and others, 2018). Under these circumstances, escape clauses for fiscal rules could allow for a temporary deterioration of the fiscal position to provide space for discretionary fiscal support. Such clauses need to be extremely well-designed. Otherwise, there is a clear risk that fiscal rules be put in abeyance following large shocks, or that countries resort to ad-hoc measures to accommodate them. A well-defined escape clause should therefore specify: (i) a limited and clearly defined set of events triggering the action of the clause, (ii) the authority responsible for activating it, (iii) the timeline and procedures to revert to the rule, (iv) an effective control mechanism; and (v) a good communication strategy (IMF, 2020).

Under the WAEMU framework, the Commission can propose to the Council of Ministers the activation of escape clauses when a country faces exceptional circumstances;¹² in this case, the obligation to comply with first-order criteria can be temporarily lifted.¹³ The Commission can also propose a directive accompanying the activation in which the terms, such as the size and the duration of the deviation, can be defined. The member government is then required to propose a set of corrective measures within 30 days to comply with the directive.¹⁴

However, there is still scope for improving the design of escape clauses in the WAEMU framework along three aspects.

First, triggers of the escape clauses under the WAEMU framework could be defined more precisely. Country experiences showed that, to preserve the credibility and effectiveness of the system of fiscal rules, trigger events of escape clauses need to be precisely defined and be limited to a pre-determined set of events that are truly outside the government's control. There should also be clear guidelines on the interpretation of events which should preferably be defined in quantitative terms (IMF, 2009).¹⁵ Meanwhile, under the WAEMU framework, the circumstances covered by the escape clauses are relatively vague (only described as "exceptional circumstances"), although regulation 11/99/CM/UEMOA has provided some criteria related to government revenues and real GDP. In particular, the WAEMU would benefit from introducing more specific criteria for the activation of clauses under exceptional events such as severe economic downturns or natural disasters. These two types of escape clauses are quite common in fiscal rules systems around the world and can be defined with some degree of precision and quantified triggers. Vague escape clauses like "emergency situation" or "public calamities" should be avoided because they allow too much discretion in interpreting trigger events.

Escape clauses for persistent security problems may also be questionable to the extent that such situations may not constitute exceptional events and would require adjusting the fiscal stance rather than deviating repeatedly from fiscal targets. In fact, some WAEMU countries experienced significant security incidents over the past two decades, the most recent of which is the lingering security crisis in the Sahel region since 2012.¹⁶ Also, estimating the impact of security and health shocks on the fiscal balance could be very complex, given their wide-ranging effects on both government spending and revenue.

Second, the activation of escape clauses in the WAEMU should follow a well-specified and transparent process that preserves the credibility of the fiscal rule. Such a process should involve the announcement of the activation by the responsible authority and a timeline and procedures to revert to the rule. The suspension in April 2020 of the application of the Union's Pact for Convergence, Stability, Growth and Solidarity among its member-countries – while justified to provide additional fiscal space—did not occur in reference to a well-defined escape clause. Rather, the suspension seemed to have occurred in an ad-hoc manner following the Declaration by the WAEMU Heads of States.

To improve the activation process of the escape clause, it is important to communicate publicly and in more details on the procedures to transition back to the rule for member countries. The 2002 Declaration mentioned that the suspension of the fiscal rules would be temporary and encouraged member states to implement fiscal consolidation after the crisis (WAEMU, 2020). However, it did not make explicit references to

¹² Article 71 of WAEMU 2003 Modified Treaty.

¹³ In the convergence phase, there are three first-order convergence criteria. Of the three criteria, the fiscal deficit and debt ceilings can only be tested *de facto*. The third criterion on the inflation ceiling is not fully under the control of the member countries, as it depends on the regional monetary policy stance and the exchange rate arrangement.

¹⁴ Article 73 of WAEMU 2003 Modified Treaty.

¹⁵ Escape clauses should be solely used for unforeseen realizations of fiscal risk and not for predictable events that could occur and lead to business cycle fluctuations.

