Program

1. Fiscal Policy, Macroeconomic Stability, & Medium-Long Term Growth
   Samuel N. Ashong

2. Fiscal Policy, Macroeconomic Stability & Medium-Long Term Growth
   Cletus K. Dordunoo

3. Monetary Policy, Exchange Rate Policy, Macroeconomic Stability & Medium Term Growth
   Charles D. Jebuni

4. Aid, Debt Management, Macroeconomic Stability & Medium Term Growth
   Mahamudu Bawumia

5. Investment, Medium-Long Term Growth & Employment Generation in Ghana
   Yaw Asante

   Ravi Kanbur

7. A Note on Public Expenditure & Poverty Reduction
   Abena D. Oduro

8. Why the Limited Impact of Social Sector Spending on Poverty Reduction in Ghana?
   Anthony Tsekpo

9. Towards a Medium-Term Development Policy Framework: Some Issues
   Ernest Aryeetey

10. *Noguchi Statement on the Management of the Economy of Ghana*

INSTITUTE OF STATISTICAL, SOCIAL AND ECONOMIC RESEARCH (ISSER), UNIVERSITY OF GHANA
AND
CENTRE FOR POLICY ANALYSIS
(CEPA)

WORKSHOP ON
MACROECONOMIC STABILITY, GROWTH AND POVERTY REDUCTION

10-11 MAY, 2001

CONFERENCE CENTRE OF THE
NOGUCHI MEMORIAL INSTITUTE FOR
MEDICAL RESEARCH,
UNIVERSITY OF GHANA

PROGRAMME

This workshop has been made possible through the generous assistance of the MacArthur Foundation and the Poverty, Inequality and Development Initiative of Cornell University.
Thursday, May 10 2001

8.30 am Registration of Participants

OPENING CEREMONY

Chairman: Mr. Alex Ashiabor, M.D. Metropolitan and Allied Bank (Gh) Ltd.

9.15 am Welcome Address Prof. Ivan Addae-Mensah
Vice Chancellor, UG, Legon

9.25 am Opening Address Hon. Yaw Osafo-Maafo
Minister of Finance

9.45 am ISSER’s Perspective on Workshop Prof. Kwadwo Asenso-Okyere
Director, ISSER

9.55 am CEPA’s Perspective on Workshop Dr. J.L.S. Abbey
Executive Director, CEPA

10.05 am Some International Perspective Prof. Ravi Kanbur
Cornell University

10.15 am Workshop Objectives/ Program Prof. Ernest Aryeeetey, ISSER

10.25 am Chairman’s Remarks

10.30 am BREAK

SESSION 1

Chairman: Mr. Alex Ashiabor

10.45 am Fiscal Policy, Macroeconomic Stability and Medium-Long Term Growth Sam. N. Ashong, CEPA
Cletus Dordunoo, CIDEM

11.15 am Discussant’s Comments Ravi Kanbur

11.30 am Open Discussion

12.25 pm Chairman’s Remarks

12.30 pm LUNCH BREAK

SESSION 2

Chairman: Dr. G.K. Agama

1.30 pm Monetary Policy, Exchange Rates, Macroeconomic Stability and Medium Term Growth Charles Jebuni, CEPA

2.00 pm Discussant’s Comments Augustine F. Gockel
Dept. of Economics, Legon

2.15 pm Open Discussion

3.15 pm BREAK

3.30 pm Aid, Debt Management, Macroeconomic Stability and Medium Term Growth Mahamadu Bawumia
Research Dept. BoG

4.00 pm Discussant’s Comments Stephen Younger
Cornell University

4.15 pm Open Discussion

5.15 pm Chairman’s Remarks

5.20 pm End of Session and Day’s Programme

Friday, 11 May, 2001

SESSION 3

Chair: Dr. J.L.S. Abbey

9.00 am Investment, Medium-Long Term Growth and Employment Generation Kwabia Boateng
Yaw Asante
Dept. of Economics, Legon,

9.30 am Discussant’s Comments Victor Nyanteng, ISSER

9.45 am Open Discussion

10.30 am BREAK

10.45 am Medium-Long Term Growth and Poverty Reduction Ravi Kanbur

11.15 am Discussant’s Comments K. Asenso-Okyere

11.30 am Open Discussion

12.25 pm Chairman’s comments

12.30 pm LUNCH BREAK
ADDRESS BY PROFESSOR IVAN ADDAE-MENSAH
VICE CHANCELLOR OF THE UNIVERSITY OF GHANA,
AT THE ISSER-CEPA WORKSHOP ON
"MACROECONOMIC STABILITY, GROWTH AND POVERTY-
REDUCTION"
MAY 10-11, 2001,
NOGUCHI MEMORIAL INSTITUTE FOR MEDICAL RESEARCH,
LEGON

Mr Chairman, Hon. Finance Minister, Other Ministers of State, Distinguished Ladies and Gentlemen.

It is with great pleasure that I welcome you to the University of Ghana, once again, and to this very timely workshop on "Macroeconomic Stability, Growth and Poverty Reduction".

There are a number of reasons why the University of Ghana should be keen to host such a workshop. The first is that the current state of the economy is enough to instigate a serious intellectual discourse, for which universities are set up throughout the world. We would therefore be remiss in our responsibilities to the state and people of Ghana if we did not engage ourselves in such an undertaking. The second is that the discussion of such issues as the future direction of economic policy often require a greater input of independent thought than is usually available from political structures. Fortunately, universities are well structured to create a platform for such independent expression and debate. As the saying goes, no country is wiser than its institutions of higher learning. If the institutions are well endowed this influences the wisdom and capacity of the nation as a whole. Our institutions therefore need to be assisted to achieve the highest possible standards.
This university has, over the years, seen some of its men and women, both faculty and students, undertake serious study of the economy. (Some of them have even had the opportunity to contribute at Governmental level as Ministers of state and advisors). But the outcome of such studies by our University has seldom found its way into policymaking for a number of reasons. One is that policy makers have often left themselves little time to consider various options in the haste to meet international deadlines, which themselves are sometimes unrealistically set. Another reason is that researchers have not created channels for disseminating their research findings widely enough. But more fundamentally, policy making institutions have for many years not shown much interest in research output and intellectual debates. We hope that this is going to change soon as part of the of positive change.

Mr Chairman, for the above reasons the University of Ghana has been very happy about the initiative taken by the Institute for Statistical, Social and Economic Research (ISSER) and the Centre for Policy Analysis (CEPA) to develop this platform. I understand that the outcome of these discussions will be handed to government for consideration at the National Economic Dialogue scheduled for 14-15 May, 2001. The University is particularly encouraged by the collaboration between ISSER and CEPA in putting forward a set of ideas for national discussion. Such collaboration needs to be supported at all times in view of the immense benefits it holds, considering the comparative advantage of the two institutions with respect to capacity.

Mr Chairman, on the relevance of the theme, it is obvious that none better could have been found at this stage of Ghana’s development. I am not an economist, but with what Ghanaians have gone through over the years, I think every Ghanaian has become a pocket economist, and has heard of words such as macro and micro economics, econometrics, supply and demand, marginal utility, and in recent time a whole barrage of economic acronyms such as PUFMARP, SAP, PAMSCAD, etc. In my own small way, what I learned from the figures that the Finance Minister announced during his presentation of the budget for the year was that the macroeconomic situation was rather precarious. It is
characterised by a huge stock of debt whose annual payment consumes about a half of our annual expenditures. That means after paying interest on debt, there is hardly any money left for running the economy. The stock of debt came about because governments supposedly spent money on our behalf, money that they did not have. I understood also that the repayment mode has been extremely inflationary and this has led to the steady depreciation of the Cedi. But I am aware that in that kind of situation it is only those who have a regular access to foreign exchange that will be protected, a facility that only very few people have. The end effect is that the rich get richer (probably through the forex bureaux) and the poor get poorer.

Mr Chairman, the logic of twenty years ago would have been “Ban the forex bureaux”, “Shut down the markets”, “Seize the assets of those rich men and women”. I daresay that kind of response to economic crises twenty years ago was precisely the result of a lack of debate on the economy. For too long, economic policy making in this country has been made the preserve of small groups whose credibility as effective policy-makers has sometimes been questionable. When they have failed to deliver, our international partners have then been handed the excuse to take control of policy making. It is now time to open up that process. It is time that debates such as those that will take place here today and tomorrow were encouraged and supported. It is time Ghanaian governments understood that one does not need to be a politician to contribute effectively to policy making. Precluding debate often leads to disaster, as our own experience of the last forty years has amply shown.

One issue that I know will be discussed by many of the workshop presenters is the HIPC initiative. I sincerely hope that in that discussion Ghanaians are made to understand and appreciate the costs and benefits of the initiative. I have been made to understand that it should be possible to simulate revenue flows under HIPC and measure welfare gains from that. Should that not be done soon and the findings made public?

The Government of Ghana has pledged to protect the poor and reduce poverty substantially in the coming decade. While this is a laudable objective, we are not unaware
of the numerous problems to be encountered on the way. In particular, to what extent will a difficult macroeconomic situation impinge on the choices that government will make? Will the drive to reduce inflation and stabilise the Cedi compromise the equally urgent need to reduce poverty? What are the best options for achieving a good measure of success? I suppose the challenge facing this workshop is to propose ways of doing this. If successful, I am sure many Ghanaians would applaud the workshop participants for rising to the challenge.

Mr. Chairman, Honourable Ministers of State, Distinguished Ladies and Gentlemen, permit me to end my welcome address by once again informing you of how delighted we are to accommodate you at the University for a workshop of national importance. I would implore you to do justice to the workshop objectives and you can be sure that the people of Ghana will show their appreciation for that.

Thank you.
FISCAL POLICY, MACROECONOMIC STABILITY, AND MEDIUM-LONG TERM GROWTH

by

Samuel N. Ashong
Research Fellow, CEPA

1. Introduction
Robust and sustainable economic growth must be backed by sound macroeconomic policies that include, inter alia, fiscal deficits that are sustainable and exchange rates that are realistic (Fischer, 1986). Through its spending and resource mobilization drives, the government sector indirectly influences the way resources are allocated and utilized in the private sector. Also, in many countries, especially those in the developing world, the government sector directly engages in various economic activities in very significant ways.

Fiscal policy simply involves the use of the government’s taxing, spending, and borrowing powers to achieve stated public policy objectives. In practice, however, fiscal policy is effected by different levels of government and through a whole range of institutions. How one defines the government sector directly affects the measurement of the fiscal deficit. Alternative measures of the public sector include the central government, the general government, the consolidated non-financial public sector, and the consolidated total public sector.

For the most part the government provides public goods and services in the public good domain such as the maintenance of law and order, defense of national sovereignty, basic education, roads, water and health facilities. A common characteristic of these services is that their provision is better left in the public domain and involves very substantial outlays of financial resources by government. The government finances its expenditures by mobilizing resources from the citizenry through taxes and non-tax sources, including borrowing. Taxes are collected in two different forms: directly through the imposition of levies and income taxes on individual incomes and company profits, and property taxes; indirectly through sales taxes (VAT) and excise duties. The government can also obtain revenues from royalties on natural resources, and assistance from foreign governments in the form of grants. There are also capital receipts by way of sales of assets and divestiture.

The government budget summarizes its revenue and expenditure operations over a specified period, usually a year. When revenues exceed expenditures the budget is said to be in surplus. Conversely, the budget registers a deficit when revenues fall short of expenditures.
Substantial evidence abounds indicating that, in many cases, poor fiscal management, culminating in large and chronic budget deficits, has been the fundamental cause of macroeconomic instability which in turn has created problems such as high rates of inflation, high nominal interest rates, large external current account deficits and sluggish and stunted growth. It is, therefore, not surprising that fiscal policy tends to occupy center stage in the design of prudent overall adjustment strategies that aim at redirecting the economic fortunes of the nation.

Fiscal adjustment to the problems posed above is usually addressed through the impact of the government fiscal balance (deficit) on broad macroeconomic variables such as the level and composition of aggregate demand, the national savings rate, and the growth of monetary aggregates. Albeit seemingly a straightforward concept, the fiscal balance is characterized by a multitude of ambiguities, including questions of usage and conflicting definitional issues which need to be settled before drawing meaningful inferences from budgetary statistics (Blejer and Cheastey, JEL 1991).

Large government budget deficits consume domestic saving and foreign resources that otherwise could be channeled to the private sector which, in many countries, has been earmarked as the lead engine in the growth process. By crowding out productive investments by farmers, entrepreneurs, and businesses, in the private sector, government deficits place the financial system under considerable strain. Deficits could also potentially induce rapid inflation, which in turn exacerbates the deficit, thus creating the all-familiar vicious cycle. Last, but not the least, budget deficits could also lead to external current account deficits and real exchange rate appreciation which adversely affect exports, worsen the competitiveness of domestic producers and create pressures for protectionist policies (Summers and Thomas, WBRO July 1993). The particular macroeconomic impact of the deficit ultimately depends on the mode by which the deficit is financed. Consequently, any assessment of fiscal policy stance would require an account of the way the deficit is financed, since each method of financing triggers its own macroeconomic effects and costs.

An important issue that often arises in defining the activities of the government sector is the proper treatment of quasi-fiscal activities undertaken by public financial institutions. Quasi-fiscal operations of the public financial entities play similar roles as taxes and subsidies that can influence the size of the fiscal deficit. The majority of quasi-fiscal activities, in the case of the
central bank, stem from its dual role as the government’s banker and as regulator of the foreign exchange and financial sector. Quasi-fiscal activities can span multiple exchange management, exchange rate guarantees, interest rate subsidies and sectoral credit ceilings, rescue operations by the central bank, and lending to the central government at below-market interest rates. Public commercial banks engage in quasi-fiscal activities by placing restrictions on financial markets, and by providing government-mandated preferential treatment for special constituents of borrowers and lenders.

Central banks and other public financial institutions undertake quasi-fiscal operations for a number of reasons. Quasi-fiscal activities make it possible for the government to take activities that would normally be classified as budgetary and conceal them in the accounts of the public financial institutions. In the process these activities may not be accorded the same legislative or parliamentary scrutiny as traditional budgetary operations. In some cases public financial institutions engage in quasi-fiscal activities because it is more convenient to administer such activities compared to budgetary operations.

The above discussion underscores the need for explicit consideration of quasi-fiscal operations in the crafting of fiscal programs. As an initial step all quantifiable quasi-fiscal activities must be rolled in the fiscal balance to project a broader and a more representative measure of the fiscal deficit. Ultimately, more transparency would be achieved by converting quasi-fiscal operations to conventional budgetary operations via the replacement of quasi-fiscal taxes and subsidies with explicit taxes and subsidies.

2. Measurement of Fiscal Deficits

Which institutions constitute the government sector? When does a fiscal transaction impact the economy? And which fiscal transactions should be included in determining the overall fiscal balance? These are among the important questions that need to be addressed before an appropriate and meaningful assessment of fiscal policy can be made.

Quite often misapplications of fiscal policies occur because the particular deficit measure employed does not adequately capture the true budget constraint of the public sector, thus painting a misleading picture of the economy’s fiscal stance. A proper diagnosis of the economic difficulties facing any country and the consequent search for a prudent fiscal policy package to address those problems require, as a necessary prerequisite, the most accurate but practical
measure of the public sector's net requirements of financial resources. To fully assess and appreciate a country's fiscal stance, however, it would be necessary to slice and view the government budget from several perspectives. Furthermore, the considerations that must be recognized in analyzing the budget, such as stage of development and degree of openness, may vary substantially among countries. Consequently, the search for the single most perfect measure of the deficit may never materialize.

The task of measuring the deficit is not minor and it carries with it important policy implications. In fact, depending on how it is measured and the time period covered, the government deficit can trigger different fiscal stances that invariably invoke different fiscal policy prescriptions. In addition, the definition of the public sector and the nature of operations included in that definition conjures important consequences for the design, implementation and monitoring of an appropriate macroeconomic package.

Furthermore, cross-country comparisons could prove highly deceptive if adjustment provisions for country-specific economic features, accounting conventions, classification, procedures and treatment of non-budgetary operations such as regulations and important guarantees are not adequately captured. Finally, for any given country, the analysis of time trends may necessitate the constant upgrading of concepts in response to changing economic circumstances.

As already alluded to, how the public deficit is measured has an important bearing on an accurate analysis of the macroeconomic consequences of deficits.\(^1\) While the analytical literature more or less tends towards a definitional and methodological consensus on the issue of the fiscal deficit, wide variations abound in empirical applications.

3. **Coverage and Scope of Government Operations**

A proper assessment of fiscal policy needs to be based on the most comprehensive definition of government possible. Relying exclusively on the central government fiscal balance could paint a distorted picture of the economy's fiscal stance if sub-national fiscal authorities and a social security fund engage in substantial fiscal operations, or when quasi-fiscal operations are

---

\(^1\) (Studies on measurement: Blejer and Cheasty, 1991; on alternative measures: Tanzi, 1985; Eisner, 1986; Blejer and Chu, 1988; Kotlikoff, 1988; Fischer and Easterly, 1990; Buitir, 1990; IMF (1986) and UN (1968) provide detailed discussion of cash and accrual deficits; Robinson and Stella, 1988 and Teijeiro, 1989 survey issues pertaining to quasi-fiscal deficits).
significant. On the other hand, the usefulness of any fiscal assessment requires that it should be predicated on data availability that is both timely and regular.

4. **Timing of Transactions: Cash vs. Commitment Basis**

Should the fiscal balance be assessed on a commitment basis or only on cash basis? The answer to this question becomes important because, as a normal practice, resources are committed by governments long before they are actually disbursed on a cash basis. On the other hand, certain tax liabilities may also accrue for some period before being ultimately settled by taxpayers.

The advantage of a fiscal balance based on cash transactions is that it can easily be linked with financial developments in the economy, especially the monetary accounts. To the extent that governments default on their commitment obligations (either because of liquidity constraints and/or the pressure to meet targets for cash-based deficit reduction), however, the fiscal deficit measured on cash basis will underestimate the government's actual usage of real resources.

The problem becomes more alarming when government payment arrears are owed to enterprises. When such enterprises borrow from the banking system to enhance their cash-flow, the measured deficit using the cash-based concept will underestimate the government's contribution to the growth of demand and of monetary aggregates. A proper accounting of the government's activities would thus require, if possible, for the budget to be presented both on a cash basis and a commitments basis, with the crucial link between the two concepts being provided by changes in arrears.

5. **The "Overall Fiscal Balance" Defined**

Measured on a cash basis, the government budget must always balance\(^2\), implying that total receipts into the budget matches total payments out of the budget. A deficit is arrived at by establishing a balance among only a subset of receipts and outlays (transactions "above the line") which are financed by the other remaining transactions (located "below the line"). Where the line is drawn depends on the analytical needs being derived from the measure of the fiscal balance.

A popular measure of the fiscal balance is the overall balance. This is obtained as the difference between revenues including grants, and expenditures including net lending, all of which are

\(^2\) See, however Equation (1) below which implies that if changes in payment arrears are included in financing the budget must also balance on a commitment basis.
placed above the line. Looking at budget from below the line, a deficit in the overall balance is financed by a rundown in the government’s cash reserves and holdings of other liquid assets, and by increasing the government’s debt obligations through borrowing from domestic sources (from both the banking sector and the non-bank public) and external sources.

6. **Assessing the Fiscal Stance**

The sheer size and complexity surrounding government budgets make it imperative to derive broad indicative measures to assess the impact of fiscal policy on domestic demand aggregates and financial resources. The overall balance defined above is one such barometer usually employed. Of particular importance is the behavior of the overall balance in relation to GDP. When considered over a period of time the fiscal balance-to-GDP ratio tracks the changing influence of the government sector on the total economy.

In spite of its usefulness as a broad measure of the aggregate demand effects of fiscal policy, the overall balance is deficient on two important fronts. First, it cannot be used to assess the impact of the government's fiscal policy actions on other key policy variables such as inflation, interest rate, money supply, and economic growth. Secondly, its simplicity conceals the complexities associated with the operations of the government and the specific institutional factors that affect and are impacted by fiscal policy.

These complexities can be better considered by the way the deficit is financed, by utilizing certain special measures of fiscal impact complementary to the overall balance, and by adapting alternative definitions of the government sector and fiscal balance.

7. **Special-Purpose Measures of Fiscal Deficit**

Policy makers from time to time fall on alternative measures of the fiscal deficit to highlight the differential impact of various budgetary transactions (such as investment, import purchases, or debt service) on important macroeconomic variables (such as inflation, balance of payments, and savings). Widely used special-purpose deficit measures include the current deficit, the primary deficit, and the domestic primary deficit.
7.1 The Current Balance

The current deficit measure attempts to relate government savings with the capital budget by omitting investment outlays and capital revenues (such as asset sales). Since it represents the difference between non-capital (current) revenues and expenditures, it provides a measure of the government's contribution to national savings. A positive current fiscal balance suggests that the government can at least finance consumption expenditures from its own revenue.