¹⁶ For more information, please see Féler and others (2021).

the triggers of the escape clauses, what was the expected size and duration of the deviation, how long the suspension would last, when consolidation would resume, what is the advised path to return to the 3 percent ceiling and the type of correction measures needed to offset the accumulated deviation. All these details related to process of returning to the rule need to be well communicated to ensure transparency and preserve the credibility of the fiscal framework.

Third, institutional reforms could also ensure that the activation of the escape clause is not subject to excessive political influence. The process in the WAEMU is somewhat similar to the European Union. For the latter, the decision of European Council to invoke the general escape clause of the Stability and Growth Pact is also based on a recommendation of the European Commission. However, the latter has the responsibility to confirm that conditions for triggering the clause have been fulfilled, an aspect that is not explicitly defined in the WAEMU framework. More importantly, the activation of the escape clause in the European Union does not suspend the procedures of the Stability and Growth Pact. It simply allows the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact, while departing from the budgetary requirements that would normally apply.

Correction Mechanisms and Sanctions (in Case of Unauthorized Deviations)

Correction mechanisms correspond to a formal set of measures that aim to specify a path back to compliance following an unauthorized breach or a projected breach—that is a deviation outside the conditions specified by the escape clause. In the WAEMU context, such mechanisms can be useful to avoid permanent drifting of public debt and to defend the peg.

The WAEMU Treaty specified corrective measures, which can be taken to promote compliance with regional convergence criteria. During *the convergence phase*, a breach of a first-order criterion requires the country to implement corrective measures that are proposed by the Commission and approved by the Council of Ministers by two-thirds majority of its members.¹⁷ When a country already complies with all first-order criteria but the Commission considers its national convergence plan to be inadequate and the breach to be likely in the future (Commission's December reports), it recommends to the Council of Ministers to request the member government to resubmit an appropriately revised plan within 30 days.¹⁸ A member's compliance with this requirement is assessed in the June report of the following year. During *the stability phase*, corrective measures are required by the Council of Ministers when there is a breach of the first-order criteria observed by the Commission, but only recommendations are issued for projected breaches. In both the convergence and stability phases, failure to implement appropriate corrective measures could lead to sanctions imposed by the Council of Ministers. Overall, the current correction mechanisms framework (for both actual and expected deviations) appears vague and lacks guidance—in particular, it does not cover the pace of correction, risks, milestones and deadlines, supervisory requirements, and economic cost.

As described above, the authority to enforce correction mechanisms lies with the Council of Ministers rather than with the WAEMU Commission. Tilting the balance in favor of the latter could be achieved by reforms broadening its powers, improving its accountability while enhancing the transparency of the decision-making process at the Council of Ministers. Measures could include (i) granting the Commission the authority to determine non-compliance with fiscal rules, (ii) requiring that the Commission submits recommendations on the application of enforcement measures to the Council of Ministers, (iii) ensuring that such recommendations are adopted unless rejected by a qualified majority voting of the Council. These improvements to the current correction mechanisms framework must also be legally reflected in both the WAEMU Treaty as well as the regional directives of the budget framework and the transparency code.

¹⁷ Article 18-22 of Additional Act no. 01/2015/CCEG/UEMOA.

¹⁸ Article 18 of Additional Act no. 01/2015/CCEG/UEMOA.

Tuning to sanctions, the system could be made more effective by increasing reputational costs.¹⁹ During the WAEMU framework's convergence phase, national fiscal deficits were deemed excessive when they failed to converge continuously towards the 3 percent of GDP ceiling. Article 74 of WAEMU's Modified Treaty provides that member countries which fail to propose and execute appropriate corrective measures for excessive fiscal deficits may be liable to sanctions of declarative or financial nature. These are (i) the publication of a statement by the Council of Ministers, possibly accompanied by additional information on the situation of the member state facing sanctions, (ii) the publicly announced withdrawal of any positive measures that may have benefited the member state, (iii) the recommendation to the West African Development Bank to review its policy of interventions in favor of the member state, and (iv) the suspension of the Union's assistance to the member state. However, these foreseen sanctions, which are mostly of a financial nature, lack credibility and may be counter-productive (because the loss in resources worsens the fiscal position of countries in breach).