A fundamental concern with this deficit measure is the implicit assumption that all current expenditure is consumption-related and does not contribute to economic growth (in the sense of not at least the physical capital stock). By implication, this measure of the deficit also assumes that all outlays categorized as investment do not have the attribute of being consumption in nature. In reality, numerous examples abound of unproductive capital spending that does little to augment the real capital stock of the economy, or does so inefficiently. On the other hand, certain current expenditures such as spending on health and education or on the operation and maintenance of infrastructure, may be highly productive and contribute either to human capital formation or to slowing down depreciation of the existing physical capital.

7.2 The Primary Balance

The primary balance (or "non-interest" balance) measures the "discretionary" budgetary stance by removing the effects of previous deficits on the budget. In practice this is achieved by excluding net interest payments on the stock of public debt from government expenditure. The primary balance provides an indicator of current fiscal effort, since interest payments are considered non-discretionary, being predetermined by the size of previous deficits and interest rates. The primary balance thus measures how current budgetary receipts and outlays improve or worsen the public sector's net indebtedness, and it is important for evaluating the sustainability of the government deficit.

Although governments can indefinitely run fiscal deficits, the primary balance must eventually reflect a surplus to cover at least part of the interest on current debt. For countries with large outstanding public debt relative to GDP, achieving a primary surplus is viewed as important, being usually necessary (though not sufficient) for a reduction in the debt-to-GDP ratio. A sufficient condition would require that nominal GDP growth exceed nominal interest rates on government debt. Thus, a primary surplus complemented by faster nominal GDP growth relative nominal interest rates will ensure a reduction in the government debt-to-GDP ratio.
Fiscal Impact of Alternative Methods of Financing the Deficit

Any assessment of the fiscal policy stance would have to take into consideration the way the deficit is financed, since each financing mode imparts particular effects and costs on the macroeconomy. The government can finance its fiscal deficit from domestic (bank and non-bank) and external sources. For countries without capital controls the distinction between domestic and foreign non-bank borrowing becomes blurred because governments, in such cases, cannot control (or in most cases monitor) purchases of government securities or the capital flows that take place in response to changes in domestic interest rates.

\[
\text{Public Sector Deficit Financing} = \text{Money Financing} + \text{Domestic Non-Bank Financing} + \text{External Borrowing} + \text{Accumulation of Payment Arrears} \quad (1)
\]

8.1 Money Financing (Monetization of the Deficit)

Government spending that is not financed by tax or non-tax revenue potentially contributes to excess aggregate demand and thus inflation. This is especially the case when government spending is financed by borrowing from the central bank. Central bank borrowing directly increases the monetary base, and therefore the money supply, and thus may constitute a source of inflationary pressure.

The government could also borrow from commercial banks. However, reliance on commercial bank financing may have effects similar to central bank borrowing if commercial banks are not mandated to restrict credit to the other borrowers outside the government sector and/or are not "fully-loaned up". Where overall credit ceilings apply, borrowing from banks may not be monetized but may crowd-out available credit to the private sector.

8.2 Domestic Non-Bank Financing

The ability of the government to finance the budget deficit by borrowing from the domestic non-bank sector usually depends on the level of development of domestic capital markets and the extent of public demand for government bonds.

In addition to purchases of market-based securities, non-bank borrowing may also reflect direct government involvement in capital markets. For example, the government may require financial institutions to hold government bonds for purposes of liquidity management. Alternatively, government may mandate highly subsidized government savings programs. This kind of
interference with the system of financial intermediation compromises the efficient use of financial savings.

Government non-bank borrowing to finance the deficit may increase domestic interest rates and thus reduce private investment. Alternatively when interest rates are controlled, private investments may be more directly reduced through credit rationing. Thus while non-bank financing has a considerable advantage of being potentially less inflationary than monetary financing, this may well occur at the cost of "crowding out" productive private sector activities. In particular domestic non-bank borrowing could be contractionary if the output elasticity of output of private investment is higher than what obtains in the government sector.

8.3 External Borrowing
Goverments can also finance fiscal deficits by borrowing externally. In principle liquid resources acquired from external sources can be used to increase both the demand for domestic goods and services and imports. To the extent that external borrowing makes possible the importation of additional resources from abroad, the impact of a deficit on excess demand pressure on domestic commodities is curtailed.

The impact of external borrowing on the domestic economy depends on the concessionality clause attached to such funds. External financing for most developing countries contains a grant element. The larger this grant element the more the government can borrow without compromising the sustainability of the fiscal effort. Concessionality thus lowers the effective interest rate because it reduces the need for domestic non-bank borrowing. External grants, the ultimate form of concessional financing, are however usually placed above the line and treated as part of revenues.

When the government resorts to non-concessional foreign borrowing to finance the deficit it accumulates debt which needs to be serviced and repaid eventually. This potentially exposes the economy to changes in the exchange rate and interest rates in the global market. Non-concessional financing in the short-run, can also lead to an appreciation of the exchange rate thus discouraging exports and encouraging imports. Because of its adverse consequences on the economy, recourse to non-concessional borrowing to finance deficits must be critically assessed in the context of the external debt position of the country, the medium-term balance of payments
prospects, the terms of borrowing, and the uses to which the resources acquired through external borrowing may be put.

8.4 Accumulation of Arrears

Often times governments finance fiscal deficits by delaying payments either on debt service, or on its purchases of goods and services. This mode of financing budgetary commitments can exact a very high price.

Payment arrears can have macroeconomic consequences similar to other forms of public borrowing. To illustrate, the impact on prices and the balance of payments would be basically identical whether the deficit is financed by borrowing from the domestic banking system or by accumulating domestic arrears to public enterprises and the private sector, which then borrow from the banking system (proxy borrowing by the private sector on behalf of the government). In addition such arrears can compromise future financing options, government credibility, and the integrity of the budgetary system.

9. Linkages between Fiscal Deficits and Other Macroeconomic Variables

The previous section examined the various options available to the government to finance the budget deficit. The section also touched on some of the broad implications of each financing mode. In this section we focus our attention to a more detailed discussion of some of the macroeconomic consequences of the government budget deficit. Specifically we will focus on the relationship between the deficit and inflation, interest rates, the external current account component of the balance of payments, and economic growth.

9.1 Fiscal Deficits and Inflation

A certain level of monetary financing of the budget deficit may, however, be non-inflating. In situations where growing economies need more money for the increased volume of transactions, where interest rates are falling (such that demand for other assets substitutable for money become less attractive), and where financial markets are developing (and the economy is becoming more monetized), the expansion in the money supply to meet the increasing demand is likely to be non-inflationary. The government is said to be obtaining resources from seignorage when it finances the budget in this way.\(^3\)

---

\(^3\) Strictly speaking the deficit financed from seignorage is required to maintain growth or whatever provides the rising demand for money.
As indicated earlier, financing the fiscal deficit by borrowing from the banking system will, ceteris paribus, increase the money supply insofar as banks are not mandated to restrict credit to the non-government sector. To the extent that government borrowing from the banking sector thus contributes to an excessive growth in the money supply, it will generate inflationary undertones.

When the government finances its deficit by inflation-induced money creation, it is said to exact a tax on inflation — an "inflationary tax". The implication is that resources of government are obtained at the expense of the diminished purchasing power of those with non-indexed nominal assets and money incomes. In most economies the majority of such persons happen to be in the poorer segments of society. Consequently, the inflation tax most often tends out to be a grossly inequitable means of financing the activities of the government.

In practice, the scope for non-inflationary deficit financing tends to be limited. When the private sector attains its desired level of money holdings, it disposes of further increases in the supply of money by spending it on goods and services. With a given supply of these commodities, prices adjust upwards until the desired ratio between money and spending is restored.

In the short-run, where prices do not immediately adjust fully to money supply increases, the government may be able to extensively finance its activities from the inflation tax. Over time, however, the scope for collecting the inflation tax is reduced: as a reaction to rising inflation rates, households and business owners reduce their real money holdings as they search for alternative assets that better preserve their value in such environments. Moreover, high inflation can negatively affect real revenues from conventional taxes if collection lags are prevalent — the Tanzi effect. Tax evasion and avoidance activities may also increase in an attempt to preserve real disposable incomes — the reverse of the Laffer curve. The net resource gain from the inflation tax in such situations may thus be greatly reduced.

9.2 Fiscal Deficits and External Current Account
For any given country, its residents can spend more than the value of output produced domestically only by purchasing goods and services from or by selling less to other countries.
This phenomenon is captured through a current account deficit in the balance of payments. Consequently, when government spending increases without a compensating increase in taxes or other measures to hold down demand in the private sector, imports will mostly likely increase relative to exports of goods and services, culminating in a worsening of the current account balance.

The following simple accounting relationship provides a clearer understanding of the link between the budget deficit and the external current balance. Gross national income (GNI) can be defined in terms of its uses or its expenditure components:

\[
GNI = PCON + PINV + GEXP + EXPORT - IMPORT = PCON + PSAV + GREV + NFTR \tag{2}
\]

where
- \(PCON\) = private consumption
- \(PINV\) = private investment
- \(GEXP\) = government spending
- \(EXPORT\) = exports of goods and services
- \(IMPORT\) = imports of goods and services
- \(PSAV\) = private saving
- \(GREV\) = government revenue
- \(NFTR\) = net transfers to abroad

By rearranging relation (2) above we obtain

\[
(GEXP - GREV) = (PSAV - PINV) + (IMPORT - EXPORT + NFTR) \tag{3}
\]

where
- \(PSAV - PINV\) = private sector savings-investment balance
- \(GEXP - GREV\) = government fiscal balance
- \(IMPORT - EXPORT + NFTR\) = external current account balance

It is clear from equation (3) that a fiscal deficit by the government must be balanced by a domestic private sector that saves more than it invests and/or by an external current account deficit. Thus the relationship between the fiscal deficit and the external current account deficit is neither entirely direct nor is it simple.

Although an increase in the fiscal deficit may be induce an increase in the external current account deficit, it could also trigger an increase in the private sector savings-investment balance via a crowding out of private investment. This can occur when public and private sector investment are close substitutes, when credit availability to the private sector for investment finance is rationed, or when higher interest rates discourage private investment.

In similar vein, an increase in the fiscal deficit may lead to an increase in the rate of private savings as individuals respond to anticipated higher tax obligations in the future tax necessitated
by the need to service the expected growth in the public debt — the Ricardian equivalence phenomenon, or to higher interest rates.

In summary, the degree of linkage between the fiscal deficit and the external current account deficit hinges critically on how government fiscal policies impact private savings and investment behavior.

9.3 Fiscal Deficits and Exchange Rates

The relationship between the fiscal deficit and the exchange rate is also not a simple one. Government fiscal operations both affect and are impacted by exchange rate policies. The fiscal balance is significantly affected by a depreciation in the nominal exchange rate (through, for instance, a policy of exchange rate devaluation). Depending on how government revenues and expenditures are structured, such effects can either be positive or negative. In particular if foreign-currency-denominated expenditures (such as interest payments on foreign debt and capital equipment purchases) exceed foreign-currency-based revenues (such as customs duties and export-based), the net effect of a nominal exchange depreciation would be to widen the fiscal deficit.

It is a well-known fact that governments cannot count on fiscal stabilization policies to pursue both internal adjustment and external adjustment objectives. Government's exclusive reliance on fiscal prudence to address a deficit in the external current account may create other domestic problems such as unemployment and low economic growth. In order to avoid such imbalances, fiscal stabilization policies have to be complemented by policies that increase the prices of commodities that are, or could be, traded internationally (tradables) relative to the prices of commodities that can only be sold domestically (non-tradables). Essentially what is needed here are government policies aimed at achieving a depreciation in the real exchange rate. Such policies, which often take form of a devaluation of the nominal exchange rate, strengthen the external current balance position for a given level of domestic output.

9.4 Fiscal Deficits and Economic Growth

Government fiscal policy affects an economy's total production of good and services, and therefore its growth prospects, via two interrelated channels: (a) through its impact on saving and investment, and consequently on the long-run growth rate of capacity output, and (b) through its
impact on the efficient allocation and uses of resources, and thus on the level of current output and future growth.

When the government is the major source of dissaving in the economy (i.e., when government current consumption exceeds current revenue) the consequences for economic growth may be quite dire. This would likely be the case if government consumption is unrelated to objectives that promote the development of human capital and/or the maintenance of the country’s physical infrastructure.

Less obvious and more subtly, the taxing and spending decisions taken by the government may alter resource allocation and utilization in the economy in ways that could impede the growth process. The economic costs of such policy interventions can be very high. As an example, government policies that grant tax exemptions and/or promote special tax rates often produce adverse supply-side effects by encouraging investments in projects with low and sometimes even negative returns. In similar vein, policies that lead to excessive marginal income tax rates are likely to dampen incentives for saving; and employment generation could be discouraged by high payroll tax rates.

Expansionary fiscal policies may induce output increases in short-run, particularly during periods of economic recessions. The success of such expansionary policies would, inter alia, depend on the policy history of any particular government. In general a government’s flexibility to embark on expansionary fiscal policies is more likely to be greatest if it had previously exercised conservatism in the formulation of fiscal strategies. But output capacity constraints, a sluggish responsiveness of domestic production to policy changes, and a country’s inability to sustain an unfavorable external payments position can significantly diminish the positive impact government-led demand expansion on output.

It is also possible that fiscal policies that prove to be overly expansionary could heighten incentive distortions in the economy and, in the process, reduce economic-wide output growth. Moreover, for countries with well-functioning financial markets, fiscal expansion could result in output reduction even in the short-run because interest rates quickly adjust upwards as financial
market participants react to the expected higher rate of inflation and to the prospect of instability in the financial market.  

4 Financial indiscipline turns punishment: inflation fears lead to capital outflow, exchange rate depreciation, interest rate hikes, and some capital reversal but only at the cost of a premium!
FISCAL POLICY, MACROECONOMIC STABILITY AND MEDIUM-LONG TERM GROWTH

Presented at Workshop on Macroeconomic Stability, Growth And Poverty Reduction, 10 - 11 May 2001

By

Prof. Cletus K. Dordunoo

Fiscal Policy

Government's overall fiscal policy encompasses the pattern of spending, taxing, and borrowing decisions of the public sector. The role of a government in the economy extends beyond fiscal policy. Public policy also includes sectoral (agricultural, industrial, services such as health and education) monetary, exchange rate, trade, and income policies, law making and enforcement that govern private sector economic activity including commercial codes for private contracts, company laws for establishing new firms, regulations governing international capital mobility, regulatory codes for environmental protection and antitrust regulation. In many economies, government also produces goods via state owned enterprises (SOEs) or "parastatal" firms, though the global size of SOEs has diminished drastically today.

The critical core of fiscal policy is determined by government budget, which establishes the income and outlays. The difference between government outlays and government revenues is the budget surplus (or deficit), which determines the amount of lending (or borrowing) of the public sector. There is also a midway position, which reveals equality between revenue and outlay, called a balanced budget or zero surplus/deficit. All this, among other factors, has critical implications for macroeconomic stability.

---

1 Prof. Dordunoo is the Chief Executive of Centre for Institutional Development and Economic Management (CIDEM).
Macroeconomic Stability

In principle we do not have absolute but relative macroeconomic stability with reference to time and select benchmarks/indicators. In practice macro stability refers to a state of macroeconomic conditions revealing absence of disturbances or shocks (emanating from policies, political developments, external terms of trade, natural disasters and wars, etc). The basic indicators of stability include both stable and predictable (i) low inflation, (ii) steady real exchange rate, (iii) realistic interest rate, (iv) low unemployment, and (v) absence of or minimal speculative attacks on both financial (monetary and capital) and goods markets.

Table 1. Basic Indicators of Macroeconomic Stability: 5-Year Moving Average

<table>
<thead>
<tr>
<th>Key Variables</th>
<th>Benchmark</th>
<th>Ghana</th>
<th>Singapore</th>
<th>Malaysia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation Rate</td>
<td>3.0%</td>
<td>32.4%</td>
<td>5.2%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Exchange Rate Depreciation</td>
<td>-5.0%</td>
<td>-38.1%</td>
<td>1.4%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Interest Rate Spread (RL-RS)</td>
<td>3.0%</td>
<td>20.0%</td>
<td>3.0%</td>
<td>-</td>
</tr>
<tr>
<td>Lending Interest Rate (RL)</td>
<td>5.5%</td>
<td>43.0%</td>
<td>6.2%</td>
<td>-</td>
</tr>
<tr>
<td>Savings Interest Rate (RS)</td>
<td>2.5%</td>
<td>23.0%</td>
<td>3.2%</td>
<td>-</td>
</tr>
<tr>
<td>Unemployment (max) (NARU)</td>
<td>4.6%</td>
<td>22.0%</td>
<td>4.7%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Misery Index (Inf.+Unemployment)</td>
<td>7.6%</td>
<td>54.4%</td>
<td>9.9%</td>
<td>22.0%</td>
</tr>
<tr>
<td>Budget deficit/surplus (% of GDP)</td>
<td>0.0%</td>
<td>-6.2%</td>
<td>+10.5%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Worst Condition (Mastritch)</td>
<td>-3.0%</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Real GDP Growth (highest attained)</td>
<td>-</td>
<td>8.6%</td>
<td>14.5%</td>
<td>13.4%</td>
</tr>
</tbody>
</table>

Source: Select writings of the Author; Ghana Economic Outlook; Various Issues; Branson; Sachs and Larrain; Dornbusch and Fischer; etc.

The general benchmarks (or standards) of stability and selected country examples are in Table 1. Stability requires that actual and expected inflation should not exceed 3% annual average, nominal exchange rate depreciation to be around 5% or less, interest rate spread around 3% in order to promote high level of financial intermediation, unemployment should be close to the natural
rate of unemployment (NARU) of 4.6%, zero budget deficit over a long period of time and in the worst of years should not exceed -3.0% (the so-called Maastricht condition). We have also added three country cases showing 5-year moving averages and the highest growth rates recorded in the recent two or so decades.

The benchmarks/indicators for macro stability in principle may be seen as and indeed constitute the basis/guide to the determination of the ECOWAS Second Monetary Zone convergence conditions. The gist of the ECOWAS criteria are: (i) a single digit inflation rate by end-2000 and 5% by 2003; (ii) gross external reserves to cover at least 3 months of imports by end-2000 and 6 months by 2003; (iii) central bank financing of budget deficit not to exceed 10% of previous year's tax revenues; and (iv) budget deficit (excluding grants) not more than 5% of GDP in 2000 and 4% by 2004. Prior to this, the First National Economic Forum of Ghana (1997) projected a balanced budget for the year 2001 which obviously will elude us. Besides, Ghana's 2001 Budget Statement calls for zero-deficit (or balanced) budget by 2004.

On the basis of the benchmarks compared with the Ghanaian situation, the inference is that Ghana (an African Hippo) exhibits a high level of macroeconomic instability, which makes it extremely difficult for the private sector to be an engine of growth. Macro stability is not sufficient but it is a necessary condition for growth and must not be compromised for anything. No wonder the highest GDP growth recorded in 1986 was estimated at 8.6% (per annum) while the potential growth rate was capable of reaching as high as double digit.

Even though Singapore has not met all the benchmarks, it has more than performed on the fiscal front, inflationary trend as well as the spread between lending and savings rates over a very long period. Real GDP growth rate ever reached 14.5% per annum before. No wonder, it became a leader in the group
of South East Asian Tigers (Refer to Dordunoo, 1996 for details). Malaysia also exhibited much more relative stability than Ghana and at a point of time was able to record a 13.4% per annum growth in real GDP. We have not shown the interest rates for Malaysia because of its special concessionary interest rate policy for promoting private sector investment as well as its policy of interest rates switching.

**Macroeconomic (In)stability & Deficit Financing**

The issue as to whether a government can continuously pursue budget deficits without disturbing macroeconomic stability is at the core of government policy debate. The empirical evidence is not very conclusive across all countries, but the summary seems to suggest that prolonged deficit financing is at the core of macroeconomic instability especially in the developing countries. (Refer to Easterly, Rodriguez and Schmidt-Hebbel for details).

On theoretical grounds, whenever governments run fiscal deficits (borrowing to pay for the excess of their spending over revenue) the result is crowding out. Crowding out of the private sector occurs when expansionary fiscal policy causes interest rates to rise, thereby reducing private spending, particularly on investment. This makes it impossible for the private sector to take advantage of the physical infrastructure in the form of roads on which huge investments have been undertaken.

Thus, even though government excessive spending may increase aggregate demand and thereby tending to raise output growth initially, the higher output levels raises interest rates in the financial assets market (as government floats treasury bills and other financial papers to mobilize funds) thereby dampening the effects of the fiscal policy on output. Additionally, the effect of higher aggregate demands tends to raise inflationary pressures and expectations as
well as trade deficits, monetary expansion and financial repression, resulting in a further macroeconomic instability.