In practice, financial sanctions have never been applied in the WAEMU when member states failed to comply with fiscal rules. International experience showed that financial sanctions often lacked credibility for two reasons (Eyraud and others, 2018). First, financial sanctions exacerbate the financial difficulties of already distressed governments, limiting the appropriateness of such sanctions and their scope for use in bad times. Second, and more important, high-profile sanctions carry a stigma and a high political cost that make their application very unlikely. Meanwhile, reputational sanctions were, in general, found to be more effective, at least in Europe (Eyraud and others, 2018). But the WAEMU framework provides for relatively weak reputational sanctions (publication of the situation of the country and the publicly announced withdrawal of any positive measures).

A more effective way of raising reputational costs would be to set up independent national fiscal councils, which would be responsible for conducting a public independent assessment and monitoring of public finances. By fostering transparency, promoting a culture of stability and accountability, and assessing the conduct of fiscal policy (and compliance with fiscal rules), they can raise reputational and electoral costs of unsustainable policies and broken commitments (IMF, 2013). Existing evidence also indicates that well-designed fiscal councils could be associated with stronger fiscal performance.

Experience shows that, to have material impact, fiscal councils need to be home-grown—this would imply creating eight national councils in the WAEMU. In countries with limited human resources and financial capacity, one possibility would be to associate these national councils with other existing independent institutions (IMF, 2013). That approach would allow the fiscal council to immediately benefit from the independence of its host and from economies of scale but requires clear procedures to avoid confusion regarding the respective mandates and functions. For instance, some responsibilities for rule monitoring and enforcement could be devolved to national BCEAO offices, which are already well-staffed and independent.²⁰ An alternative option could be to create a single regional fiscal council, which would be tasked with assessing the fiscal policy and compliance with rules of all member states.

¹⁹ Sanctions are penalties that are automatically applied in case of noncompliance with a fiscal rule. They are imposed without any further action required to return back to the rule. Meanwhile, correction mechanisms require that a path back to compliance is specified following a breach, to avoid drifting away from the fiscal anchor (Eyraud and others, 2018).

²⁰ Devolving these responsibilities to statistical offices or other judicial institutions does not seem adequate in the case of WAEMU because these institutions lack appropriate capacity for monitoring and enforcement.

Public Financial Management Reforms

The second pillar for regional fiscal coordination is a sound framework for public financial management. As mentioned earlier, the latter is paramount to support the effective implementation of fiscal policy. To this end, the WAEMU region began moving toward harmonizing budget laws and procedures starting in the late 1990s, including budget and accounting laws and laws governing public accounting and the chart of accounts. The 2015 revision of the fiscal framework also stressed the need for member countries to continue to work on these aspects.

Some progress towards shared PFM systems was observed in 2009 with the revision of the regional PFM directives and their adoption by the Council of Ministers. The 6 regional directives originally adopted in 2009 aimed at providing a common framework for better and more transparent PFM practices (Table 4). They followed international best standards in harmonizing the presentation of fiscal statistics across member countries according to the GFSM 2001 standards; strengthening accountability of public expenditure by fostering the transition to results-based budgeting and clarifying the responsibility lines; and buttressing internal financial controls over budgetary execution. The directives do not, however, provide guidance on fiscal risk management. The WAEMU commission regularly undertakes a self-assessment of the PFM reforms required by the directives. The self-assessment exercise is intended to have a positive impact on encouraging reforms and leading to visible improvements in performance. Moreover, two additional regional directives related to accounting materials and the financial regime for territorial collectivities were adopted in 2011.

However, these *de jure* PFM improvements at the regional level currently remain impeded by obstacles at the national level. Initially, there were delays with respect to the *transposition* of the directives into national legislations which was expected to take effect by end-2011. This first deadline was missed, and other deadlines were set, but by end-2019, all WAEMU countries had transposed the six PFM directives.²¹

With regards to *implementation* of the transposed directives, the WAEMU Commission had set a five-year period for member countries to implement all 6 regional directives by January 2017. However, progress was slow and uneven among member countries and across reform areas. Older assessments by the WAEMU had shown that there was a rather quick implementation of provisions relating to public information and budget formulation, which came into effect in 2012. Meanwhile, the implementation of the remaining provisions, mainly relating to budget execution and controls, lagged behind and missed the 2017 deadline.

The 2021 evaluation showed good progress compared to recent years though there is still scope for further advancement to meet the objectives set in 2009: adopting a common budget nomenclature and improving the presentation of fiscal accounts both seem relatively advanced, the adoption of regulations and required manuals to improve internal expenditure controls and transparency of accounts continue to lag behind despite quicker progress in recent years (Table 3).

²¹ In order for the regional directives to become fully operational, two steps are needed. First, Transposition requires that member countries submit their draft law to the WAEMU Commission for the latter's assessment of conformity. In a second step, recommendations of the Commission are then embedded in the finalized law which can be approved. This process is meant to ensure coherence between the regional and national PFM legal and regulatory frameworks.

Table 3. WAEMU: National Implementation of the 6 Regional Directives in Public Financial Management, 2021

(Percent completion)

Directives	Be nin	Bu rkina Faso	Cô te d'Ivoire	Gu inea Bissau	Ma li	Ni ger	Se negal	To go
No. 01/2009/CM/UEMOA on Transparency Code	75	70	84	66	64	80	86	81
No. 06/2009/CM/UEMOA on Framework Budget Law	96	93	82	9	82	84	76	75
No. 07/2009/CM/UEMOA on General Regulations of Public Accounting	95	90	77	9	91	81	91	87
No. 08/2009/CM/UEMOA on Common Budget Nomenclature	10 0	10 0	10 0	92	10 0	10 0	10 0	10 0
No. 09/2009/CM/UEMOA on Accountancy Plan	58	94	74	50	91	73	59	10 0
No. 10/2009/CM/UEMOA on Fiscal Statistics	55	55	54	40	28	43	50	45

¹ Red: percent completion under 40 percent; Orange: percent completion between 40 percent and 80 percent; Green: percent completion above 80 percent.
Source: WAEMU Commission

In addition, the effectiveness of the *de jure* PFM improvements at the regional level have also been undermined by continued harmful PFM practices. These practices have contributed to the disconnect between the evolution of the deficit and the debt levels, suggesting that deficit rule was not always effective in preventing debt accumulation and fostering fiscal discipline. This disconnect was partly due to non-negligible stock-flow adjustments (SFA) which accounted on average for more than 1 percent of GDP between 2013 and 2019 (Box 1).²² While some of these SFA operations reflected good PFM practices, others were due to severe PFM deficiencies in budget execution, such as spending occasionally taking place outside of the normal expenditure chain. In some cases, this spending was associated with the abuse of exceptional procedures that were used during emergency situations and in others, spending simply circumvented regular expenditure controls or other budgetary rules including those related to budget time limits, approved ceilings and in some cases even approved appropriations (Imbert and others, 2022).²³ These PFM irregularities could have been an important cause of expenditure overruns, as spending was often executed without corresponding approved appropriations and formal commitments and were thus not adequately recorded in fiscal accounts. As a result, the true scale of public expenditure is likely to have been concealed and may have led to underestimated fiscal

²² The SFA is the outcome of an accounting debt decomposition exercise and it captures the increase in public debt that cannot be explained by the fiscal deficit (adjusted for exchange rate valuations and GDP growth).

²³ Existing assessments indicate that controls in WAEMU countries are generally perceived to be very cumbersome - rigid, redundant, and slow - and to have contributed to the proliferation and overexploitation of unorthodox procedures over time (Doe and Pattanayak, 2008).