Table 2. Ghana: Selected Indicators

<table>
<thead>
<tr>
<th>Variables</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (%) */</td>
<td>4.2%</td>
<td>4.7%</td>
<td>4.4%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Budget Deficit/GDP Ratio (%)</td>
<td>-8.3%</td>
<td>-6.1%</td>
<td>-6.6%</td>
<td>-7.0%</td>
</tr>
<tr>
<td>Domestic Interest Payments/GDP ratio</td>
<td>4.6%</td>
<td>5.0%</td>
<td>4.2%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Foreign Interest Payments/GDP ratio</td>
<td>2.3%</td>
<td>2.0%</td>
<td>2.1%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Domestic Debt/GDP Ratio (%)</td>
<td>24.8%</td>
<td>26.0%</td>
<td>28.2%</td>
<td>28.4%</td>
</tr>
<tr>
<td>Foreign Debt/GDP Ratio (%)</td>
<td>89.4%</td>
<td>79.7%</td>
<td>101.3%</td>
<td>104.5%</td>
</tr>
<tr>
<td>Inflation Rate (%)</td>
<td>20.8%</td>
<td>15.7%</td>
<td>13.8%</td>
<td>40.5%</td>
</tr>
<tr>
<td>Depreciation Rate (¢: $) (%)</td>
<td>22.7%</td>
<td>-4.1%</td>
<td>-33.0%</td>
<td>-91.5%</td>
</tr>
<tr>
<td>Interest Rate Spread (%)</td>
<td>18.9%</td>
<td>22.0%</td>
<td>17.3%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Lending Interest Rate (%)</td>
<td>46.6%</td>
<td>40.5%</td>
<td>37.3%</td>
<td>40.0%</td>
</tr>
<tr>
<td>Deposit Interest Rate (%)</td>
<td>27.7%</td>
<td>18.5%</td>
<td>20.0%</td>
<td>22.0%</td>
</tr>
<tr>
<td>Unemployment Rate (%)</td>
<td>23.0%</td>
<td>20.0%</td>
<td>19.5%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Per Capita GDP ($)</td>
<td>$370</td>
<td>$377</td>
<td>$383</td>
<td>$392</td>
</tr>
</tbody>
</table>

Source: Ghana Economic Forecasts March 2001, by Centre for Institutional Development and Economic Management (CIDEM), Primary Data from BOG, MOF and GSS.
*/Note: The Ghana-Vision 2020 indicates growth targets of 7.2%, 7.8% and 8.3% for 1997, 1998 and 1999 respectively in “The First Step 1996-2000”. The actual rates are in the Table.

The burden of domestic debt servicing and amortization may be traced to deficit financing in Ghana. The financing of the deficit, through the banking sector and other means, leads to excess liquidity in the economy. The Government then resorts to the floating of financial papers (for example, treasury bills) to mop up the excess liquidity. The high yield, risk-free financial papers attract both private and even public sector agents (including SOEs) to invest in these treasury bills. The interest payments on these papers alone accounted for over 30% of recurrent expenditure over a period of about a decade. Many businesses prefer to invest in the government treasury bills rather
than invest in their businesses. Consequently many businesses close down resulting in large masses of helpless unemployed and a group of idle rich. The excess demand also puts pressure on the domestic currency as the demand for imported especially consumer goods begins to rise resulting in rapid depreciation of the domestic currency. Even though the target should be real exchange rate stability, it remains critical that the nominal rate depreciates within acceptable bounds in order not to trigger off speculative attacks on the domestic currency, hoarding of foreign exchange, and hedging. Huge and rapid depreciation (through the so-called J-effect) in itself does cause inflation.

It must be noted that macro instability does not promote accelerated growth and development. Table 2 shows selected annual indicators of the Ghanaian economy that reveal the extent of macroeconomic instability accounting partially for the low per capita income of Ghana that is less than $400 per annum. From the Debt\GDP ratio, indeed Ghana is a highly indebted poor country (HIPC).

Medium-Long Term Economic Growth

Endogenous growth theory has put a lot of emphasis on key factors of production such as capital, labour and their productivity as well as changes in the terms of trade, openness, exchange rate changes and convertibility, neighborhood effect, policy credibility, etc. However, the sustainability of medium-term and long-term growth depends critically on private sector investment, capital formation and productive labour employment. But investment is always higher when saving is higher and government budget deficit is smaller or is in surplus.

Government budget deficits imply a reduction in output growth; indeed government budget deficits absorb private saving – households buy government securities (treasury bills) rather than the stocks or bonds that firms
issue or own equity to finance their investment. Thus, funds are diverted from growth toward other purposes. *If the only objective is to promote growth, the government should balance the budget or even run a surplus to free resources for investment.* This is what many countries did during the period of accelerating their growth and development.

However, it is important to note that there is an initial tradeoff between growth and the social objectives that may lie behind a budget deficit at certain times. Despite this argument, the fact remains that the deficits in the medium-long term weakens the private sector and, therefore, impairs its ability to pay higher tax which in the long-run weakens governments ability to generate higher levels of revenue and therefore the provision of social services. Besides, government budget deficits signal loss of financial discipline and send wrong signals to investors (both nationals and foreigners).

It is important to state that the emphasis on increasing the incentives to work, save and invest is a valid one. There are many aspects to this emphasis, but the empirical evidence strongly suggests the following: In order to increase future growth in output, production costs including taxes, interest rates, land litigation, instabilities in supply of utilities such as water and electricity should be reduced and that all policies to increase investment (if possible investment subsidies) must be promoted by reducing government budget deficits.

**Policy Recommendations**

On the basis of the foregoing and for the purposes of policy debate and advocacy, we advance the following recommendations for consideration by policy decision makers:

1. Strictly adhere to the ECOWAS Second Monetary Zone convergence criteria.
2. Avoid policy inconsistencies and incredibility that wreck havoc and cause shocks/disturbances leading to instabilities in the Ghanaian macroeconomic environment.

3. Escow prolonged deficit financing; put the fiscal house on a sound keel; and avoid financial waste/mismanagement; the fight against corruption must be intensified and won.

4. Encourage private sector investment; promote all policies that will lead to increases in investment (both domestic and foreign). In particular, reduce production costs including taxes, interest rates, land litigation and instabilities in the supply of utilities such as water and electricity in order to increase the level of productivity.

5. Balanced budget is necessary for stability, but surplus budget is even more stability enhancing; the government must strive for it. Parliament may consider passing a balanced budget act.

6. Review the Ghana-Vision 2020 and re-set the vision targets using the technique called “bottom up” rather than “top to bottom” approach. Experts in Futures Studies/Methodology for Development Management must be called upon to assist.

7. Set more realistic levels of interest rates and narrow the spread between the lending and savings rates; the framework for interest rate determination must be transparent. Government should commission a study on the impact of monetary policy in general and interest rate policy in particular on the real growth of Ghana’s economy.

8. Promote transparency and accountability in the mobilization of financial resources at the national and district levels; improve tax collection, and reduce the overall burden of tax on the citizenry; misery index is too high to be sustained. Also remove all bureaucratic bottlenecks that weaken effective public service delivery to the private sector. Indeed they constitute additional costs for business.

9. Prioritize and improve effective and efficient utilisation of public funds to increase value for money spent.

10. Review and enhance the monitoring and evaluation (M&E) system under the MTEF approach to budgeting and financial management as far as the receipts and outlays are concerned; the public sector agencies/institutions must adhere to the Financial Administration Regulations (FAR). Strengthen all the institutions that are involved in public sector taxation and expenditure.
Monetary Policy, Exchange Rate Policy, Macroeconomic Stability and Medium Term Growth

By

Charles D. Jebuni
Core Research Fellow
Centre for Policy Analysis
Accra, Ghana
Monetary Policy, Exchange Rate Policy, Macroeconomic Stability and Medium Term Growth

1. Introduction

Ghana has chosen growth as the path to poverty reduction. Both the nature and sustainability of that growth are important in the effectiveness of this strategy.

Macroeconomic stability generated by self-reinforcing monetary and exchange rate policies that moreover provide incentives for investment is crucial for generating and sustaining growth in the long run. Ghanaian experiences and experiences elsewhere suggest that both the assignment and direction of change of monetary and exchange regimes are important for achieving macroeconomic stability and growth. Conflicts in the assignment of monetary and exchange rate policies can result in the loss of both macroeconomic stability in terms of low rates of inflation and economic growth.

In this paper, I discuss experiences with two broad monetary policy regimes as a basis of informing our policy advice. The first is the independent national monetary regime which we have practiced from independence to date. This period has involved different combination of exchange rate and monetary policy regimes and we shall examine their implications for macroeconomic stability and growth.

The second regime is the currency union alternative in which national sovereignty over monetary policy is effectively employed in maintaining the exchange rate. This appears the more current tendency. Since Ghana has no experience of its own except under the currency Board system prior to independence, we will rely on other African experience.


The post independence exchange rate arrangement can be classified into three broad periods on the basis of the exchange rate regime and the effective assignment of the exchange rate.

The first period, 1957-1982, was one of a fixed exchange rate regime with the exchange rate effectively assigned to maintaining a low rate of inflation. From 1983 to 1991 Ghana moved to a more flexible exchange rate regime with the exchange rate assigned to maintaining Ghana’s international competitiveness. In the period since 1992 while maintaining a flexible exchange rate system the exchange rate is being used as a nominal anchor against inflation.
2.1 Pre-ERP Period: 1957 - 1982

Ghana maintained a fixed exchange rate regime with only three devaluations in 1967, 1971 and 1978 for the entire period. The post war orthodoxy resulted in fixed exchange rate arrangements globally. At independence, Ghana had also accumulated external reserves of about US$269 million. These, it seemed provided a credible basis for a fixed exchange rate.

The post independence development exigencies required expansion in both social and economic infrastructure. The Nkrumah government, which took over power from the British, therefore engaged in massive development and modernization projects. Fiscal policy, it was argued had to be expansionary to meet our development requirements. Fiscal expansion occurred when cocoa, the country’s chief export earner was in a boom. While the cocoa boom lasted, the policy appeared credible to private economic agents. Soon after these projects began, the price of cocoa started to fall. The London price of cocoa declined from US$977 in 1958 to an all time low of US$400 per tonne in 1965.

Taxing the export sector, running down external reserves and domestic borrowing, financed the expansion in expenditures. With a liberalized trade and payments regime and considerable reserves for imports, the fiscal expansion did not result in serious inflation. Between 1957 to 1960, inflation averaged about 1 percent per annum. The equilibrium exchange rate as estimated by Frimpong-Ansah (1991) and Stryker (1990), however, appreciated.

However, with further fiscal expansions following the launching of the Five Year Development Plan in 1959 and a Seven Year Development Plan in 1963, the situation changed. Fiscal expansion fed into money growth and the rate of inflation accelerated. The rate of inflation increased from the 1 percent average between 1957-60 to 6 percent between 1961-63 and by 1965, it was 22.7 percent.

Net foreign reserves increased initially from the US$269 million at independence to US$295 million in 1959. Thereafter, as seen in Table 1, they declined rapidly with fiscal expansion to US$89 million in 1964 and turned negative from 1965. Corresponding with the decline in reserves, fiscal and monetary expansion after 1961 was an increasing overvaluation of the currency. In the initial phases, the deviation of the nominal from its equilibrium was insignificant. However from 1962, the difference increased to 4 percent and by 1966, it was about 60 percent.
In spite of the clear indication of the need to change the exchange rate from 1962 onward, the government maintained the 1957-fixed rate. In part it was argued that this was necessary to control the deterioration in inflation and also in part to ensure cheap imports of capital equipment and intermediate goods for the industrialization program.

Table 1: Selected Macroeconomic Indicators in Ghana, 1960 - 1983

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Reserves as % of GDP</th>
<th>Nominal Exchange Rate (c/US$)</th>
<th>Equilibrium Exchange Rate (c/US$)</th>
<th>Measure Of Overvaluation</th>
<th>M2 Growth Rate (%)</th>
<th>Inflation Rate (%)</th>
<th>Fiscal Deficit % of GDP</th>
<th>Balance of Trade % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>21.2</td>
<td>0.71</td>
<td>0.71</td>
<td>0.00</td>
<td>13.3</td>
<td>0.9</td>
<td>-5.9</td>
<td>-7.1</td>
</tr>
<tr>
<td>1961</td>
<td>12.2</td>
<td>0.71</td>
<td>0.71</td>
<td>-0.09</td>
<td>6.3</td>
<td>6.2</td>
<td>-6.2</td>
<td>-9.2</td>
</tr>
<tr>
<td>1962</td>
<td>12.9</td>
<td>0.71</td>
<td>0.74</td>
<td>4.07</td>
<td>17.6</td>
<td>5.9</td>
<td>-8.7</td>
<td>-4.1</td>
</tr>
<tr>
<td>1963</td>
<td>12.1</td>
<td>0.71</td>
<td>0.77</td>
<td>7.41</td>
<td>10.0</td>
<td>5.6</td>
<td>-8.2</td>
<td>-6.4</td>
</tr>
<tr>
<td>1964</td>
<td>5.5</td>
<td>0.71</td>
<td>0.87</td>
<td>22.11</td>
<td>31.8</td>
<td>15.8</td>
<td>-8.2</td>
<td>-3.9</td>
</tr>
<tr>
<td>1965</td>
<td>-0.5</td>
<td>0.71</td>
<td>1.04</td>
<td>45.39</td>
<td>3.4</td>
<td>22.7</td>
<td>-5.9</td>
<td>-10.3</td>
</tr>
<tr>
<td>1966</td>
<td>-1.8</td>
<td>0.71</td>
<td>1.14</td>
<td>60.30</td>
<td>6.7</td>
<td>14.8</td>
<td>-2.8</td>
<td>-5.5</td>
</tr>
<tr>
<td>1967</td>
<td>-3.5</td>
<td>0.84</td>
<td>1.01</td>
<td>19.84</td>
<td>0.0</td>
<td>-9.7</td>
<td>-5.6</td>
<td>-4.7</td>
</tr>
<tr>
<td>1968</td>
<td>-2.6</td>
<td>1.02</td>
<td>1.07</td>
<td>4.84</td>
<td>9.4</td>
<td>10.7</td>
<td>-6.0</td>
<td>-2.4</td>
</tr>
<tr>
<td>1969</td>
<td>-5.2</td>
<td>1.02</td>
<td>1.09</td>
<td>6.65</td>
<td>11.4</td>
<td>6.5</td>
<td>-3.2</td>
<td>-1.9</td>
</tr>
<tr>
<td>1970</td>
<td>-1.1</td>
<td>1.02</td>
<td>1.05</td>
<td>2.52</td>
<td>10.3</td>
<td>3.0</td>
<td>-1.4</td>
<td>-0.7</td>
</tr>
<tr>
<td>1971</td>
<td>-0.4</td>
<td>1.03</td>
<td>1.10</td>
<td>6.90</td>
<td>9.3</td>
<td>8.8</td>
<td>-3.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>1972</td>
<td>4.5</td>
<td>1.33</td>
<td>1.18</td>
<td>-17.62</td>
<td>42.6</td>
<td>10.8</td>
<td>-4.4</td>
<td>6.7</td>
</tr>
<tr>
<td>1973</td>
<td>6.1</td>
<td>1.17</td>
<td>1.26</td>
<td>-8.95</td>
<td>17.9</td>
<td>17.1</td>
<td>-4.8</td>
<td>7.0</td>
</tr>
<tr>
<td>1974</td>
<td>0.0</td>
<td>1.15</td>
<td>1.30</td>
<td>-5.82</td>
<td>27.6</td>
<td>18.8</td>
<td>-3.7</td>
<td>-0.7</td>
</tr>
<tr>
<td>1975</td>
<td>2.4</td>
<td>1.15</td>
<td>1.49</td>
<td>6.43</td>
<td>37.6</td>
<td>29.8</td>
<td>-6.4</td>
<td>3.3</td>
</tr>
<tr>
<td>1976</td>
<td>0.3</td>
<td>1.15</td>
<td>2.10</td>
<td>58.23</td>
<td>36.7</td>
<td>55.4</td>
<td>-9.5</td>
<td>1.6</td>
</tr>
<tr>
<td>1977</td>
<td>0.0</td>
<td>1.15</td>
<td>3.72</td>
<td>177.28</td>
<td>60</td>
<td>116.5</td>
<td>-8.6</td>
<td>0.3</td>
</tr>
<tr>
<td>1978</td>
<td>0.1</td>
<td>1.76</td>
<td>6.08</td>
<td>220.37</td>
<td>68.8</td>
<td>73.1</td>
<td>-8.5</td>
<td>0.9</td>
</tr>
<tr>
<td>1979</td>
<td>1.2</td>
<td>2.75</td>
<td>8.30</td>
<td>133.37</td>
<td>15.8</td>
<td>54.5</td>
<td>-6.5</td>
<td>1.0</td>
</tr>
<tr>
<td>1980</td>
<td>0.5</td>
<td>2.75</td>
<td>10.8</td>
<td>201.65</td>
<td>33.8</td>
<td>50.2</td>
<td>-4.0</td>
<td>0.3</td>
</tr>
<tr>
<td>1981</td>
<td>-0.3</td>
<td>2.75</td>
<td>21.52</td>
<td>563.57</td>
<td>51.3</td>
<td>116.5</td>
<td>-6.1</td>
<td>-1.5</td>
</tr>
<tr>
<td>1982</td>
<td>0.0</td>
<td>2.75</td>
<td>24.10</td>
<td>693.88</td>
<td>23.4</td>
<td>22.3</td>
<td>-5.4</td>
<td>-0.1</td>
</tr>
<tr>
<td>1983</td>
<td>-3.1</td>
<td>8.83</td>
<td>50.84</td>
<td>1278.70</td>
<td>40.2</td>
<td>122.8</td>
<td>-2.6</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

To compensate for the effect of the overvaluation of the exchange rate on the balance of payments, import licensing was introduced in December 1961 and in 1962 exchange controls were also introduced. These measures failed to stem the deterioration in the external position as well as inflation. The government rejected an IMF stabilization program involving devaluation in 1965. The situation worsened until the government was overthrown in 1966. Analysis of the period from 1960 to 1965 also showed that in spite of the huge increase in investment, growth in per capita income was stagnant. (Ahmad, 1970).

By the time the National Liberation Council government took over from Nkrumah in February 1966, the economy was thought to have declined to its lowest level. Exports were at best stagnant and imports scarce. There were shortages of some consumables - especially milk and sugar. Most factories were producing below capacity because of lack of raw materials. Growth rate in per capita GDP had remained negative for four consecutive years since 1964.

Terms of trade of Ghana's exports were on the decline and the currency was over-valued. Faced with these economic hardships, the NLC government accepted an IMF/World Bank economic package and on July 8, 1967 devalued the currency. The par value of the cedi was set at US$1.00 = ₡1.02, a devaluation of 30 percent. With the support of both the Fund and the Bank, credit facilities were extended to the government and that momentarily eased the import pressure that the Nkrumah government had faced.

Up to 1971, Ghana's currency had remained pegged to the sterling. Yet in November 1967, when the pound sterling was devalued, Ghana like many other sterling area countries did not devalue her currency. As a result of the increasing balance of payments difficulties, depletion of foreign reserves and a build-up of uncleared short-term debts, in December 1971 the Busia government devalued the currency again, this time by 44 percent to a par value of ₡1.82 = US$1.00. After the Acheampong coup which toppled the Busia government in January 1972, the cedi was revalued to ₡1.28 = US$1.00, resulting in an effective depreciation of the currency by 25 percent. However, from 1973 the currency started appreciating and continued to do so up to 1978, largely as a result of rising government deficits and inflation. In June 1978, Ghana introduced a flexible exchange system under which the exchange rate for the cedi in terms of the US dollar was to be adjusted to reflect the underlying economic, financial, and balance of payments situation. Such adjustments were discontinued in August 1978 when the rate of exchange was fixed ₡2.75 = US$1.00.
As in the immediate post-independence period, Ghana tried to maintain a fixed exchange rate regime between 1972 and 1982 as an anchor against inflation. Almost all prices were controlled with the government setting ceiling prices. A change in the exchange rate would therefore translate into price changes. To avoid this and keep down domestic currency costs of intermediate imports, the exchange rate was fixed. To compensate or even substitute for the use of the exchange rate, the controlled regime intensified import licensing, quota, exchange controls etc. (Jebuni, et al 1994).

Ghana politicians did not seem to recognize the inconsistency in the assignment. They did not also seem to recognize the constraint placed on domestic macroeconomic policies by assigning the exchange rate as the anchor against inflation. They behaved as if one could pursue domestic macroeconomic policies independent of the role assigned to the exchange rate.
In the event, fiscal and monetary expansion accelerated. Borrowing from the banking system financed the resulting fiscal deficits. Money supply increased and the rate of inflation increased. As Table 1 shows, Ghana run serious and increasing deficits all through the period 1971 to 1982. Money supply increased by more than 30 percent per annum on average during the same period. The rate of inflation hit over 100 percent per annum by 1981. Contradiction in assignment and expansionary fiscal policy resulted in the loss of both macroeconomic stability and growth.

The extent of overvaluation of the currency increased reaching 693 percent by 1982. In a more open economy with capital flows the country would have hit a currency crisis similar to Mexico of 1994 given the poor fundamentals.¹ In the nearly closed economy, the increasing over-valuation in the currency resulted in exporters exiting the formal system through smuggling and black-marketing (Leith and Lofchie, 1993 and Bartes, 1993).

Figure 1 below also indicates that from about 1960 when the per capita growth rate decelerated, the situation worsened subsequently. As the exchange rate became increasingly overvalued and Ghana introduced other measures to compensate for it, both growth in per capita income and export performance suffered. From 1972 to 1982, per capita GDP growth, on average, was negative and exports as a percentage of GDP declined continuously.

Throughout this period, except for 1968-71 when some fiscal discipline was maintained, Ghana could not control the rate of inflation, neither could she achieve any appreciable growth rates. This was mainly because she could not maintain the fiscal and monetary discipline that was expected from the maintenance of a fixed exchange rate.

¹ See Bordo and Schwartz, 1996 for the analysis of currency crisis episodes illustrating the point. Also Flood and Marion, 1996.
In the period between 1983 and 1991, the Government implemented a wide range of trade and payments policies with the objective of switching away from direct government intervention and controls towards increased reliance on market outcomes. In particular, the official exchange rate was adjusted downwards in several discrete steps during the period from April 1983 through January 1986. Following the series of devaluations in the initial phases of the economic reform program, the foreign exchange market was gradually liberalized.

The combination of exchange rate and tariff reforms affected not only the real exchange rate but also the relative profitability of producing for the domestic market vis-à-vis the external market. A real depreciation increases the profitability of producing tradables.

While this period as a whole has been characterized by a more flexible exchange rate regime, the assignment of the exchange rate allows for the period to be classified into two sub-periods. Whereas the objective of foreign exchange management between 1983 and 1991 was to create incentives for exporting and to maintain Ghana's external competitiveness, since 1992 the objective of foreign exchange management has become unclear. More recently, the exchange rate has been seen as a nominal anchor against inflationary expectations. This has resulted in a consumption-based management of the exchange rate.
<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP Growth (%)</th>
<th>Net Reserves (US$ mil)</th>
<th>Nominal Exchange Rate (d/US$)</th>
<th>Real Exchange Rate Index</th>
<th>Broad Money (M2) Growth (%)</th>
<th>CPI Inflation (Average) % of GDP</th>
<th>Balance of Trade % of GDP</th>
<th>Dom. Prim. Balance</th>
<th>Narrow Deficit</th>
<th>Broad Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>8.7</td>
<td>180.9</td>
<td>36.0</td>
<td>42.7</td>
<td>72.1</td>
<td>39.6</td>
<td>-0.9</td>
<td>-0.9</td>
<td>-2.1</td>
<td>-2.1</td>
</tr>
<tr>
<td>1985</td>
<td>5.1</td>
<td>164.4</td>
<td>54.4</td>
<td>58.1</td>
<td>59.5</td>
<td>10.4</td>
<td>-0.7</td>
<td>-1.2</td>
<td>-2.7</td>
<td>-2.7</td>
</tr>
<tr>
<td>1986</td>
<td>5.2</td>
<td>69.9</td>
<td>89.2</td>
<td>74.4</td>
<td>53.7</td>
<td>24.6</td>
<td>0.3</td>
<td>1.5</td>
<td>-5.6</td>
<td>-3.3</td>
</tr>
<tr>
<td>1987</td>
<td>4.8</td>
<td>-60.5</td>
<td>153.7</td>
<td>94.0</td>
<td>53.0</td>
<td>39.8</td>
<td>-2.3</td>
<td>1.2</td>
<td>-5.1</td>
<td>-2.4</td>
</tr>
<tr>
<td>1988</td>
<td>5.6</td>
<td>-88.3</td>
<td>202.4</td>
<td>98.1</td>
<td>43.0</td>
<td>31.4</td>
<td>-2.1</td>
<td>0.4</td>
<td>-5.3</td>
<td>-2.7</td>
</tr>
<tr>
<td>1989</td>
<td>5.1</td>
<td>-93.5</td>
<td>270.0</td>
<td>109.7</td>
<td>26.9</td>
<td>25.2</td>
<td>-4.3</td>
<td>0.5</td>
<td>-5.3</td>
<td>-2.1</td>
</tr>
<tr>
<td>1990</td>
<td>3.3</td>
<td>-104.0</td>
<td>326.3</td>
<td>100.0</td>
<td>18.0</td>
<td>37.3</td>
<td>-5.2</td>
<td>0.3</td>
<td>-4.8</td>
<td>-1.9</td>
</tr>
<tr>
<td>1991</td>
<td>5.3</td>
<td>-147.1</td>
<td>367.8</td>
<td>95.7</td>
<td>19.9</td>
<td>18.0</td>
<td>-4.9</td>
<td>1.8</td>
<td>-4.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>1992</td>
<td>3.9</td>
<td>123.0</td>
<td>437.1</td>
<td>103.9</td>
<td>52.9</td>
<td>10.1</td>
<td>-7.3</td>
<td>-4.3</td>
<td>-11.6</td>
<td>-8.3</td>
</tr>
<tr>
<td>1993</td>
<td>5.0</td>
<td>-53.7</td>
<td>649.1</td>
<td>125.4</td>
<td>27.4</td>
<td>25.0</td>
<td>-11.7</td>
<td>-1.6</td>
<td>-13.1</td>
<td>-8.6</td>
</tr>
<tr>
<td>1994</td>
<td>3.8</td>
<td>-167.0</td>
<td>956.7</td>
<td>149.8</td>
<td>46.2</td>
<td>24.9</td>
<td>-6.6</td>
<td>1.1</td>
<td>-12.1</td>
<td>-8.5</td>
</tr>
<tr>
<td>1995</td>
<td>4.5</td>
<td>-252.1</td>
<td>1,200.4</td>
<td>122.1</td>
<td>37.4</td>
<td>59.5</td>
<td>-4.2</td>
<td>3.1</td>
<td>-9.0</td>
<td>-5.2</td>
</tr>
<tr>
<td>1996</td>
<td>5.2</td>
<td>19.3</td>
<td>1,637.2</td>
<td>116.3</td>
<td>34.2</td>
<td>46.6</td>
<td>-4.5</td>
<td>0.7</td>
<td>-14.1</td>
<td>-10.6</td>
</tr>
<tr>
<td>1997</td>
<td>3.1</td>
<td>-263.5</td>
<td>2,050.3</td>
<td>113.7</td>
<td>45.1</td>
<td>27.9</td>
<td>-9.3</td>
<td>3.2</td>
<td>-9.3</td>
<td>-8.5</td>
</tr>
<tr>
<td>1998</td>
<td>4.7</td>
<td>-27.8</td>
<td>2,314.2</td>
<td>104.0</td>
<td>24.3</td>
<td>-10.8</td>
<td>0.6</td>
<td>-3.5</td>
<td>-7.9</td>
<td>-6.4</td>
</tr>
<tr>
<td>1999</td>
<td>4.4</td>
<td>-124.6</td>
<td>2,647.3</td>
<td>109.2</td>
<td>10.3</td>
<td>12.5</td>
<td>-14.3</td>
<td>0.1</td>
<td>-4.7</td>
<td>-5.4</td>
</tr>
<tr>
<td>2000</td>
<td>3.7</td>
<td>5,321.6</td>
<td>183.5</td>
<td></td>
<td>23.4</td>
<td>25.2</td>
<td>-18.4</td>
<td>0.8</td>
<td>-5.4</td>
<td>-8.9</td>
</tr>
</tbody>
</table>

Sources: Bank of Ghana, Ghana Statistical Service, Ministry of Finance (Accra) and International Financial Statistics (IMF)

Notes: 1/. Narrow Budget excludes foreign grants.

The difference between the narrow and broad balance is that the former excludes "foreign-financed" development expenditure.

The results in terms of inflation and growth targets for the two periods, contrast sharply. Whereas between 1984 and 1991, per capita income growth rate averaged 1.8 percent in spite of the adverse developments due to poor agricultural harvest in 1990, it decelerated to about 1.0 percent, on average, between 1992 and 2000.

Inflation shows the same pattern. Between 1984 and 1991, the inflation rate moderated, hitting a low of 18 percent in 1991. After a further decline in 1992, and with increasing fiscal laxity and the tendency for the Central Bank to intervene to control the rate nominal depreciation of the exchange rate, inflation accelerated reaching a peak of an average of 59.5 percent in 1995 before declining to 30 percent in 1997.
3. Monetary Union

Since the second half of the 1990s, monetary integration initiatives have received attention in Africa. In West Africa, the creation of a single currency has been part of the grand design of the Economic Community of West African States (ECOWAS) since its inception. The establishment of the ECOWAS unit of account, the West African Clearing House, the West African Monetary Agency, and West African travelers cheques can all be interpreted in terms of efforts at monetary union.

The attempts more recently to establish a second monetary zone among the English speaking West African countries represent more direct and more serious efforts at monetary integration. In the monetary union, national sovereignty of both monetary and exchange rate policies is given up to a third party. And in this scheme, monetary policy is employed to maintain the exchange rate.

The basic argument for African monetary unions is that African governments lack the political institutions necessary for governments to commit credibly on an individual basis to fiscal and monetary discipline. It is agreed that monetary unions can provide an alternative mean of credible commitment to sound macroeconomic policies. Such a monetary arrangement, it is expected, will lead to macroeconomic stability and long-run economic growth. I summarize below a few findings with respect to the experience of the CFA zone to inform our judgment.

1) "From 1960 to 1993 the countries of the Franc Zone exercised a significant amount of monetary discipline, preserving their fixed peg to the French franc and enjoying substantially lower inflation than other African states" (Stasavage, 1997, pp. 2-3).

2) "Though GDP growth was higher in the CFA countries until the beginning of the 1970s and remained strong in the oil-producing countries of BEAC during 1973-85, the CFA zone performed poorly when compared to other sub-Saharan African countries during 1986-93. In contrast to sub-Saharan African countries outside the CFA Zone where total investment increased over the three periods, it decreased in the CFA Zone as a result of the crowding out of private investment after 1985" (Guillaume and Stasavage, 2000 p. 1399).
3) "Comparing fiscal stabilization performance in CFA and non-CFA Sub-Saharan African countries in the period 1980-93 provides another indication of a lack of discipline on the part of the CFA states. The differences are most notable for the period of declining terms of trade beginning in 1986. Average overall government deficits (after grants) in non-CFA Sub-Saharan African countries with adjustment programmes decreased by 2.8 percent of GDP between the two periods of 1980-85 and 1986-92" (Stasavage, 1997, pp.134-136).

4. Conclusion

One of the fundamental problems with African monetary unions is the low level of trade integration among African countries. This has led some to argue that the stability enjoyed by CFA zone may well come from the monetary stability generated by the peg with the French franc than the common currency across members. In other words, the CFA arrangement reflects the desire for a monetary anchor.

Will African monetary unions require an external anchor, or can African countries form independent monetary unions?

In the medium term, the currency union is not available to Ghana and we must manage our monetary arrangements to promote long-term macro economic stability and growth. This will require:

a) A low but positive real interest rate monetary stance coupled with a bias for slowly depreciating real exchange rate;

b) Achieving (a) will require fiscal discipline as an essential precondition;

This may require institutional arrangements that can effectively constrain the fiscal authority – i.e., an independent central bank.
List of References


AID, DEBT MANAGEMENT, MACROECONOMIC STABILITY
AND MEDIUM TERM GROWTH

Dr. Mahamudu Bawumia¹
Research Department
Bank of Ghana

(Paper Prepared for Presentation at Workshop on Macroeconomic Stability,
Growth and Poverty Reduction)

May 10-11 2001

University of Ghana, Legon

¹ THE VIEWS EXPRESSED IN THIS PAPER ARE THOSE OF THE AUTHOR AND NOT THE VIEWS OF THE BANK OF GHANA. ALL ERRORS ARE ALSO MINE.
Introduction

As with many issues in economics, there has been considerable debate about the relationship between aid, debt and economic growth. This paper attempts a critical analysis of the links between these variables with particular reference to Ghana. The paper argues that there is no direct relationship between aid flows and economic growth in Ghana. There have been periods where large aid inflows for example, have not resulted in higher growth. Rather, the policy environment is found to be the critical to a positive effect of aid on growth. On the issue of Dutch disease it is also argued aid inflows have not been responsible for the observed appreciation of the real exchange rate of cedi between 1994-97.

The major problem identified however was the fact that the budgetary process has become very dependent on aid flows with actual expenditures undertaken on the anticipation of aid flows. Such expenditures have recently exceeded projected expenditures even though aid flows have fallen below their projected levels.

Despite a period of sustained growth under Structural Adjustment, Ghana found herself with an unsustainable debt burden by the end of 2000, forcing the government to opt for the HIPC initiative. The paper also examines the potential impact of this initiative on growth and concludes that the HIPC initiative, on its own, is insufficient for growth in the medium term. The rest of the paper proceeds as follows. Section II examines the literature, Section III reviews the relationship between aid, debt and growth in Ghana over different periods, Section IV examines the impact the impact of aid on exchange rate misalignment, Section V examines the impact of aid on Ghana’s external indebtedness and Section VI concludes.
II. Literature Review

The role of aid in economic growth from the neo-classical Solow (1956) growth model is to increase capital accumulation. Since output per worker growth is a function of capital per worker, an increase in aid by increasing capital per worker should, ceteris paribus, result in higher growth in the medium term. Chenery and Strout (1966) and Griffin (1970) sees the role of aid as filling the foreign exchange gap.

Mosely et al (1987) question the simplistic assumptions underlying the Solow model in the context of developing countries. In particular, they argued that foreign aid may not result in an increase in investment if government reduces its capital spending out of its own funds in proportion to the aid receipts, i.e. aid is fungible.

Aid can also reduce a country’s growth rate if it increases the recipient’s debt burden. A high debt burden can discourage foreign investment and thus reduce growth (Krugman, 1988, Buow and Rogoff, 1991).

Easterly (2001) argues that slower growth rates over the 1975-94 period for developing countries the main cause of the observed high public debt ratios. The key to reducing these high debt ratios on a sustainable basis is to be found in higher rates of growth.

Other literature has also been more sceptical about the growth-promoting role of aid. Edwards and van Wijnbergen (1989) for example have criticised the application of the two-gap model on the grounds that it ignores relative prices and thus turns the focus away from the influence of the real exchange rate on the effectiveness of aid. Morrisey (1992), Younger (1992) and Vos (1993) all examine the impact of aid from the Dutch-Disease perspective of its impact on the real exchange rate. An appreciating real exchange rate reduces exports and thus economic growth. Sackey (2000) finds that aid flows into Ghana have resulted in real exchange rate depreciations rather than appreciations.
The cross-country empirical evidence on the impact of aid on growth has generally been inconclusive. While, Griffin (1970), Weiskopff (1972), Mosely et al (1987), and Boone (1995) find that there is no relationship between aid and either the savings rate or economic growth. Papnek (1973), Gupta and Islam, 1983 and Mosely, 1995 on the other hand find that aid positively impacts on growth.

Foreign aid played a prominent role in the successful development of Korea and Taiwan. American aid to Korea in the 1950s reached 15% of GNP. Foreign aid helped to rebuild or add to physical infrastructure, import vital inputs and technology, restore macroeconomic stability and non-inflationary growth and undertake land reform. Foreign aid in Mobutu’s Zaire on the other hand achieved no such growth enhancing policy reforms.

One can argue that the debate about the impact of aid on economic growth is a rather futile one. There are circumstances under which aid can help the growth process and others under which aid can retard the growth process. A lot depends on the domestic policy environment and how the aid is used. Burnside and Dollar (2000) find that aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policies. In the presence of poor countries on the other hand, aid has no positive effect on growth.

III. AID, DEBT AND GROWTH IN GHANA

What is the relationship between aid and economic growth in Ghana? We trace the developments in these variables between 1960 and 2000 (Table 1). In doing this, we draw from Younger and Harrigan (2000).
Table 1. Official Development Assistance, External Debt and Real GDP Growth in Ghana (1960-94)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>1.44</td>
<td></td>
<td>3.372178</td>
<td>0.726942</td>
</tr>
<tr>
<td>1961</td>
<td>1.40</td>
<td></td>
<td>4.026976</td>
<td>1.380429</td>
</tr>
<tr>
<td>1962</td>
<td>2.72</td>
<td></td>
<td>4.311648</td>
<td>1.652135</td>
</tr>
<tr>
<td>1963</td>
<td>7.93</td>
<td></td>
<td>2.185294</td>
<td>-0.47121</td>
</tr>
<tr>
<td>1964</td>
<td>8.55</td>
<td></td>
<td>1.359698</td>
<td>-1.27939</td>
</tr>
<tr>
<td>1965</td>
<td>18.73</td>
<td></td>
<td>-5.11332</td>
<td>-7.19567</td>
</tr>
<tr>
<td>1966</td>
<td>20.88</td>
<td>2.613635</td>
<td>0.561452</td>
<td>-1.72436</td>
</tr>
<tr>
<td>1967</td>
<td>17.03</td>
<td>18.83</td>
<td>5.562385</td>
<td>3.497996</td>
</tr>
<tr>
<td>1968</td>
<td>19.10</td>
<td></td>
<td>9.22475</td>
<td>7.503496</td>
</tr>
<tr>
<td>1970</td>
<td>17.40</td>
<td></td>
<td>5.30457</td>
<td>2.29853</td>
</tr>
<tr>
<td>1971</td>
<td>16.79</td>
<td></td>
<td>-3.02587</td>
<td>-5.9251</td>
</tr>
<tr>
<td>1972</td>
<td>10.05</td>
<td></td>
<td>2.856772</td>
<td>0.157698</td>
</tr>
<tr>
<td>1973</td>
<td>7.43</td>
<td></td>
<td>7.076138</td>
<td>4.624545</td>
</tr>
<tr>
<td>1974</td>
<td>22.56</td>
<td></td>
<td>-14.333</td>
<td>-16.5329</td>
</tr>
<tr>
<td>1975</td>
<td>10.76</td>
<td></td>
<td>-3.55532</td>
<td>-5.44882</td>
</tr>
<tr>
<td>1976</td>
<td>14.16</td>
<td></td>
<td>1.807158</td>
<td>0.282376</td>
</tr>
<tr>
<td>1978</td>
<td>20.93</td>
<td></td>
<td>-1.67998</td>
<td>-3.39927</td>
</tr>
<tr>
<td>1979</td>
<td>20.48</td>
<td></td>
<td>0.558622</td>
<td>-1.69838</td>
</tr>
<tr>
<td>1980</td>
<td>13.67</td>
<td></td>
<td>-2.98105</td>
<td>-5.64543</td>
</tr>
<tr>
<td>1981</td>
<td>12.57</td>
<td></td>
<td>-6.71132</td>
<td>-9.71208</td>
</tr>
<tr>
<td>1982</td>
<td>9.35</td>
<td></td>
<td>-4.54785</td>
<td>-7.84499</td>
</tr>
<tr>
<td>1983</td>
<td>15.22</td>
<td></td>
<td>8.386862</td>
<td>4.865695</td>
</tr>
<tr>
<td>1984</td>
<td>27.89</td>
<td></td>
<td>4.969483</td>
<td>1.322152</td>
</tr>
<tr>
<td>1985</td>
<td>30.21</td>
<td></td>
<td>4.996393</td>
<td>1.469775</td>
</tr>
<tr>
<td>1986</td>
<td>39.32</td>
<td></td>
<td>4.538072</td>
<td>1.131599</td>
</tr>
<tr>
<td>1987</td>
<td>39.32</td>
<td></td>
<td>5.381699</td>
<td>2.101763</td>
</tr>
<tr>
<td>1988</td>
<td>45.18</td>
<td></td>
<td>3.296</td>
<td>4.807684</td>
</tr>
<tr>
<td>1989</td>
<td>33.11</td>
<td></td>
<td>3.099284</td>
<td>1.652715</td>
</tr>
<tr>
<td>1990</td>
<td>49.79</td>
<td></td>
<td>3.802</td>
<td>5.121066</td>
</tr>
<tr>
<td>1991</td>
<td>33.91</td>
<td></td>
<td>3.968</td>
<td>6.32426</td>
</tr>
<tr>
<td>1992</td>
<td>32.75</td>
<td></td>
<td>3.532426</td>
<td>1.627711</td>
</tr>
<tr>
<td>1993</td>
<td>32.75</td>
<td></td>
<td>4.686309</td>
<td>2.11020</td>
</tr>
<tr>
<td>1994</td>
<td>50.22</td>
<td></td>
<td>3.638739</td>
<td>0.963487</td>
</tr>
<tr>
<td>1995</td>
<td>5.074</td>
<td></td>
<td>4.328839</td>
<td>1.743674</td>
</tr>
<tr>
<td>1996</td>
<td>5.346</td>
<td></td>
<td>4.926395</td>
<td>2.307347</td>
</tr>
<tr>
<td>1997</td>
<td>5.651</td>
<td></td>
<td>4.287734</td>
<td>1.633732</td>
</tr>
<tr>
<td>1998</td>
<td>5.921</td>
<td></td>
<td>4.652257</td>
<td>2.100675</td>
</tr>
<tr>
<td>1999</td>
<td>6.001</td>
<td></td>
<td>4.384091</td>
<td>1.862892</td>
</tr>
<tr>
<td>2000*</td>
<td>28.12</td>
<td>5.946</td>
<td>3.700359</td>
<td>0.655543</td>
</tr>
</tbody>
</table>

Sources: Younger and Harrigan (2000), Bank Of Ghana Annual Reports, Ghana Statistical Service, IMF

*Provisional
1960-1964

Until the mid-1960s, aid flows were relatively unimportant in Ghana. ODA per capita (1987 constant dollars) in 1960 amounted to $1.44, rising to $8.55 by 1964. This reflects the fact that the Nkrumah government inherited a sizeable amount of foreign reserves from the colonial government and thus needed very little in the way of external aid at this time. Real GDP growth was positive during in this period, with a declining trend from an average of 3.8% between 1960 and 1963 to 1.3% by 1965 and −1.27% in per capita terms.