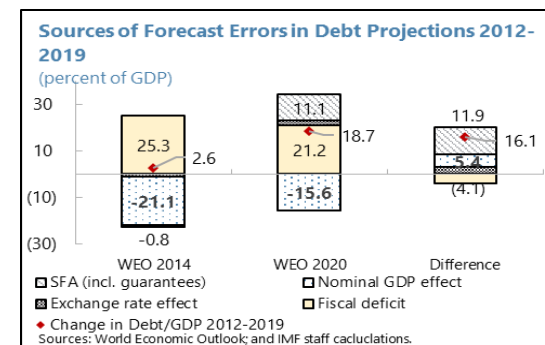
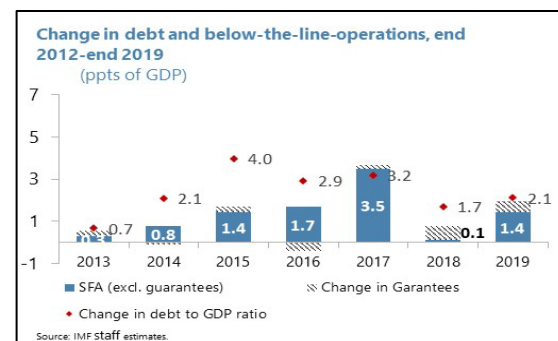
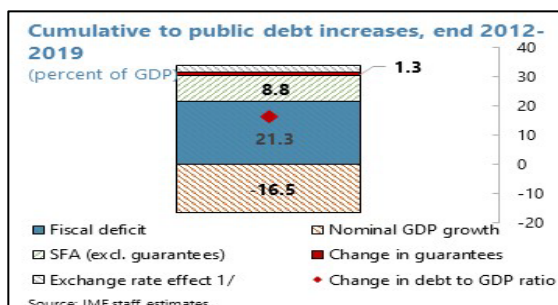
deficits on a commitment basis.²⁴

Box 1. Public Debt Dynamics and Stock-Flow Adjustments (SFA) over 2012-19

WAEMU public debt levels have increased significantly since 2012. An accounting decomposition of the main drivers of debt dynamics shows that about two-thirds of the debt increase was due to cumulated fiscal deficits, while about a third arose from cumulative SFA (abstracting from automatic debt dynamics of growth and exchange rate).

SFA averaged about 1.3 percent of GDP per year between 2013 and 2019. They peaked in 2017 (3.3 percent of GDP) due to a one-off operation related to the expansion of the debt perimeter in Senegal. SFA reflect a mix of sound and poor budget management practices. While the arrears clearance in Côte d'Ivoire in 2018 and the extension of the debt perimeter in Senegal in 2017 are consistent with best PFM standards, some of the SFA also reflected off-budget spending, such as prefinancing schemes in Benin, Togo and Senegal as well as treasury financing of persistent deficits of SOEs in Senegal.

The debt ratio increased by about 17 percentage points of GDP between end-2012 and end-2019, while, at the time of the October 2014 WEO vintage, the debt ratio was projected by staff to increase slightly (by 2 percent of GDP) over the same period. An analysis of the sources of the forecast errors shows that errors came mostly from an underestimation of SFA, which was also the main factor behind forecast errors on debt projections.