1965-1969

Aid inflows increased in the second-half of the 1960s averaging around $19.00 per capita between 1965-1969. Aid per capita increased from $8.55 in 1964 to $20.88 by 1966 and $24.28 by 1969. As a share of GDP, ODA to Ghana in this period was higher than that for SSA and low-income developing countries. After the overthrow of the Nkrumah government in 1966, the NLC government, confronting a large accumulated debt burden left by the Nkrumah government, signed an agreement with the IMF to devalue the cedi and cut public expenditures. There was increased programme aid as a result to support the balance of payments.

As Table 1 shows, however, real output growth declined in 1966 by 5% as a result of the effects of the coup d’etat. By 1969 however, output growth had increased in real terms to 5.5% with real per capita income growing by 3.5%.

1972-1983

1972-83 was a decade of consistent application of bad economic policies with attendant poor performance. It should be noted that this period was one of sustained deterioration in the economy under six "different" governments. By no means did these governments
pursue the same policies. However, for the most part, the policies of this period emphasized import substitution, underpinned by a restrictive foreign exchange regime, quantitative restrictions upon imports and price controls, with the state playing a major role as producer. At the time of the overthrow of the Busia government in 1972, ODA per capita (1987 constant dollars) was $16.79. ODA per capita declined to $7.43 by 1974 under the Military regime of Colonel I. K. Acheampong. This was in response to Colonel Acheampong’s decision to repudiate some of Ghana’s commercial debts on the grounds that they were contracted irregularly.

Aid flows, however, increased in the second half of the decade reaching $20.93 per capita by 1979. The aid was largely in the form of multilateral loans rather than grants. This led to an increase in the total external debt from $895m in 1975 to $1,407m by 1980. Ghana faced difficulties servicing the debt by the end of the 1970s despite the low debt-service ratios. In 1979, arrears on payments of short-term loans amounted to $432m and the international financial institutions began to refuse credit. The balance of payments crisis led to a depletion of gross official reserves and an accumulation of payments arrears, reaching $577m by 1982 (Younger and Harrigan, 2000).

Growth performance in the 1970s was mixed. The lowest growth of negative 14% was experienced in 1975, coinciding with the oil-supply shock as well as a policy reversal from a market-oriented stance to an inward looking protectionist regime. The period of turbulence, however, also had positive growth episodes, with the highest peak rate reaching 9% in 1970 and 1978. Between 1979 and 1982, economic growth was decidedly negative, averaging −3.0% per annum. Aid flows in this period also declined sharply from $20.93 per capita in 1979 to $9.35 by 1983.

By late 1983, a combination of frequent coup attempts against the regime, a severe Sahelian drought, sporadic bush fires, the flight of capital from the country, and continuing miserable performance of the economy and the absence of a realistic alternative from the intellectual left (and the Eastern Bloc countries), convinced the Rawlings regime by August 1983 that the best possible solution to the challenge posed to
its survival and the desperate economic situation was to seek help (aid) from the IMF and World Bank.

The 1983 Budget, announced by Dr. Kwesi Botchwey, the Finance Secretary, signaled the governments' change of course. This Budget contained a significant devaluation of the cedi and an increase in the prices of basic foodstuffs. This marked the beginning of Ghana's Structural Adjustment Program with financial support from the IMF and World Bank.

1984-2000

Ghana’s SAP involved a liberalization of the exchange rate (devaluation) and trade regime, privatisation of state enterprises, financial sector reform, and a tightening of the budget. The persistence with which Ghana tackled the SAP in the 1980s made it a darling amongst the donor community. ODA per capita increased from $9.35 in 1983 to $45.18 by 1989. Most of the support was in the form of non-concessional loans. As Younger and Harrigan (2000) note most of the reforms under Ghana’s SAP would not have been possible without the external support provided by the donors. Public spending was also increased with grants to support the budget increasing from 0.55% of domestic revenues in 1983 to 10.23% by 1991.

IV. AID FLOWS, EXCHANGE RATE MISALIGNMENT AND DUTCH DISEASE EFFECTS

As stated earlier, Ghana has received substantial aid flows since the onset of its Structural Adjustment Programme in 1983. These aid flows have come in the form of grants, project loans and programme loans. Increasingly Ghana has become dependent on aid inflows over the years and when expected aid inflows do not materialize, this can throw the budget out of line and result in macroeconomic instability if the authorities have already undertaken expenditures in anticipation of such inflows. Furthermore, there is the
possibility that such aid inflows, by resulting in real exchange rate appreciation would adversely affect exports via the Dutch disease phenomenon. What is the empirical evidence? Has the inflow of foreign aid resulted in real exchange rate appreciation of the cedi?

As stated earlier, one of the channels through which aid may reduce growth is through its impact on the real exchange rate. An appreciating real exchange rate results in lower export growth and lower economic growth.

Figure 1 shows that the real exchange rate of the cedi (calculated using PPP with 1990 as the base year) appreciated significantly over the 1992-1997 period (Figure 1). However, economic growth continued at an average of 4.2% per annum. The Dutch disease argument does not appear to have been validated over this period.

Also, the real exchange rate depreciated between 1990 and 1994 but appreciated between 1994 and 1998. It has since depreciated sharply since 1999. However, the level of aid inflows did not differ significantly between the 1990-1994, 1994-1997 and 1998-2000 periods. It is therefore not clear, a priori, that external aid inflows were responsible for the different movements in the real exchange rate. However, a look at the projected versus actual inflows compared to the actual and projected budget expenditures suggests an interesting line of enquiry.
Real Exchange Rate Movement for the Cedi Between 1990-2000

Figure 1.

A look at the data from 1997-2000 is revealing in this regard. It is instructive to note (see Table 2) that aid inflows also fell well short of their projected levels in 1998, 1999 and 2000. This notwithstanding, government expenditures were above their projected budgetary levels in 1999 and 2000. This contrasts sharply with 1998 when government expenditures were fell substantially below the projected budgetary levels.

Table 2. Projected and Actual Aid Receipts and Government Expenditures £ millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected Aid £m</th>
<th>Actual Aid £m</th>
<th>Projected Expenditure £m</th>
<th>Actual Expenditure £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>1524.8</td>
<td>1075.2</td>
<td>3883.1</td>
<td>3848.1</td>
</tr>
<tr>
<td>1998</td>
<td>1804.0</td>
<td>1075.2</td>
<td>5053.0</td>
<td>4486.75</td>
</tr>
<tr>
<td>1999</td>
<td>1622.0</td>
<td>1275.0</td>
<td>4054.0</td>
<td>5094.9</td>
</tr>
<tr>
<td>2000</td>
<td>3778.0</td>
<td>2385.5</td>
<td>7572.8</td>
<td>8009.1</td>
</tr>
</tbody>
</table>
The lesson here is that there needs to be an appropriate sequencing of fiscal policy, with expenditures only undertaken after very firm commitments of funds or actual inflows.

V. Aid, Debt and HIPC

Total external debt, which stood at 4431m in 1970, $1,407m by 1982, $3,296m by 1989 and $6.1bn by 2000. The structure of the external debt also changed. In 1982, 36.0% of the debt was official multilateral, 49.0% was official bilateral and 15.0% was Private. By 2000, 71% of the debt was official multilateral (56% IDA), 22% was official bilateral (Paris Club creditors) and 8% was commercial. This structure of the debt has implications for the HIPC initiative as will be discussed later.

Of the total stock of debt, 71% is owed to multilateral creditors (of which 56% is IDA), 22% to bilateral creditors (Paris Club creditors) and 7% to commercial creditors. The debt-service ratio increased from 15.6% in 1982 to 50.6% by 1989. By 1994 however, the debt service ratio had fallen to 24.6%. At the end of 2000, the debt/Export ratio was 224%, debt/budget revenue was 709% and debt/GDP ratio was 124%. Debt service/Exports was 22% and debt service/budget revenue ratio was 40%.

In addition to external debt, domestic debt at the end of 2000 stood at US$1.7 billion, largely comprising 91-day Treasury Bills and absorbing 45% of budget revenue in its service. The servicing of domestic and external debt accounted for 85% of government revenue in 2000. It does not take Albert Einstein to recognise this trend is unsustainable. It was against this background that the government announced in the 2001 budget, the decision to join the HIPC initiative.
HIPC AND ITS POTENTIAL IMPACT ON GROWTH

The World Bank and International Monetary Fund introduced the Heavily Indebted Poor Country Initiative (HIPC) in 1996 to address the problem of external indebtedness of low-income countries (mostly in Sub-Saharan Africa). The HIPC framework was reviewed in 1998/99 and a new Enhanced HIPC framework was introduced.

Essentially, the HIPC initiative is available to countries that have unsustainable debt burdens. While debt sustainability will differ from country to country, a country will qualify for HIPC if it has a debt to export ratio of 150% and above in net present value (NPV) terms and a NPV debt-to-revenue ratio of 250%. In addition there is a threshold of exports/GDP ratio of 30% and Revenue/GDP of 15%.

HIPC STAGES

Stage 1: 3-Year satisfactory performance track record by HIPC country. Reduction of non-ODA debt of 67% in NPV terms (Naples Terms).

Stage 2: Decision Point. The debt relief is fixed at this point. The international financial community (Paris Club Creditors) will make a commitment to provide 90% flow reduction of debt in NPV terms after a 3 year satisfactory performance track-record and at least a full one year implementation of its Poverty Reduction Programme (Cologne Terms).

Stage 3: Completion Point. Paris Club will provide a reduction of the eligible stock of debt of 90% or more in present value terms
Under the enhanced HIPC initiative, some multilateral institutions have agreed to provide interim debt relief between the decision point and the completion point. These mechanisms include:

i) IDA can provide up to 30% of its total relief during that period which may result in a 50% or more debt service reduction

ii) IMF can provide 60% of its total relief or 20% in any one year (Three years maximum), which may result in 100% debt service reduction

iii) EIB/EU may forgive 100% debt service payment until the present value reduction is provided

On the economic front, some studies (e.g. Debt Relief International and Bank of Ghana) have estimated that Ghana would get debt service relief to the tune of $183 million in 2001, $263 million in 2002 and $256 million in 2004 if she joined HIPC (Table 4). Under these projections Ghana’s debt service/budget revenue will decline to 8% by 2003. On the face of it these projections make HIPC irresistible for a country with a precarious balance of payments position such as Ghana.

Projections such as these are based on assumptions about export growth, output growth, etc. which may or may not materialize. It is important that we look at the 22 countries which have reached their decision points under the enhanced HIPC initiative to ascertain the extent of debt relief possible. Table 3 shows that many HIPC countries have had significant amounts of debt relief. Examples include Cameroon and Mozambique who have had debt relief of $2bn and $4.3bn respectively.
TABLE 3. HIPC RELIEF FOR 22 DECISION POINT COUNTRIES

NOMINAL DEBT SERVICE RELIEF COMMITTED UNDER
(in million US$)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Relief</th>
<th>Approval Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benin</td>
<td>460</td>
<td>Jul 2000</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>700</td>
<td>Jun 2000</td>
</tr>
<tr>
<td>Cameroon</td>
<td>2000</td>
<td>Oct 2000</td>
</tr>
<tr>
<td>The Gambia</td>
<td>90</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Guinea</td>
<td>800</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Guinea Bissau</td>
<td>790</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Madagascar</td>
<td>1500</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Malawi</td>
<td>1000</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Mali</td>
<td>870</td>
<td>Sep 2000</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1100</td>
<td>Jan 2000</td>
</tr>
<tr>
<td>Mozambique</td>
<td>4300</td>
<td>Apr 2000</td>
</tr>
<tr>
<td>Niger</td>
<td>900</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Rwanda</td>
<td>810</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Sao Tome and Principe</td>
<td>200</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Senegal</td>
<td>850</td>
<td>Jun 2000</td>
</tr>
<tr>
<td>Tanzania</td>
<td>3000</td>
<td>Apr 2000</td>
</tr>
<tr>
<td>Uganda</td>
<td>1950</td>
<td>Jan 2000</td>
</tr>
<tr>
<td>Zambia</td>
<td>3820</td>
<td>Dec 2000</td>
</tr>
<tr>
<td>Bolivia</td>
<td>2060</td>
<td>Jan 2000</td>
</tr>
<tr>
<td>Guyana</td>
<td>1030</td>
<td>Nov 2000</td>
</tr>
<tr>
<td>Honduras</td>
<td>900</td>
<td>Jul 2000</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>4500</td>
<td>Dec 2000</td>
</tr>
</tbody>
</table>

Source: World Bank

ESTIMATED TOTAL DEBT RELIEF FOR GHANA (in present value terms)

Relief from Naples Terms 274
Relief from HIPC Initiative: 1219
of which: multilateral creditors 687
bilateral & commercial creditors 532

TOTAL DEBT RELIEF 1493

Source: Debt Relief International

TABLE 4. ESTIMATED POTENTIAL DEBT RELIEF FOR GHANA

POTENTIAL DEBT RELIEF

14
<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBT SERVICE (US$ m):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WITHOUT HIPC</td>
<td>415</td>
<td>384</td>
<td>367</td>
</tr>
<tr>
<td>AFTER HIPC</td>
<td>232</td>
<td>121</td>
<td>111</td>
</tr>
<tr>
<td>SAVINGS</td>
<td>183</td>
<td>263</td>
<td>256</td>
</tr>
<tr>
<td>DEBT SERVICE/ BUDGET REVENUE:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WITHOUT HIPC</td>
<td>38%</td>
<td>30%</td>
<td>25%</td>
</tr>
<tr>
<td>AFTER HIPC</td>
<td>21%</td>
<td>9%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: Debt Relief International

The HIPC initiative is expected to reduce the “debt overhang” i.e. the negative impact of a large external debt burden on growth. A debt overhang can contribute to investment disincentives and could delay private capital flows required to generate sustainable growth. Therefore, the removal of the debt overhang via the implementation of the HIPC initiative will permit Ghana to focus on the policies required to tackle other impediments to sustainable growth, including inadequate physical infrastructure, human capital and institutions. By reducing the debt burden, more resources would be freed to undertake poverty reducing and growth-enhancing expenditures. Lower government borrowing would result in lower interest rates, less crowding out of the private sector and higher investment.

There are however those who have argued that there is a lack of sufficient empirical evidence to show that HIPC works. Which countries have benefited and by how much? Is HIPC not just another ruse by the international financial institutions to subjugate the poor
countries of the developing world? If this argument appears familiar, it is precisely because we heard these arguments when the IMF and World Bank asked countries to pursue Structural Adjustment Programmes (SAPs). In fact, it can be argued, quite strongly, that many poor countries in sub-Saharan Africa adopted SAPs in the 1980s to enable them get out the very poverty and debt burdens that they now find themselves after two decades structural adjustment.

UNDERSTANDING THE GROWTH PROCESS IN GHANA

Ndulu and O'Connell (2000) in what is arguably the most comprehensive study on economic growth in Africa between 1960-97 estimate that output per worker declined by 0.12 percent during this period. Growth in factor accumulation (physical capital per worker (by 0.52%) and education per worker (by 0.50%) was offset by a decline of total factor productivity (TFP) by 1.15%. These results suggest that the slow rate of per capita income growth in Ghana over the 1960-1997 period can be attributed largely to slow technological progress.

Furthermore, their regression estimates suggest that policy variables were the most significant contributor to economic growth during the period. Amongst the policy variables, exchange rate policy was the most significant contributory policy variable over the 1960-97 period, followed by government spending/GDP (fiscal policy).

The policy implications of these findings suggest that we ought to take a careful look at what is responsible for the slow growth of technological progress (total factor productivity). What institutional arrangements or institutions need to be put in place to support the growth process?

It is important to note that technological progress, to be meaningful in the growth process must be actualised by the private sector and be reflected in agriculture in the medium term. One of the structural impediments to technical progress in the agricultural sector is the land tenure system, as it exists today. Litigation over land and the difficulty in
establishing property rights over land greatly increases transactions costs in this industry. As difficult as it is, policy makers need to look very critically at the issue of land reform as was the case in Taiwan and Korea in the 1950s.

In the context of HIPC, the PRSP for Ghana must also be original. A rehash of the same old ideas would only end up yielding the same old results. In terms of strategy or policy to reduce poverty, what have we not really done before that needs doing? In this regard, any PRSP without a clear strategy for land reform cannot be taken seriously.

What should be clear to all policy makers is that the HIPC initiative, on its own, will not result in growth in the medium term if not complemented with policy measures that will enhance economic growth. If policy makers go to sleep after taking the HIPC laxative, we will only wake up to find that we will need yet another HIPC type relief to clean up the mess.

Debt Management

The management of domestic and external debt in Ghana has continued to pose a challenge to policy makers with increasing size. The Aid and Debt Management Unit of the Ministry of Finance was established in 1987 with the specific task of formulating and implementing an appropriate debt management strategy. It is clear however, from the recent misreporting issue with the IMF that all is not well with the debt management in Ghana.

Given the large fiscal burden, debt management and liquidity management are not adequately separated. There is a need to separate the two functions since it is usually the case that the optimal choice of a debt manager is different from that of a liquidity manager. Attempting to pursue both functions through a single institution runs the risk of confusing the market.
The government should also increasingly its expenditures through the issue of longer-dated securities. The reliance on 91-day Treasury bills to finance medium term government expenditures is an expensive choice in the long run.

VI. CONCLUSIONS AND POLICY RECOMMENDATIONS.

This paper attempts a critical analysis of the links between aid, debt and growth these with particular reference to Ghana. The paper argues that there is no direct relationship between aid flows and economic growth in Ghana. There have been periods where large aid inflows for example, have not resulted in higher growth. Rather, the policy environment is found to be the critical to a positive effect of aid on growth. It is also argued aid inflows have not been responsible for the observed appreciation of the real exchange rate of cedi between 1994-97.

The major problem identified however was the fact that the budgetary process has become very dependent on aid flows with actual expenditures undertaken on the anticipation of aid flows. Such expenditures have recently exceeded projected expenditures even though aid flows have fallen below their projected levels. It is therefore important for policy makers to make sure there is an appropriate sequencing between aid receipts and budget expenditures. In particular, expenditures should be undertaken only on the receipts of the promised aid.

It was also argued that the growth process in Ghana is largely driven by the slow growth in technological progress. Aid can therefore enhance growth by helping remove structural and institutional bottlenecks to technological progress. For example, foreign aid directed at achieving land reforms is more likely to be more productive in the medium to long-run.

In addition, the strategy for poverty reduction and economic growth must be formulated and packaged to allow individual and household/community identification with the programme. Each extended family in Ghana should be encouraged to take a closer look at
poverty amongst its members, analyse the causes, and take measures to improve the lot of poor members of the family. A profile of each member of the extended family should be obtained, and annual extended family or community meetings should be encouraged to assess progress. At such meetings, family members are more likely to be more receptive to ideas from family/community members on issues like HIV and birth control than some government functionary sitting in Accra. It is time to move from a macro-level approach to poverty reduction to a micro-level approach.

Aid in Ghana, from the evidence so far, appears to be more supportive to the growth process in a liberal private sector-friendly and stable macroeconomic environment. It is therefore imperative that policy makers do not entertain demands for protectionist and interventionist policies.

Furthermore, it is important to revamp the management of aid and debt (domestic and external) in Ghana. In particular, it would be useful to separate the functions of debt management from those of liquidity management. The monitoring and management of the database on Ghana’s debt stock also needs improvement. In this regard the lines of communication between the Bank of Ghana, Ministry of Finance and Controller and Accountant Generals department should be improved.
References


Introduction

Employment is the main of livelihood for the overwhelming majority of Ghanaians. The provision of employment and access to productive employment is at the core of the poverty problem the country now faces. Employment growth, especially in the productive sector, has been very slow relative to the growth of the labour force, since the early 1980s, resulting in an estimated 25% of the labour force being in unemployment or underemployment. According to GLSS data, growth in new employment remained negative or close to zero between 1991/92 and 1999/99, with the formal sector experiencing a decline in its share of the labour force by nearly 28% whilst the only sector with above 2% growth in employment (non-farm self-employment) increased its share by 14%.

The slow growth in employment opportunities has been attributed largely to the slow growth of the economy and the lack of investments in new plant and equipment. A growth rate of 7-8% per annum is the minimum growth rate necessary for the Ghanaian economy to generate sufficient productive employment for its labour force. However, the actual growth rate has been at an average of less than 4% since 1985. Thus, the economy is not expanding fast enough to meet the needs of employment for the labour force, which has been growing at an annual average of 3% since the 1980s.

Empirical evidence shows that Ghana needs to achieve an investment rate of above 15% to significantly increase the rate of employment. But the average rate of investment has been less than 12% since the 1980s. The need to boost investment in Ghana cannot, therefore, be over-emphasised. How do we raise investment rate to at least 15% so as to improve employment in the medium-to-long term?

It is imperative for Ghana to improve upon the current level of investment so as to avoid "the low skill, bad jobs trap".¹

¹ Snower (1994) describes this trap as a vicious cycle of low productivity, deficient training, and deficient skilled jobs that prevents an economy from competing effectively in the market for skill-intensive products.
Investment Trends in Ghana

The growth and the distribution of investments constitute a major factor in determining the performance of an economy in terms of employment and poverty-reduction. New investments are required to equip new labour market entrants and to re-tool the existing labour force. Without this, any expansion in employment in the economy could lead to lower capital per worker and hence lower productivity. Furthermore, the pattern of investment is important in determining employment per unit of investment undertaken, given that capital requirements per labour, or labour intensity, varies among sectors and industries in an economy.

Compared with other countries, the level of investments in Ghana could be described as low. Appendix Table 1 shows investment trends for Ghana, Korea, and Malaysia. Even though data for Korea and Malaysia are up to 1988, the differences between these countries and Ghana are very striking. Between 1980 and 1984, private investment as a percentage of GDP averaged 3.6% for Ghana, with total investment averaging only 5%. The corresponding figures for Korea and Malaysia were 24.2% and 18.3% respectively for private investment and 30.2% and 34.0% for total investment. Other averages are shown in the table. Even though total investment as ratio of GDP has increased steadily, the levels of investment achieved in the early to mid 1990s is nowhere near the levels achieved by the these two countries in the early to mid 1980s. Why are private investment levels low in Ghana? What should the government do to boost private investment?

Private investment, which is already low in Ghana, has declined substantially since 1991, from about 9% of GDP to slightly less than 2% in 1996, as shown in Table 1. This decline is due to several factors:

- High cost of capital arising from high domestic interest rates (crowding out effect of public sector expenditures) and depreciating exchange rate
- Lack of stability in the political environment- issues of governance and policy credibility
- Limited capacity of domestic manufacturing to compete abroad- another vicious cycle of low investment in plant and equipment, leading to inability to compete, that is, preventing the economy from taking advantage of potentials created by international trade and forcing it into low productivity sectors
- Decline in cocoa and gold prices, which have undermined investments in mining, the main driving force behind industrial investments in Ghana, since mid-1980s
- Lack of growth in real consumption: the average annual growth rate of private consumption per capita was only 0.1% between 1980 and 1997.

After 1992 foreign direct investment appeared to have increased. During 1993-99, gross investment to GDP ratio is reported to have increased to 20-24% (The World Bank, 2001). This trend is perhaps due to the introduction of the 1992 constitution and establishment of democratic government, and hence the hope of a return to the rule of law. It may also be due to the increased effort by government to mobilize external private resources as donor fatigue set in, as the Investment Code was revised in 1994 and the GIPC was mandated to be proactive. The Gateway Project was also set up to help identify and remove all bureaucratic bottlenecks to investment. The implementation of the divestiture programme was also accelerated. Private investment was estimated at about 50% of total investment in 1999.
### Table 1. Trends in Investment 1991-96

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Domestic Investment</th>
<th>Public Investment</th>
<th>Private Investment</th>
<th>Foreign Direct Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(US$)</td>
<td>%GDP</td>
<td>%GDP</td>
<td>%GDP</td>
</tr>
<tr>
<td>1991</td>
<td>1003</td>
<td>14.2</td>
<td>8.2</td>
<td>8.7</td>
</tr>
<tr>
<td>1992</td>
<td>1092</td>
<td>14.8</td>
<td>9.1</td>
<td>4.7</td>
</tr>
<tr>
<td>1993</td>
<td>1320</td>
<td>17.1</td>
<td>11.3</td>
<td>4.6</td>
</tr>
<tr>
<td>1994</td>
<td>1405</td>
<td>17.5</td>
<td>12.7</td>
<td>3.2</td>
</tr>
<tr>
<td>1995</td>
<td>1437</td>
<td>17.1</td>
<td>12.2</td>
<td>2.8</td>
</tr>
<tr>
<td>1996</td>
<td>1262</td>
<td>2.0</td>
<td>2.0</td>
<td>1.85</td>
</tr>
</tbody>
</table>


---

### Constraints to Investment in Ghana

In Asante (2000) and Tsikata et al. (2000) the following factors, among others, were observed to have influenced private investments in Ghana:

1. **Macroeconomic instability:** Macroeconomic instability was found to be a major hindrance to private investment. According to Rodrik, "Uncertainty matters a lot. Indeed it may matter so much as to render insignificant some of the traditional determinants of investment, such as the cost of credit, level of profitability, and tax incentives" (Rodrik, in Serven and Solimano, 1993:280-281). 45% of respondents surveyed asserted that economic instability is a major obstacle to investment. However, individual components (the black market premium and the variability of the real exchange rate) of the overall measure of instability were insignificant. Therefore, partial proxies for macroeconomic instability may not be powerful investment inhibitors if taken individually, suggesting that policies that address only some of the components of macroeconomic instability may not be enough to improve private investment, since investment is depressed by overall instability. The insignificance of the coefficient of variation is not supported by the survey where 83% of the respondents ranked exchange rate variability as a major constraint and 51% responded that exchange rate uncertainty was the most serious type of uncertainty. Again, this may be due to the fact that in the past the exchange rate was fixed but currently it is floating and depreciating at an alarming rate and therefore causing a lot of concern for investors.

2. **The growth rate of real credit to the private sector** was identified as a significant determinant of private investment in Ghana. This is strongly supported by the survey where 69% of the firms surveyed claimed that the problem of getting credit is a major obstacle to investment. Also, 37% of the respondents whose fixed investments have not increased over the last three years gave credit problems as the reason. Additionally, of the non-exporters who are considering producing for the export market, 27.3% mentioned credit as the main obstacle. The question of finance must therefore be addressed in order to ensure continuing participation of the private sector in investment.
3. **Openness:** The controlled trade regime constituted a major hindrance to private investment. This is due to the fact that overvalued exchange rates, lack of foreign exchange, corrupt and erratic issue of import licensing, foreign exchange quotas for various sectors, and rent-seeking activities have characterized Ghana's controlled economic history. These hamper the acquisition of foreign exchange for the importation of needed inputs for investment. The controlled regime is also likely to discourage foreign direct investment if economic agents realize that the controls are not sustainable. While the controlled regime has been detrimental to private investment, the results of the survey indicate scepticism about the current trade liberalization exercise. About 40% of the respondents claimed that the pace is too fast while 43.7% asserted that the exercise has adversely affected their businesses. The survey and interview results indicated, *inter alia*, that aspects of the market, which have been either over-liberalized and/or are being "polluted", needs to be reassessed for redress. The excessive inflow of imported manufactures, including unwholesome goods, because of the taste for 'made-in-there' goods has serious implications for the development of local industry and its potential for employment generation. Here, it is difficult to imagine a foreign investor plunging his 'infant' company into a manufacturing activity, which is already saturated with so-called 'superior' imported goods.

4. **Political instability and democratic rule:** Measured by a "successful coup" dummy, political instability had a negative sign in all the trials and highly significant in all of them. This suggests that the military takeovers may have created a climate hostile to private investment. This is, however, not supported by the survey results where only 22% claimed that political uncertainty acts as a major constraint to their investments. The view that democratic traditions provide an enabling environment for FDI was validated by the study. The democratisation dummy was significant and had the expected sign.

5. **Fiscal Incentives:** The study indicated that corporate tax reductions have contributed to raising investor confidence in the economy. As such, periodic rate reductions might constitute an appropriate long-term fiscal strategy for building a permanent investor confidence. The survey also revealed the need to address the burden imposed by the existing up-front tax. The contention was that it constituted a drag on business performance and investment promotion, especially at a time when the cost of capital (interest rates) was very high.

6. **Complementarities between Public and Private Investment:** Theoretically, the effect of public investment on private investment is ambiguous. While government investment in infrastructure is expected to be complementary to private investment, government investment in non-infrastructure may compete with private investment especially if the government competes with the private sector for funds or in the product market. Blejer and Khan (1984) show (by decomposing public investment into infrastructural and non-infrastructural investment) that government investment in infrastructure is complementary with private investment whereas other types of government investment are not. In Asante (2000) the coefficient of the public investment variable was observed to be positive and significant, suggesting that the positive externality of infrastructural investment outweighs the negative effect of non-infrastructural investment. This result is consistent with the one obtained in the case of Cote d'Ivoire (Kouassy and Bohoun, 1992:25)
Recent reviews of public and private sector investments, however, indicate that on the whole the complementarities between public and private investments are limited (Boateng, 2001).

- The correlation between private investment and public investment is low. The ratio of private investment to public investment fell from 1.06:1 in 1991 to 0.16:1 in 1999, indicating a negative correlation, and giving the impression that private investments and public investments are substitutes in the national accounts.
- According to studies based on RPED data, among manufacturing firms over the period 1992-98, investment in plant and equipment was as low as 10% of the value of capital stock and that of building and land a mere 3%. About half of sampled firms did not invest due to high risks and uncertainty.²
- Private investment does not seem to follow public investment, in the spatial sense: investments in rural infrastructure have not led to any appreciable shift in the location of enterprises to the rural areas. In some rural areas where electrification has been completed, there is no indication that the communities were exploiting new economic advantages such as introduction of power driven corn-milling machines.³

**Employment Trends**

The performance of the Ghanaian labour market in recent years may be summarised in the following terms:

- Increasing income security, as a result of a combination of declining percentage of stable, formal sector jobs and declining real earnings, for the majority of the labour force
- Widening gap in earnings between gainers (private sector management and consultants) and losers (production workers, lower tiers of own-account workers and self-employed)
- Continuing low absorption capacity in prosperous sectors of the economy, due to debilitating macro and micro environmental factors
- Increasing non-salary related causes of industrial disputes, which suggest problems with structure and or interpretation of collective bargaining or with the industrial relations system as a whole.

The share of self-employment in the labour force has been increasing, though relative earnings in the sector have depreciated significantly (-28.4% between 1991/92 and 1998/99). In the agricultural sector, where about 50% of the labour force is still employed, the evidence from GLSS indicate some movement from the food crop sector to export crop farming, which is a desirable shift. The significant improvement in the non-traditional agricultural export sector has been due to the increase in investments in that area, particularly, through the joint efforts of such bilateral agencies such as USAID, and the

---

government of Ghana in promoting production and efficient marketing (packaging and freight) facilities.

In the private formal sector, average employment levels dropped by 11.1% between 1980 and 1995, as shown in Table 2. This decline is due largely to the low investment and other production bottlenecks in the form of poor supply of utilities, turbulent industrial relations atmosphere and high cost of working capital.

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Employment Per establishment</th>
<th>Percent Decline in Average Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>325</td>
<td>-</td>
</tr>
<tr>
<td>1990</td>
<td>319</td>
<td>1.9</td>
</tr>
<tr>
<td>1995</td>
<td>289</td>
<td>11.1</td>
</tr>
</tbody>
</table>

Source: K. Boateng (1998). Table 4

Employment: Impacts of Recent Foreign Direct Investments

Employment impacts of investment depends on a number of factors, namely,

- The nature of the production function, whether it is labour or capital biased: the more labour biased the production function the greater the employment impact of the investment. Thus, agricultural investments tend to create more jobs in the short run than mining sector investments, because mining is more capital intensive.
- Over the long run, the impact of investment on employment also depends on the elasticity of substitution between labour and capital, and hence on the wage-rental ratio: high wage-rental ratio limits substitution in favour of labour and hence the amount of labour absorbed per cedi of investment.
- Structure of Product and labour markets: the more competitive the market is the greater the impact of investment on employment

Some Empirical Observations

- Labour content per unit of domestic value added is higher for manufactured exports than for domestic production or in import-substituting industries
- Exportables are in general more labour intensive
- Elasticity of substitution is between 6-8% in the manufacturing sector
- Labour intensity is highest in wood, and garments sector
- Output elasticity of labour demand is 3-5% in manufacturing sector
- Service sector has highest labour absorption rate (in packaging and tourism)
- Mining sector has the lowest labour absorption rate
- Employment growth in the formal sector is higher in enterprises with decentralized bargaining structure than in those with centralized bargaining
On per dollar of FDI basis, investments in export trade create more jobs ($8000 per job created) in the long run than investments in other sectors; the lowest employment to investment ratio is in the service sector where every $96,000 worth of investment creates only one Ghanaian job. A corollary of this is that service sector jobs created by FDI tend also to be skill intensive and high wage, compared with export sector or tourism jobs. (Boateng, 2001) One explanation for the low employment-investment ratio in the service sector is that the sector is now dominated by multinational consultancies and these are usually skill intensive.

Table 3 Projects Registered by Ghana Investment Promotion Centre (GIPC)
(Between September 1994 to December 1999)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of Projects</th>
<th>Total Investment Cost $ml</th>
<th>Expected employment creation</th>
<th>Investment per Ghanaian Labour Employed $ml</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service</td>
<td>264</td>
<td>831.61</td>
<td>847</td>
<td>8680</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>251</td>
<td>278.47</td>
<td>971</td>
<td>17323</td>
</tr>
<tr>
<td>Tourism</td>
<td>117</td>
<td>22.01</td>
<td>244</td>
<td>2481</td>
</tr>
<tr>
<td>Building&amp;Const</td>
<td>83</td>
<td>105.18</td>
<td>478</td>
<td>9575</td>
</tr>
<tr>
<td>Agriculture</td>
<td>82</td>
<td>169.46</td>
<td>314</td>
<td>9775</td>
</tr>
<tr>
<td>Export Trade</td>
<td>67</td>
<td>8.57</td>
<td>131</td>
<td>1011</td>
</tr>
</tbody>
</table>

Source: Boateng (2001) Table 5.2

Aggregate and industry-specific data on employment are lacking. However, it is estimated that non-traditional export firms employed about 70,000 people in 1999, representing an annual growth of 19% during the period 1993 and 1999. During the same period FDI accounted for 34% of the value of non-traditional exports (The World Bank, 2001).

---

4 A 1996 study by USAID indicated that on average $6000 in export earnings were needed to create one job for one direct full-time worker.
Promoting Pro-Employment Investments in Ghana

There are good prospects for generating productive employment in the various sectors of the Ghanaian economy. The following steps could help realise those opportunities:

1. Identify and support high labour absorptive sectors: The evidence shows high labour absorption in export trade, in particular non-traditional agricultural exports, and tourism. These sectors should be supported with:
   a. Improved processing, packaging, storage and marketing facilities, both directly through public investments, and indirectly through fiscal incentives for private investments in these areas
   b. Skill training and provision of extension services
   c. Access to land, and an environment of peace and harmony in land acquisition, which require serious national land reform initiative

2. Modernise the labour market, by
   a. Installing an industrial relations atmosphere that gives effective recognition to civil, legal and economic rights of labour market agents, including the right to fair remuneration and reasonable profits, through the enactment of the proposed Labour Bill and establishment and empowerment of the Labour Commission
   b. Providing an effective and efficient labour market and small scale business information systems, which would enhance labour and industrial mobility
   c. Re-orientating human resource development institutions to be responsive to changing skill demand needs of the economy

3. Create an enabling macro-economic environment, by tackling the following macroeconomic constraints:
   a. Effective debt management, coupled with effective prioritisation of discretionary expenditures in favour of pro-employment activities, given the current high levels of domestic and foreign debt service
   b. Current poor economic conditions facing gold and cocoa sector, which pose challenges for sound exchange rate policy, and
   c. Institutional capacity to formulate, implement, monitor and review employment impacts of public and private investment, and to achieve an efficient growth and private investment-oriented public service.

4. Review and vigorous pursue macroeconomic policy framework pertaining to the real sector, in particular:
   a. Industrial development policy
   b. Export development policy
   c. Investment Policy
   d. Agricultural development policy
   e. National Poverty Reduction Programme
References


<table>
<thead>
<tr>
<th></th>
<th>Ghana</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private</td>
<td>Public</td>
<td>FDI</td>
<td>Total</td>
<td>Private</td>
<td>Public</td>
<td>Total</td>
<td>Private</td>
<td>Public</td>
<td>Total</td>
</tr>
<tr>
<td>1980</td>
<td>4.2</td>
<td>1.9</td>
<td>0.10</td>
<td>6.1</td>
<td>24.3</td>
<td>5.5</td>
<td>29.8</td>
<td>19.6</td>
<td>11.7</td>
<td>31.3</td>
</tr>
<tr>
<td>1981</td>
<td>3.0</td>
<td>1.7</td>
<td>0.06</td>
<td>4.7</td>
<td>21.0</td>
<td>5.4</td>
<td>26.4</td>
<td>19.1</td>
<td>15.4</td>
<td>34.5</td>
</tr>
<tr>
<td>1982</td>
<td>2.6</td>
<td>0.9</td>
<td>0.05</td>
<td>3.5</td>
<td>25.2</td>
<td>6.8</td>
<td>32.0</td>
<td>17.6</td>
<td>17.6</td>
<td>35.2</td>
</tr>
<tr>
<td>1983</td>
<td>3.0</td>
<td>0.8</td>
<td>0.01</td>
<td>3.8</td>
<td>25.2</td>
<td>6.1</td>
<td>31.3</td>
<td>17.1</td>
<td>17.8</td>
<td>34.9</td>
</tr>
<tr>
<td>1984</td>
<td>5.2</td>
<td>1.6</td>
<td>0.03</td>
<td>6.8</td>
<td>25.0</td>
<td>6.3</td>
<td>31.3</td>
<td>17.9</td>
<td>16.2</td>
<td>34.1</td>
</tr>
<tr>
<td>1985</td>
<td>7.3</td>
<td>2.2</td>
<td>0.09</td>
<td>9.5</td>
<td>24.2</td>
<td>6.1</td>
<td>30.3</td>
<td>14.8</td>
<td>16.7</td>
<td>31.5</td>
</tr>
<tr>
<td>1986</td>
<td>7.1</td>
<td>2.2</td>
<td>0.08</td>
<td>9.3</td>
<td>24.1</td>
<td>5.8</td>
<td>29.9</td>
<td>10.2</td>
<td>15.0</td>
<td>25.2</td>
</tr>
<tr>
<td>1987</td>
<td>6.9</td>
<td>3.5</td>
<td>0.10</td>
<td>10.4</td>
<td>25.6</td>
<td>5.6</td>
<td>31.2</td>
<td>11.2</td>
<td>11.7</td>
<td>22.9</td>
</tr>
<tr>
<td>1988</td>
<td>7.1</td>
<td>3.7</td>
<td>0.10</td>
<td>10.8</td>
<td>26.2</td>
<td>5.3</td>
<td>31.5</td>
<td>15.5</td>
<td>11.2</td>
<td>26.7</td>
</tr>
<tr>
<td>1989</td>
<td>8.5</td>
<td>4.9</td>
<td>0.29</td>
<td>13.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>7.5</td>
<td>4.7</td>
<td>0.24</td>
<td>12.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>8.7</td>
<td>8.2</td>
<td>0.30</td>
<td>16.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>4.7</td>
<td>9.1</td>
<td>0.35</td>
<td>13.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>4.6</td>
<td>11.3</td>
<td>2.21</td>
<td>15.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>3.2</td>
<td>12.7</td>
<td>4.50</td>
<td>15.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>2.8</td>
<td>11.2</td>
<td>1.72</td>
<td>14.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>2.0</td>
<td>12.2</td>
<td>1.85</td>
<td>14.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ave</td>
<td>3.6</td>
<td>1.4</td>
<td>0.05</td>
<td>5.0</td>
<td>24.2</td>
<td>6.0</td>
<td>30.2</td>
<td>18.3</td>
<td>15.7</td>
<td>34.0</td>
</tr>
<tr>
<td>1980-4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>19.6</td>
<td>11.7</td>
<td>31.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985-8</td>
<td>7.1</td>
<td>2.9</td>
<td>0.09</td>
<td>10.0</td>
<td>25.0</td>
<td>5.7</td>
<td>30.7</td>
<td>12.9</td>
<td>13.7</td>
<td>26.6</td>
</tr>
<tr>
<td>1989-2</td>
<td>6.7</td>
<td>7.4</td>
<td>0.30</td>
<td>14.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993-6</td>
<td>3.2</td>
<td>11.9</td>
<td>2.6</td>
<td>15.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Economic Policy, Distribution and Poverty: The Nature of Disagreements

Ravi Kanbur*
Cornell University
sk145@cornell.edu
http://www.people.cornell.edu/pages/sk145/
First Draft: December 2000
Minor Changes: January 2001

Contents

1. Introduction
2. Disagreements Over What and Between Whom?
3. Some Areas of Agreement
4. The Nature of Disagreements I: Aggregation
5. The Nature of Disagreements II: Time Horizon
7. A Seeming Disagreement: The “Growth” Red Herring
9. Conclusion

1. Introduction

The end of history lasted for such a short time. If the early 1990s raised hopes of a broad based consensus on economic policy for growth, equity and poverty reduction, the late 1990s dashed them. The East Asian crisis and the Seattle debacle saw to that. In the year 2000, the Governors of the World Bank, whose mission it is to eradicate poverty, could meet only under police protection, besieged by those who believe instead that the institution and the policies it espouses cause poverty. And the street demonstrations in Prague, Seattle and Washington, D.C., are one end of a spectrum of disagreement, which includes vigorous debate in the pages of the leading newspapers, passionate involvement of faith based organizations, and the genteel cut and thrust of academic discourse.