Going forward and to ensure that the 3 percent deficit rule remains an effective tool to constrain the debt trajectory, enhancing the PFM system should be a priority. To this end, it is critical for member countries to expedite the implementation of the directives at the national level. A number of reasons could explain the implementation delays observed so far. First, it could be that PFM reforms were highly ambitious to begin with and required a longer implementation period. Second, the directives entailed enhanced budget transparency which may be currently difficult to enforce in WAEMU member states given the increased security spending in response to terrorism (subject to military secrecy and confidentiality). Third, for some WAEMU countries, there have been delays in much-needed technical assistance to help officials complete the implementation process. In this regard, it is important to further upgrade member state capacity in macro-fiscal forecasting to ensure reliable and timely data provision. Reliable forecasts would mitigate risks that large deviations from the

²⁴ Irregularities in fiscal accounting can often lead to differences between above-the-line fiscal balance and below-the-line net financing data and in large stock-flow discrepancies between government debt and deficits (Khemani and Wiest, 2016).

announced policy stance undermine the credibility of the fiscal rule (IMF, 2009). Moreover, it would also allow some degree of internal monitoring of the adherence to the rule and may also foster ownership of the rule at the national level. In tandem, member countries could also increase transparency of macro-fiscal forecasts and commit to a more comprehensive and timely fiscal reporting. Other practical difficulties in advancing the PFM reform agenda include limitations of national budgetary and accounting systems, challenges in implementing accrual accounting, and limited access to budgetary information by the general public.

Fiscal Risk Sharing and Coordination Mechanisms

The third pillar of fiscal discipline in a currency union is the introduction of explicit coordination mechanisms. They pertain to various areas of public finances—taxes, expenditures, and financing. Their purpose is to prompt countries to take into consideration the effect of their policy actions on other member states. Without coordination, cross-country spillovers could lead to inadequate national policies. For instance, countries may underinvest in expenditure programs that benefit other countries of the union.

There is a case for enhancing tax coordination in the WAEMU. The WAEMU Treaty has placed emphasis on reducing existing excessive disparities in the tax structure among member states. The framework of tax coordination in the WAEMU is one of the most advanced in the world *de jure*, but remains in many areas ineffective *de facto*, partly because some directives are not well implemented by member states (Mansour and Rota-Graziosi, 2013; Diakité and others, 2017 and World Bank, 2019). In addition, some regional tax directives may need to be revised to give priority to curbing the use of tax incentives through investment and sectoral codes as well as raising minimum rates of excises. Finally, the regional framework governing tax policy coordination could be strengthened by effective monitoring and sanctioning mechanisms. To date, no WAEMU country fully adheres to the tax directives. Moreover, the WAEMU Court of Justice has never heard a single case on public finances, suggesting that current monitoring and sanctions mechanisms are not being enforced (Fahner, 2021). In this regard, the WAEMU Commission could initiate a review of the region's tax coordination framework to ensure that directives remain well-designed and to identify specific weaknesses in implementation and compliance. This endeavor would be most successful if undertaken in collaboration with national authorities to ensure ownership of the reforms. In parallel, there is also merit in undertaking a detailed review of member countries legislation to identify gaps and promote greater adherence to the provisions found in the directives.

The path to reach the second-order convergence criterion on tax revenue will be difficult. The 2021 tax to GDP ratio at the WAEMU level is estimated at 13.2 percent of GDP—still well below the 20 percent of GDP floor. In June 2019, the Council of Ministers adopted an action plan to help countries reach the convergence criterion on tax revenue and increase fiscal space for investment spending. The action plan aims at improving and standardizing VAT collection, excise duty, and direct tax collection. It also defines actions to improve collaboration and coordination by reducing tax competition among union members and strengthening information exchange and digitalization efforts.

Another area where coordination is beneficial in a currency union is the management of large idiosyncratic shocks with contagion effects. An example of such shocks is an epidemic like the Ebola outbreak or security shocks affecting some WAEMU countries (Feler and others, 2021). Large idiosyncratic shocks can have spillover effects. For instance, if the policy response of a country affected by an epidemic is insufficient, this

epidemic can spread and lead to cross-border migrations, raising the budgetary cost for other member states. To address this issue, the following three main approaches could be considered:

- Compensate temporary deviations from the deficit rules in countries affected by shocks with additional fiscal efforts in countries that are not impacted. The first approach is to use the rules' escape clauses (provided that they are well defined) to allow member states hit by a large shock to benefit from a temporary relaxation of the rules and/or a slower convergence path back to the deficit target. At the same time, unaffected countries would have to make extra efforts to ensure that the aggregate fiscal stance of the union remains unchanged. However, this option may be difficult to implement, both from an operational and political point of view. It may be complicated to quantify how much deviation should be allowed. Also, while affected countries would make (legitimate) use of the provision, nonaffected countries may face little incentives to do extra efforts, resulting in a looser aggregate stance. Finally, this approach may impair the credibility of the overall rule system (since a rule is, by definition, a lasting constraint that is not expected to change too often).
- A regional stabilization fund. This fiscal sharing mechanism would provide temporary transfers to countries affected by a negative asymmetric macroeconomic shock and could be financed by annual contributions from member states.²⁵ Basdevant and others (2015) suggested that, for the WAEMU, a simple, automatic, and non-regressive system of transfers ranging between 0.75 to 1.25 percent of GDP would smooth income in a comparable way to what occurs in federal states. Transfers would be proportional to: (1) the size of the shocks, (2) the relative size of each economy compared with the rest of the union, and (3) the resources accumulated in the fund each year. If no country was affected by a negative shock, then no disbursement would take place and contributions would be saved in the fund. The authors also suggested that regional bonds issuance could be an additional source of financing for the fund but that this measure would need to be complemented by carefully designed fiscal integration.

Work towards a larger union budget. Another approach would be to pool risks through a small and targeted common budget, which could be deployed as health emergency allocations for instance. This is difficult to achieve and perhaps a more medium-term endeavor. As of now, the WAEMU budget is small, representing only 0.2 percent of the region's GDP (CFAF 205 billion in 2019). By comparison, the European Union budget amounts to 1 percent of EU GDP.

²⁵ In the case of the euro zone, there is evidence that risk-sharing through a regional fund could provide full insurance against very severe, persistent and unanticipated downturns (Furceri and Zdzienicka, 2013).

Conclusion

This paper has assessed the effectiveness of the WAEMU regional fiscal surveillance framework along three pillars that prove to effectively support fiscal discipline in a monetary union—common fiscal rules, shared public financial management systems, and coordination mechanisms for decentralized fiscal policies.

Two main conclusions of the analysis could be highlighted. First, the calibration exercise of regional debt and fiscal ceilings concludes that the debt and deficit ceilings that prevailed before the suspension of the rule (70 percent of GDP for the former and 3 percent of GDP for the latter) remain adequate targets and strike a good balance between growth and development considerations and fiscal sustainability. Second, keeping the deficit ceiling in headline nominal terms seems more suitable than structural or cyclically-adjusted balance rules in the WAEMU context, given the practical difficulties in effectively implementing, monitoring, and communicating such rules.

Going forward, fiscal consolidation during the coming years is needed and would require a well-designed fiscal framework, one which would also include better fiscal discipline and coordination. To this end, there are a number of reforms of the three pillars discussed in the paper that could strengthen the WAEMU regional framework.

First, there is scope to *strengthen the design and enforcement* of the WAEMU fiscal governance framework. Reforms that could enhance compliance with fiscal rules include: (i) strengthening monitoring by bolstering the independent enforcer role of the WAEMU Commission; (ii) enhancing the credibility of escape clauses for authorized deviations from the rule including by clearly defining triggers as well as the timeline and procedures to revert to the rule, and (iii) and redefining correction mechanisms as well as sanctions for unauthorized deviations including by increasing reputational costs.

A second avenue of reforms is *enhancing PFM* to contain stock-flow adjustments, prevent a buildup of fiscal imbalances and tighten the link between the evolution of fiscal and debt targets. In this regard, member countries must accelerate the implementation of the regional directives on PFM reforms, especially those related to improving internal expenditure controls and transparency of accounts. Moreover, regional action should be complemented by efforts to improve discipline at the national level to minimize deviations from approved budget appropriations and impose stricter compliance with expenditure controls. National action could aim to: (i) establishing clear legal frameworks for budget execution that restrict the use of exceptional and other simplified procedures – which have often been a source of below-the-line operations - to very limited cases, (ii) streamlining expenditure controls under the normal chain of expenditure so that they become to become less cumbersome and less redundant, and therefore reduce incentives for recourse to less stringent and ad hoc procedures and (iii) adopting automated tools in the Financial Management Information System of fiscal reporting (Imbert and others, 2022).

Finally, *fiscal coordination* mechanisms are critical to allow WAEMU countries to address shocks, especially asymmetric ones. One area of reform involves enhancing tax coordination through effective implementation and compliance with directives, as well as revising some regional tax directives to curb the use of tax incentives. Another area is to enhance fiscal risk sharing to manage idiosyncratic shocks. A more ambitious long-term project is to work towards a small union budget.

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Appendix 1. Thinking about the Maximum Debt Limit for the WAEMU

This appendix describes the steps followed to calculate the maximum debt limit for the WAEMU following two distinct approaches. The first one focuses on the principle of “fiscal fatigue” (Gosh et al., 2013), while the second puts emphasis on the preservation of debt servicing capacity.

Fiscal Fatigue

The approach based on the concept of “fiscal fatigue” consists in estimating the limit above which debt cannot be stabilized in times of fiscal stress. The main idea is that policymakers cannot do “whatever it takes” to generate primary surpluses to stabilize debt in a very unfavorable macroeconomic environment (Gosh et al., 2013).

This maximum debt level is reached when negative macroeconomic conditions, measured more specifically by the interest-growth differential, create an upward pressure on debt, but the government cannot increase the primary balance to offset this pressure due to political economy or other constraints. We approximate the maximum debt level that could be stabilized under stress by calculating the ratio of the maximum achievable primary balance to the interest rate-economic growth differential ($r-g$) under stress:

$$D^* = PB_{max} / (r - g)_{stress}$$

Based on data from the April 2021 vintage of the WEO database, we calculate that the 95th percentile of the distribution of the interest-growth differential (based on effective interest rates on debt) for countries in the region stands at around 3.3 percent. Regarding the maximum achievable primary balance, using historical evidence from the WEO dataset since 1996, we calculate the 95th percentile of the distribution of primary balances for WAEMU countries and find a value of 2.7 percent of GDP. This maximum primary surplus would result in a debt limit of 80 percent of GDP.

Preserving Debt Servicing Capacity

Another approach to estimate the maximum debt limit is based on the principle of preserving debt carrying capacity. More specifically, the approach focuses on the ratio of interest expenses to revenues (excluding grants), as an indicator of the ability to repay debt. Arguably, for sub-Saharan African countries, given low revenue mobilization, a measure of this ability to repay debt is more relevant for sustainability than the debt level per se. In fact, empirical evidence shows that the interest to revenue ratio is tightly linked to fiscal stress in emerging markets and developing economies (Bentum, David, Slavov, and Sode, 2022). In addition, econometric models suggest that thresholds for the ratio that would signal upcoming fiscal stress would range from 16 to 19 percent. Based on these thresholds for the interest to revenue ratio, denoted τ , we can obtain the associated debt limit level beyond which fiscal stress is likely by using the following relationship:

$$D^* = \tau \left(\frac{Revenues/GDP}{Effective\ Interest\ Rate} \right)$$

Using the average revenue (excluding grants) to GDP ratio and average effective interest rates over 2015-2019 for the WAEMU, one would obtain the debt limits outlined in Table 2 depending on the threshold used.

Appendix Table. Estimates of the Debt Limit

	Threshold	
	16%	19%
Revenue/GDP	14.9%	14.9%
Effective Interest Rate	3.3%	3.3%
Debt Limit	72%	86%

Source: Authors' estimates based on WEO database.

Overall, the results indicate that considering a debt limit of around 80 percent of GDP for the WAEMU seems appropriate. This is the simple average of debt limit obtained under the different approaches considered.



PUBLICATIONS