The last two years have seen my involvement in an extensive process of consultation on poverty reduction strategies. The consultation reached out to most interested constituencies in the academic, policy making and advocacy communities. It covered the IFIs and the myriad UN specialized agencies, Government Ministries in the North and the South, Northern aid agencies, academic analysts in rich and poor countries, Northern and Southern advocacy NGOs, and NGO’s with ground level operations working with the poor. It involved a global electronic consultation, as well as conventional written contributions, and scores of meetings. A particularly valuable exercise was the systematic attempt to elicit directly the “Voices of the Poor” through participatory assessments.

This paper presents an analysis of the broad themes of disagreement in these consultations and more generally among those concerned with poverty reduction. It has to be noted first of all that there are swathes of agreement in areas where there would not have been consensus two decades ago. Any discussion of disagreements has to start with an acknowledgement of these areas of agreement. But, clearly, there are deep divisions on economic policy, distribution and poverty. These divisions spilled out in the consultations, mostly politely but sometimes in vehement discourse, written and oral, harbingers of the street battles to come.

The paper tries to answer an obvious question: How can people with seemingly the same ends disagree so much about means, and how can seemingly the same objective reality be interpreted so differently? The simple answer, which the protagonists themselves often provide, is of course to question the motives or the analytical capacity of those one disagrees with. The suggestion that “the others” are either not truly interested in attacking poverty (quite the opposite, in fact), or that they make elementary errors of fact or interpretation, is never very far below the surface.

However, it is argued here that at least some of the disagreement can be understood in terms of differences in perspective and framework. Understanding disagreements in these terms—rather than in terms of motives or intelligence—is more conducive to encouraging dialogue rather than confrontation. The object of this paper is to provide an

1 Most of this consultation was under the auspices of the World Bank’s World Development Report on Poverty, of which I was Director until I resigned in May, 2000.
account of some of the underlying reasons for deep disagreements on economic policy, distribution and poverty, and to couch these in an analytical rather than a rhetorical frame. But before doing this we need to say a little more about disagreements over what and disagreements between whom.

2. Disagreements Over What and Between Whom?

Disagreements over what? The next section will review some broad areas of consensus on poverty reduction strategies. But the focus of this paper is on disagreements, and these have begun to coalesce around a seemingly irreducible core of economic policy instruments. There are major disagreements on the pace and sequencing of fiscal adjustment, monetary and interest rate policy, exchange rate regimes, trade and openness, internal and external financial liberalization including deregulation of capital flows, the scale and methods of large scale privatization of state owned enterprises, etc. Perhaps trade and openness is the archetypal, emblematic, area around which there are deep divisions, and where certainly the rhetoric is fiercest.

Disagreements between whom? Any attempt at categorization and classification risks doing violence to a complex and richly textured reality. But the following grouping would be recognizable to many, and captures broad elements of policy disagreements. One group, call them Group A, could be labeled “Finance Ministry”. In this group would obviously be some who worked in finance ministries in the North, and in the South. It would also include many economic analysts, economic policy managers and operational managers in the IFI’s and the Regional Multilateral Banks. A key constituent would be the financial press, particularly in the North but also in the South. Finally, one would include many, though not all, academic economists trained in the Anglo-Saxon tradition.

Another group, call them Group B, could be labeled “Civil Society”. This group would obviously include analysts and advocates in the full range of advocacy and operational NGO’s. There would also be people who worked in some of the UN specialized agencies, in aid ministries in the North and social sector ministries in the South. Amongst academics, non-economists would tend to fall into this group.

To repeat, any such classification is bound to be too simple a reflection of reality. Although the terminology of “Group A” and “Group B” is easier to deploy, A and B are better thought of as tendencies rather than as defined and specific individuals. There are clearly people who work in the IFIs who are not “Finance Ministry types”, just as there are academic economists trained in the Anglo-Saxon tradition who would, for example, caution strongly on capital account liberalization. The U.N specialized agencies and Northern aid agencies are often a battle ground between Finance Ministry and Civil Society tendencies. And, as the next section makes clear, some NGO positions on specific policies would be approved of in Finance Ministries, and vice versa.

This being said, however, the proposed classification offers a sharp enough, and recognizable enough, characterization of divisions to help us understand the nature of disagreements. Group A types are those who tend to believe that the cause of poverty
reduction is best served by more rapid adjustment to fiscal imbalances, rapid adjustment to lower inflation and external deficits and the use of high interest rates to achieve these ends, internal and external financial sector liberalization, deregulation of capital controls, deep and rapid privatization of state owned enterprises and, perhaps the strongest unifying factor in this group—rapid and major opening up of an economy to trade and foreign direct investment. On each of these issues, group B types tend to lean the other way.

The real question we face is why? Why is it that these two groups disagree so much across key areas of economic policy? The basic contention of this paper is that much of the reason lies in differences in perspective and framework on three key features characterizing assessments of economic policy, distribution and poverty: Aggregation, Time Horizon, and Market Structure. First, Group A tends to view the consequences of economic policy in much more aggregative terms than does Group B. Second, Group B’s major concerns are with consequences over a time horizon which is both much shorter and much longer than the “medium term “ horizon which Group A typically adopts. Third, Group A instinctively approaches the distributional consequences of economic policy through a competitive market structure, while Group B instinctively thinks of a world in which market structure is characterized by pockets of market power, and economic policy feeds through this non-competitive structure to the consequences for the poor.

The elaboration of Aggregation, Time Horizon and Market Structure, as providing a framework for understanding deep disagreements on economic policy, distribution and poverty, is the core task of this paper. But before elaborating on disagreement, let us consider areas of agreement.

3. Some Areas of Agreement

The consultations revealed wide areas of agreement--some old, some new, and some surprising.

There is no question that there is now broad agreement that education and health outcomes are on par with income in assessing poverty and the consequences of economic policy. This is now so commonplace that it is easy to forget it was not always the case, that twenty-five years ago great intellectual and policy battles were fought in the World Bank on broadening the conception of development and poverty reduction. Perhaps today’s new proposals on conceptualizing poverty—for example, that empowerment and participation should in their turn be treated on par with education and health and income—will equally become tomorrow’s foundations.

Another area in which the consultations revealed considerable agreement, at least at a certain level of generality, was on the role of international public goods in determining the well being of the poor. Whether couched in terms of cross border spillovers of environmental externalities or financial instability, or in terms of the central role of basic
research into tropical agriculture and tropical diseases, the recognition was clearly abroad that public intervention is needed in these areas. The emerging importance of this issue was instinctively grasped by most. It may well be that this happy state of affairs is due precisely to the fact that this is a relatively new issue in the policy arena, that once we get into the details, divisions will grow. Thus, for example, while there was overall broad support for the idea of a Vaccine Purchase Fund to bridge the gap between the costs of basic research and the purchasing power of the poorest nations, there was already some dissent on such funds being unwarranted subsidies to corporations, who should instead be directed to supply drugs they already have at prices the poorest can afford.

A third area where there is a surprising amount of agreement, or more accurately not as much disagreement as there was twenty or even ten years ago, is on the old “Markets versus State” debate. There has definitely been some coming together on this. Particularly interesting were the positions of NGO’s with actual ground level operations working directly with poor. In the consultations, these organizations tended to be very pragmatic. The question for them was always what worked to improve the standard of living of the people they were helping, not about ideologies favoring state over market or the other way round.

Consider, for example, the work and philosophy of SEWA, the Self Employed Women’s Association, which operates in Gujarat State in India. SEWA grew out of the long history of organizing textile workers in Ahmedabad, but applied and modified those lessons to organizing women in the informal sector. Starting from an urban base, it has now also expanded to organizing in rural areas (http://www.sewa.org). SEWA’s ground level campaigns, and their national advocacy work, reflects a pragmatism which eschews ideological positions on “state versus market”. They have supported certain types of trade liberalization because they increase the demand for the output and labor of their members. But they have opposed other types of trade liberalization when they hurt, for example, the employment and incomes of the husbands and brothers and fathers of their members. They are strong supporters of deregulating the control of the Gujarat State Forestry Commission on the livelihoods of their members. But they oppose deregulation of the pharmaceutical industry because of the devastating impact of these on basic drug prices, and they support increased regulation in Export Processing Zones to ensure that labor standards are met. Is SEWA pro-state or pro-market? It is difficult to say. What is clear is that SEWA is pro-poor. One of their best known pamphlets is in fact entitled “Liberalizing for the Poor.”

The more one moves away from ground level operations, the more one moves to advocacy groups of any shade, pragmatism gives way to more defined a priori positions on state and market. But even here, the divides are not as great as they were at the height of the cold war, or at the zenith of post cold war triumphalism that heralded the “end of history”. At the turn of the century the real questions are to do with the right balance of market and state, and how things actually work on the ground.

---

2 In July 1999 I was involved in an immersion exercise organized by SEWA and the German Institute for North-South Dialogue. Officials from aid agencies and parliaments were taken by SEWA for a few days to experience the lives of the women SEWA works for and with.
Alongside this lessened divide on markets versus state, there is broad agreement on the central importance of institutions in regulating markets, in regulating government, in determining the interaction between households in the market place, and thus in determining the outcomes for the poor. One of the striking findings from the Voices of the Poor exercise was how important institutions like the police and the courts were to the reality of poor people’s lives. At the macro level, the role of institutions in determining the investment climate was also agreed upon in the consultations. Of course, once again, this was at a certain level of generality. When detailed discussions started, and especially when they impinged on economic policies, divisions tended to appear.

So there is broad consensus in some areas and at a certain level of discourse, to set against the divisions that are the focus of this paper. But these very agreements throw into sharp relief the disagreements that remain. It is almost as if the battle is more intense because it is now focused more sharply on fewer and fewer remaining issues. Let us turn now to the nature of these disagreements.

4. The Nature of Disagreements I: Aggregation

In the current discourse on economic policy, distribution and poverty, there is a strong sense of people talking past each other, each side equally convinced that it has the truth, even when confronted with seemingly the same objective reality. How can that be? One key factor is that different people instinctively operate at different levels of aggregation when they talk about outcomes, or about the consequences of different economic policy interventions. This goes beyond the simple point about GDP versus poverty or other distribution indicators, which is the usual way in which this divide is portrayed. Many in Group A now work with poverty measures which calculate, for example, the fraction of people in a country who fall below a critical level of income or expenditure—the most commonly used threshold is the famous $1 per person per day poverty line. Even with something like this measure, the two groups have very different perspectives on poverty outcomes. Some of the differences are obvious, others less so.

The following personal experience illustrates the reaction that many analysts in Group A get when they present their formal poverty analysis to broader audiences. After doing detailed academic work on the Ghana Living Standards Survey (GLSS) in the 1980s and early 1990s, in 1992 I found myself as the head of the World Bank’s Field Office in Ghana. Work on GLSS data by a range of analysts showed that the incidence of poverty in Ghana, defined as above but with a local poverty line, fell between 1987 and 1991. The exact magnitude varied depending on the detailed calculations, but there was a three or four percentage point decline over these four years. This was pitifully small, but it was actually very good by African standards.

The analysis presented, in common with the best practice in this area, had made all the necessary adjustments and corrections to overcome the shortcomings of these sorts of data. For example, considerable effort was put into correcting for regional price
variations, making imputations for dwellings, correcting for household size, etc., in arriving at the poverty measure. But when the analysis was presented in Ghana, very few people believed it. From academics in the Universities, through foreign and local NGO’s, to the trade unions and the Rotary Clubs—there was an astonishing degree of disbelief. And this is not an uncommon reaction, at least in Africa, to such analysis which shows poverty decreasing. The natural reactions of Group A analysts to this disbelief usually go through the whole gamut—that people do not really understand the detailed statistical analysis, that those who criticize represent special interest groups, that some people will never admit that they are better off, etc. But before dismissing disbelief in this way, it is as well to consider that there might be legitimate reasons for this response, understandable even within the standard framework of household survey based analysis.

There at least three reasons why the claim that poverty had gone down in Ghana, for example, could be questioned. The first of these is well recognized by household survey analysts. The income-expenditure based measurement of well being has improved a lot over the years—for example, production for home consumption is now routinely included, capturing of regional price variation is getting better, and imputing use value to dwellings is also becoming standard. However, one thing that these measures do not capture very well, or at all, is the value of public services. There are separate modules in these surveys with questions on education and health and infrastructure and so on, but these are rarely, almost never, integrated into the income/expenditure measure of well being because of conceptual and data difficulties. And it is this income/expenditure measure that is used in calculating the headline poverty ratios.

So, it is quite possible for public services to worsen considerably and yet for this effect to not show up in the income-expenditure based measures of poverty incidence. If the bus service that takes a woman from her village to her sister’s village is cancelled, it will not show up in these measures. If the health post in the urban slum runs out of drugs, it will not show up. If the primary school text books disappear, or if the teacher does not turn up to teach, it will not show up. But those with ground level operations and personnel will pick these up. And to them, as well as to the poor, the claim that poverty has gone down will ring hollow. None of this is to say that it is not useful to calculate nationally representative, household survey based, income-expenditure poverty measures. It is simply to say that focusing on them solely misses out on disaggregated detail which others can help to fill in, and which influences the perceptions and assessments of these others.

The second reason for the disconnect one often finds between household survey based poverty measures used by Group A and the perceptions of Group B is that of regional or group disaggregation. Even accepting the income-expenditure based measures to be an accurate representation of wellbeing, quite often a national fall in the poverty incidence can be composed of large movements in opposite directions. For example, in Ghana, between 1987 and 1991, the fall in national poverty was composed of a fall in rural areas and a rise in urban areas. In Mexico between 1990 and 1994, the fall in national poverty was composed of a fall in urban areas, but an increase in some rural regions. It is

---

3 I include myself among those who have had such reactions.
important to realize that we are not talking here about the odd household or two getting worse off. The poverty index for entire regions increased. While the fall in the national poverty index, and the falls in those regions which are driving this fall at the national level, are clearly to be welcomed, just focusing on the aggregate picture is liable to miss out the increasing poverty in Accra, the capital of Ghana, or in the Chiapas region of Mexico. And for an NGO working with street children in Accra, or for a local official coping with increased poverty among indigenous peoples in Chiapas, it is cold comfort to be told, “but national poverty has gone down.” A similar story can be told about gender based disaggregation, and other groupings based on ethnicity and race.

It should be clear that in the above type of disconnect neither view is “wrong”. Different parts of the same objective reality are being seen and magnified. It is both true that the national poverty incidence has declined, and that major groups have been made worse off. The problem is that instead of attempting to understand the other perspective each side hunkers down to defend its view in increasingly strident terms. Group A analysts just keep repeating that poverty has gone down, and do not make any concessions to the complex group specific patterns, while Group B analysts and advocates become increasingly irritated and alienated from a discourse which does not match the reality they know.

Consider now a third and not frequently appreciated disconnect related to aggregation. The work horse poverty concept of Group A analysts is the incidence of poverty—the percentage of the total population below some poverty line, say one dollar per person per day. This is the concept they instinctively go for. For example, the leading International Development Target, broadly accepted by donor agencies, is to halve by 2015 the incidence of poverty. But analysts and especially advocates and operational types in Group B instinctively think of the absolute numbers of poor as the criterion. The potential for disconnect should be clear. In Ghana, for example, while the incidence of poverty was falling at around one percentage point per year between 1987 to 1991, the total population was growing at almost twice that rate, with the result that the absolute number of poor, even using the standard income-expenditure based measure, grew sizably.

Think again of the local NGO with ground level operations. If the number of people turning up to soup kitchens, the number of homeless indigents who have to be provided shelters, the number of street children, increases, then those who work in these organizations are, quite rightly from their perspective, going to argue that poverty has gone up. That the incidence of poverty has fallen is of little relevance to them, and to be told repeatedly and insistently that poverty has fallen is bound to lead to difficulties in communication and dialogue. One sees this also at the global level. The World Bank’s figures show that over the 1990s the absolute numbers of the poor stayed roughly constant at around 1.2 billion. The incidence of poverty has fallen, since total world population is on the increase. Has global poverty fallen or stayed the same? One challenge often heard in the consultations was: “How can you say economic growth helps the poor? Look, there has been all this growth in the 1990s, and yet the total number of poor has not changed at all!” Leaving to one side the growth issue, to which a whole
section is devoted later in the paper, it is easy to see how communication can be derailed by different groups meaning different things by the same word—poverty. In this case a good start would be clarity and comprehension, but even that might not help because the issue of whether the criterion is the incidence of poverty or the absolute numbers of the poor is still left open.

Thus, instinctive adoption of different levels of aggregation in describing and evaluating the distributional and poverty consequences of economic policies explain at least some of the disconnect one observes. The above arguments and characterizations would all be present for each of the economic policies in dispute—for example, the impact of trade policy reform on distribution and poverty. Understanding these differences is the first step in more fruitful dialogue between those who primarily rely on national poverty incidence measures derived from household surveys to assess the evolution of poverty, and those who have a much more finely disaggregated view of the outcomes of economic policy. Unfortunately, at the moment the lack of mutual comprehension is leading to polarization, with Group A often retreating into the formal technical bunker, and simply repeating their findings without trying to understand what Group B is trying to say, and Group B dismissing Group A analysis as either out of touch with reality or, even worse, actively manipulated to get certain answers. Neither of these positions is healthy, and bridging the aggregation divide is essential if we are to move forward.

5. The Nature of Disagreements II: Time Horizon

Implicit or explicit differences in the time horizon over which the consequences of policy are assessed explain some of the deep disagreements on economic policy, distribution and poverty.

The “medium term” is the instinctive time horizon that Group A uses when thinking about the consequences of trade policy, for example. This is implicit in the equilibrium theory which underlies much of the reasoning behind the impact of policy on growth and distribution. It is also implicit in the way empirical analysts interpret their cross-country econometric relationships between growth, equity or poverty on one side and measures of openness on the other. There is of course no simple way to link the short or medium or long term of economic theory and modeling to actual calendar time. But by and large when Group A talks about the consequences of policies for distribution and growth they have in mind a five to ten year time horizon.

But Group B has concerns that are both more short term and more long term. Those who work with the daily reality of poor people’s lives, are extremely concerned, like the poor themselves, about short term consequences of economic policy which can drive a family into starvation, to sell its assets at fire sale prices, or to pull its children out of school. For them it is no use to be told that over a five to ten year horizon things will pick up again. In fact, it is not even good enough to be told that in the medium term things will be better than they would have been without the shock of this policy change because
without the policy change things were in decline anyway. All this is true, but short run survival trumps medium run benefits every time, if the family is actually on the edge of survival. As Keynes might have said, in the short run they could all be dead.

Increasingly, Group A accepts the issue of short-term vulnerability and shocks as being an important one, not only because it affects well being in the short term, but because behavioral responses to this vulnerability may themselves lead to inefficiencies which affect the prospects for growth and poverty reduction in the medium term. And the issue of safety nets is back on the table, after its banishment in the 1980s, the banishment itself being a reaction to their inefficiencies and misuse in the 1960s and 1970s. However, safety nets are sometimes thought of by Group A as being an add on, to address the negative short term consequences of trade opening, for example. They tend to be cautious about them as a systematic part of an insurance and redistribution mechanism, and they certainly would not want to see trade opening to be halted or slowed down because these safety nets and compensation mechanisms, however temporary, were not in place. This last point is central, and an acid test. In the absence of safety nets, Group B would be cautious or downright hostile to trade openness. Group A would want to press ahead, often dismissing those who argue for caution as either not understanding that openness would actually lead to greater equity and poverty reduction, or as special interest groups with protection on their minds. Not facing up to the implicit difference in time horizon accounts for at least some of the vehement disagreements on this score.

There are also those who have what they see as a much longer time horizon than a decade. Environmental groups, including some with religious perspectives on stewardship of the earth’s resources, fall into this category. For them, it is the fifty or the hundred-year perspective that is important. They do not see how economic growth can be sustained given limits on the earth’s carrying capacity, and they see both immediate and long term negative consequences of resource depletion. An important corollary of this line of thinking is that implicit or explicit redistribution from rich nations to poor nations will have to substitute for economic growth as the foundation for global poverty reduction. Group A are essentially techno-optimists. They refer back to the gloomy scenarios painted by the Club of Rome in the 1970s and point out that none of these came to be true. While there are clearly some market distortions which lead to an inefficiently high level of resource depletion, and cross border spillover effects which lead to their own coordination problems, their answer is to fix these distortions rather than forcibly hold down investment and growth. In any event, they do not see it as a politically feasible option over the five to ten year horizon to ask the rich countries to undertake massive redistribution in favor of the poor countries, and they have a strong sense that technological change will come to the rescue over a fifty or hundred-year horizon, as it always has in the past.

In the consultations, therefore, Group A was fending off both shorter term and longer term perspectives. But the real point is that oftentimes it was not clear that it was this difference in perspective, rather than the specifics of trade policy or privatization policy or whatever, which was driving the difference. Clarity is not resolution, but it is a start.

Undoubtedly the most potent difference in framework and perspective centers on market structure and power. The implicit framework of Group A in thinking through the consequences of economic policy on distribution and poverty is that of a competitive market structure of a large number of small agents interacting without market power over each other. The instinctive picture that Group B has of market structure is one riddled with market power wielded by agents in the large and in the small. This is true whether they are talking about the power of big corporations in the market place or in negotiating with governments, or of the power of the local moneylender in determining usurious rates of interest in the village economy. They see the formulation and implementation of economic policy as being influenced by agents with market power, and they see policy feeding through to consequences through a market structure which is not competitive.

The immediate response of Group A to the suggestion that openness in trade, for example, might hurt the poor in poor countries is to (implicitly or explicitly) invoke the basic theorems of trade theory. Opening up an economy to trade will benefit the more abundant factor because this factor will be relatively cheap and opening up will increase demand for this factor overall. Since unskilled labor is the factor abundant in poor countries, opening up will benefit unskilled labor and hence the poor. Leaving aside the fact that this is a theory of medium term equilibrium, and thus subject to the disagreements discussed in the previous section, it is also a theory based on competitive product and factor markets. In particular, if local product and factor markets are segmented, because of poor infrastructure or because of the local monopoly power of middlemen and moneylenders, the simple theory will not go through quite so simply. But it is precisely such situations (as well as the disaggregated and the short term consequences discussed earlier) that are highlighted repeatedly in discussions about the possible negative consequences of openness. The tendency among Group A is to dismiss these claims, and to revert again to stating the conclusion that openness is good for equity.

Another example is capital mobility. Leaving to one side the question of portfolio capital, where Group A has itself moved to a more cautious stance since the financial crises of the late 1990s, there is the issue of mobility of investment capital. A very strong belief in Group B is that increased mobility of investment capital makes workers in both receiving and sending countries worse off. Such a view is derided by Group A analysts as being incoherent—“How can you say that when capital leaves the US it hurts US workers, and when it gets to Mexico it hurts Mexican workers as well?!”

Of course in a framework with perfectly competitive markets, it is indeed incoherent to suggest that increased capital mobility makes workers worse off everywhere. At most it will make workers in only one country worse off. Moreover, since with mobility capital will move to the highest return, this is more efficient so the gainers could more than afford to compensate the loser, if such a mechanism existed. But consider the following set up. Capital and labor markets are not perfectly competitive. Rather, capital and labor
bargain in each country over wages and employment. Now make capital mobile. It can be seen that this is akin to increasing the bargaining power of capital relative to labor, so that increasing capital mobility, whatever its effects on efficiency, could end up making workers in both countries worse off relative to capital. This is the implicit framework Group B used over and again in the consultations, with added emphasis on the political power of big multinational corporations to influence economic policy on such issues as capital controls or regulation of Foreign Direct Investment. The answer of Group A was to reply with the findings of the (implicit or explicit) competitive framework, and cycle of non-dialogue would go on from there.

The above are examples from trade and openness, but the same divide is present in discussions of the consequences of other economic policies such as privatization of state owned enterprises. The implicit framework of those supporting rapid and large scale privatization is one where state monopoly is replaced by a competitive structure of firms without monopoly power. The implicit framework of those more cautious in this regard is one of a state monopoly, which might be at least somewhat responsive to the needs of consumer through political pressure, being replaced by a private monopoly with no such restraints.

The point of the above discussion is to highlight differences in basic frameworks used instinctively in thinking through the distributional and poverty consequences of economic policies. Of course many in Group A are aware of how non-competitive elements can affect their predictions (for example, trade theory has made great strides in recent years in incorporating elements of monopolistic competition), but in policy discourse it seems as though Group A has by and large plumped for the competitive market structure framework. But thinking through the distributional consequences of economic policies when market structures are not competitive, in the small or in the large, will be needed before the framework of Group A can be made to speak to the concerns of Group B. For example, whether the capital-labor bargaining framework discussed above is valid is an empirical question that can be tested for different countries and industries. But until such models are worked out commensurately with the now standard competitive framework models, there can be no basis for comparison and assessment. And until that is done, it will be a standoff between two very different perspectives on market power.

7. A Seeming Disagreement: The “Growth” Red Herring

The word “growth” was immediately divisive in the consultations, with Group A accusing Group B of being “anti-growth”, and Group B characterizing Group A as holding the view that “growth is everything.” In fact, there is more agreement here than meets the eye, and the rhetoric of both groups stands in the way of seeing the degree of agreement that does exist.

Unfortunately, the word “growth” is used in both in its technical sense of “an increase in real national per capita income,” and also to connote a particular policy package, disagreements over key elements of which has been the focus of this paper. This package is “growth oriented policies” as seen by Group A and “economic policies which hurt the
poor” as seen by Group B. If used in the technical sense, one would probably find less disagreement on whether growth so defined could help poverty reduction. Or rather, the discussion could then focus on economic policies and on Aggregation, Time Horizon and Market Structure as discussed in this paper, which is where the true nature of disagreements is to be found.

Consider the claim by some that others are “anti-growth”, usually followed by empirical demonstrations that growth (increase in real per national per capita income) is strongly correlated across countries and over time with reductions in national level measures of income poverty. There is no question that these correlations are very strong indeed. But that is not the point. In all of the consultations over the two years, not one person from Group B in Eastern Europe, for example, claimed that the disastrous increase poverty and worsening of social indicators in Eastern Europe in the 1990s had nothing to do with the precipitous decline in real national per capita income during this period. Nobody made the claim that had the decline in per capita income been even greater, the poor would have somehow been better. The claim that they did make, however, was that the policy package that the transition economies were advised (or forced) to adopt was what led to the decline in per capita income and to the increase in poverty.

As another example, not one person from Group B in East Asia claimed that the tremendous improvement in poverty and social indicators in East Asia, over the thirty years prior to 1997, had nothing to do with the fact that per capita income in these countries multiplied several fold over this period. Nobody made the claim that the position of the poor would have been better had this growth been negative. But what they did claim was that the policy package put in place by these countries over these years differed in key elements from the policy package currently being recommended by the IFI’s and some Northern Finance Ministries. Finally, coming to 1997, not one person from Group B in East Asia claimed that the sharp increases in poverty registered in East Asia during the crisis had nothing to do with the fact that per capita income collapsed. They did not make the claim that had the per capita income decline been greater, the poor would have been better off. What they did claim was that the policy package these countries were encouraged to adopt in the mid 1990s, especially rapid capital account and financial sector liberalizations, caused the crisis and the attendant decline in per capita income and the increase in poverty.

To characterize these positions of Group B as claims that growth does not help the poor, and to then refute them by showing the undoubted negative correlation between per capita income and poverty, not only misses the point—it does the debate a disservice as well. The real debate to be engaged is on the policy package and the consequences of different elements of it for distribution and poverty. Correlations between per capita income and poverty are beside the point because the real dispute is about the consequences of alternative policies.

Now in fact, in written and oral contributions from Group B in the consultations, very often one would indeed find statements of the type “growth is not the answer to poverty” or “the IFI’s are obsessed with growth as the answer to poverty.” But an effort must be
made to understand what the true meaning of such statements is, from their context and from extended dialogue. Statements such as the ones above often captured intent much better if “growth” were replaced by something like “Washington consensus policies” or “the standard IFI package.” It might be argued that one should take the words for what they are, but one also finds very often that Group A uses “growth” as shorthand for “growth oriented policies” by which they would mean a certain type of policy package, the contents of which we have been discussing. If Group A slips into this usage, it is understandable that in responding, Group B does the same. Thus part of the problem is that the word “growth” is used to mean both an increase in per capita income, and to refer to a policy package, and this is true of Group A and Group B.

None of the above is to minimize in any way the deep disagreements that do exist on Aggregation, Time Horizon and Market Structure. Even with growth defined as increase in per capita income, Section 5 has already discussed how some in Group B argue that this is not the answer over a fifty or a hundred year time horizon. Also, Section 4 discussed how any given increase in per capita income could be associated with myriad disaggregated patterns of distributional and poverty change, even when national poverty falls. But the vehemence of the “growth” debate, on both sides, is somewhat misplaced if by growth one means simply an increase in real national per capita income. The current growth debate, certainly as presented by some elements of Group A, misses the point, and derails dialogue on the real issues of poverty reduction strategies.


Faced with such deep divisions based on legitimate differences in perspective and framework, what should one do? The answer is clearly to develop dialogue based on an attempt at mutual understanding of the different frameworks, how they can lead to different interpretations and conclusions, what sort of evidence might help to resolve some of the differences, and to come out with measured and nuanced positions. Unfortunately, quite the opposite seems to be happening. Over the past few years, the divide has grown and a polarization has set in. For the IFI’s, the siege of their biannual meetings is proving a traumatic experience. More generally, Seattle both symbolized and crystallized the vehemence of the disagreements. The stance everywhere is one of confrontation and negotiation, rather than understanding and dialogue.

My focus here is on Group A, especially when it presents policy messages that synthesize analytical work. Here again, a negotiating stance seems to be in play, especially among some parts of the IFI’s and the G7 Treasuries. Even when, intellectually and analytically, Group A accepts the complications, qualifications and nuances brought about by considerations of disaggregation, differences in time horizon, and non-competitive market structures, the tendency is for the policy messaging—for example on trade and openness-- to be sharp and hard, for fear that to do otherwise would be read as a sign of weakness by “the other side”. Especially since Seattle, a “line in the sand”, “this far, no further,” mentality seems to have gripped elements of Group A—in the IFI’s, in the G7 Treasuries, in the Financial Press and some in academia. “Give them
an inch of nuance and they’ll take a mile of protection” is the mindset. Paradoxically, the growing areas of agreement noted at the outset—for example on education and health, and on institutions—tend to lead to a sharper stance being taken on the remaining areas of dispute on core economic policies.

This is unfortunate. At least twice before, elements of Group A have taken such a hard stance, with a negotiating mindset, and both times have had to retreat after considerable conflict which negatively affected the prospects for future dialogue. The first example of this is capital account convertibility, on which the IFI’s, with the broad support of G7 Treasuries, took a bold stand in the early and mid 1990s, and dismissed those who were skeptical of the benefits and fearful of the consequences. Since the 1997 crisis the tune has changed, but the earlier intransigence did not help the dialogue when the need for a nuanced position was finally recognized.

The second example is debt relief for the poorest countries. Prior to 1995 the IFI’s, again with broad backing from many G7 Treasuries, stood very firm against debt relief. The policy messaging of the time was sharp and hard, for fear that any opening would be the “thin end of the wedge” through which large scale debt write downs would break open the IFI’s. In 1995, the policy messaging changed and indeed began to call for debt relief. It is hard to believe that analysis and evidence suddenly revealed the truth in 1995. Rather, the G7 Treasuries and the IFI’s recognized political pressure from the growing global coalition for debt relief. But the negotiating stance adopted before 1995 sowed seeds of mutual suspicion that affect the dialogue on debt relief today, even under very different circumstances.

There is a second strand of argument in play on the simplicity or complexity of policy messages, this time directed at the IFI’s and Aid agencies by some elements of Group A, particularly some in the Financial Press and in the G7 Treasuries. This is that these agencies should keep their policy messages simple, for fear that any complications and nuances will lead them into ever more complicated activities. Keeping their messages simple, in this view, will save the aid agencies from themselves, or at least from their tendency to take on a broader and broader development agenda. This point is made in the context of economic policies, but also in fear that the agreement on the importance of institutions, for example, may lead Aid agencies to intervene where they cannot and should not.

Some clear thinking is needed here. It is perfectly coherent to hold simultaneously the view that the consequences of economic policy for distribution and poverty are complex and nuanced, and that aid agencies and donors cannot and should not attempt too complex a set of interventions in developing countries. Indeed, there is an argument to be made for outside intervention to be highly cautious precisely because of the complexity of the situation on the ground. This is certainly true of institutional reform, but it is also true of economic policy. What is problematic, however, is to present a falsely simple

---

4 As the World Bank’s Chief Economist for Africa, in 1995/96 I was a member of the joint World Bank/IMF Task Force which put together the first proposal for debt relief to the Heavily Indebted Poor Countries (HIPC).
view of the world in the policy messaging emerging from aid agency analysis, as a device to restrain complex and unproductive expansionism by aid agencies. The latter problem must be faced on its own terms, and must not be allowed to influence the synthesis of analysis.

If the world is complex, or if the evidence is uncertain, or if legitimate differences in perspective and framework explain differences in conclusions, analysis must take these on board. And the policy messaging that comes from such analysis must reflect the nature of those complexities. Inappropriate simplifying and hardening of policy messages, either as a way of constraining the operations of an aid agency, or as a negotiating device because of the fear that nuancing will be seen as a sign of weakness in policy debate, will only serve to polarize the debate further and will not be conducive to broad based dialogue.

9. Conclusion

When the institution whose self-stated mission it is to eradicate poverty can only hold its Annual Meetings under siege from those who believe its mission is to further the cause of the rich and powerful, there is clearly a gap to be bridged. And the gap is not just between the IFI’s and their critics. There is a growing divide on key areas of economic policy, even as agreement broadens in other areas. Indeed, the conflict over economic policy gets more intense as the areas of disagreement shrink to what seem to be an irreducible core.

This paper has argued that underlying the seemingly intractable differences are key differences of perspective and framework on Aggregation, Time Horizon and Market Structure. Simply recognizing and understanding the underlying nature of the disagreements in these terms would be one step in bridging the gap. But more is needed. More is needed from both sides, but my focus here is on Group A. For those at the more academic end of that spectrum, the message is that explicitly taking into account these complications is more likely to shift the intellectual frontier than falling back yet again on conventional analysis. For those at the more operational and policy end of the spectrum, especially those in policy making and policy implementing institutions, the message is that recognizing and trying to understand legitimate alternative views on economic policy, being open and nuanced in messages rather than being closed and hard, is not only good analytics, it is good politics as well.

---

5 An equally interesting set of further analytical issues is opened up when interactions between Aggregation, Time Horizon and Market Structure are considered.
A Note on Public Expenditure and Poverty Reduction

By Abena D. Oduro
Centre for Policy Analysis
Accra.

Presented at a Workshop on MACROECONOMIC STABILITY, GROWTH AND POVERTY REDUCTION IN GHANA
Organised by ISSER and CEPA, in Collaboration with Cornell University
A Note on Public Expenditure and Poverty Reduction

Introduction
Poor people in Ghana are characterised by an inadequate supply of assets, limited access to infrastructure and basic utilities and services. These features suggest that they may not be able to take advantage of opportunities that they may perceive. They have a limited capacity to protect themselves from risk and to reduce the impact of shocks that they may experience. In Ghana rural poverty contributes the largest component to national poverty. A feature of rural poverty is the substantial proportion of subsistence producers. This raises two issues. The first is improving the rural poor’s access to markets. The second is whether there are functioning rural markets.

Restraining the quantum of public expenditure is a critical component of the economic reform programmes implemented by several African countries. A rapid expansion in public expenditures can translate into large budget deficits that are destabilising and will dampen economic growth. From a poverty perspective however the concern should not only be with the quantum of public expenditure but also with the components or structure of such spending. Even though rising public expenditure may have a negative effect on economic growth it is recognised that it may also have a “crowding-in” effect that encourages and indeed facilitates the expansion of private sector investment and therefore growth.

In designing public expenditure programmes for poverty reduction it is essential that the budget constraint is taken cognisance of. The first step should be to ensure that the total expenditure is consistent with macroeconomic targets and programme. The second step is to allocate public resources so as to have the maximum impact on poverty reduction given the budget constraint.

How Public Expenditure impacts on poverty reduction
Public expenditure can have a mitigating effect on poverty through:

- The provision of infrastructure and services to the poor
- Creating the conditions that will enhance the ability of the poor to accumulate assets
- Facilitate the creation of institutions that will reduce the incidence of risk facing the poor
- Reduce the impact of negative shocks through the provision of safety nets.

For public expenditure to be poverty reducing the following is required:

- Provision of adequate resources. It is the consensus that spending on basic education, primary health care, feeder roads and rural water and sanitation are necessary types of expenditure for poverty reduction. In assessing whether public expenditure is pro-poor an examination of trends in the allocation of public resources to these sub-sectors is usually undertaken.
- Provision of quality services. A sub-standard quality of service provided will reduce the demand for the service and translate into a waste of resources. Evidence abounds in Ghana and other developing countries that the utilisation of subsidised sub-
standard services provided by the public sector can be lower than the utilisation of more expensive but better quality services provided by the private sector.

- Efficiency in the use of resources. Improved efficiency implies a reduction in waste and therefore being able to obtain more output from the available inputs. This requires improved timing in the supply of inputs and ensuring that resources do reach the intended destination. The quality of the service provided is directly linked to the issue of efficiency in resource use.

- Target the poor. Evidence suggests that public spending in Ghana is not adequately pro-poor. This is not necessarily because spending is not directed at basic education and primary health care for example. It is because the subsidies going to these sectors are not sufficiently taken up by the poor. The spending programmes need to be adequately designed to ensure that the poor are encouraged and able to make use of the subsidised service or facility that is being provided.

What are the mechanisms that need to be established and actions that need to be taken to ensure that the four features identified above of a public expenditure system that is poverty reducing is achieved?

* Information. More data needs to be available to guide the design of a public expenditure programme for poverty reduction. The data must be differentiated on the basis of location, gender and income. Although the poor are to be found in all regions of Ghana, there is a high concentration of poverty in the three northern regions. An examination of data on infrastructure and services indicates that there is what may be correctly described as a historical bias in the allocation of public resources to these regions. The inadequate supply of infrastructure and basic utilities may explain the persistence of poverty in these regions and the difficulty in registering significant declines in the incidence of poverty despite the years of continuous positive national economic growth. To illustrate the point further the table below provides data on two disadvantaged regions in Ghana, one in the south and the other in the northern part of the country. There is a clear mismatch between the population and the resources that have been provided by the public sector. The Bongo District with twice the population of the Juaboso-Bia district does not have a hospital and has only one health centre. The number of public primary schools is less than 20% of what has been provided in Juaboso-Bia. This disparity cannot be explained by the size of the district and the high cost of getting resources to a dispersed population. The evidence seems to suggest the population is less dispersed in the Bongo district than in Juaboso-Bia. Thus it would be less expensive to provide resources in that district. For these disparities to be removed there is a need for region and district level data to be used in the allocation of expenditures. It is also important that the formula or criteria used to allocate spending on a region and district level is made available and is clearly articulated. Gender differentiated data must also inform the allocation of resources and the design of projects. The Statistical Service and the data collecting departments of the various ministries and departments must be mandated to collect and present the gender, location and income differentiated data that is required on a regular basis.
Table 1. Comparing Two Districts in Ghana

<table>
<thead>
<tr>
<th></th>
<th>Juaboso-Bia District</th>
<th>Bongo District</th>
</tr>
</thead>
<tbody>
<tr>
<td>Area of the district</td>
<td>4496 sq. km.</td>
<td>459 sq. km.</td>
</tr>
<tr>
<td>Population</td>
<td>53,716</td>
<td>100,358</td>
</tr>
<tr>
<td>Population density</td>
<td>52 persons per sq km.</td>
<td>218 persons per sq km.</td>
</tr>
<tr>
<td>No. of settlements/communities</td>
<td>2485</td>
<td>137</td>
</tr>
<tr>
<td>No. of health facilities</td>
<td>1 Hospital (MOH)</td>
<td>1 Health Centre</td>
</tr>
<tr>
<td></td>
<td>4 Health Centres (MOH)</td>
<td>6 sub-district clinics</td>
</tr>
<tr>
<td></td>
<td>1 Health Centre (private)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>26 Clinics (1 MOH)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>36 Primary Health Centres</td>
<td></td>
</tr>
<tr>
<td></td>
<td>14 Maternity Homes</td>
<td></td>
</tr>
<tr>
<td>Education Facilities</td>
<td>134 Pre-Primary nurseries</td>
<td>12 Nusery Schools</td>
</tr>
<tr>
<td></td>
<td>216 Primary (public)</td>
<td>39 Primary Schools</td>
</tr>
<tr>
<td></td>
<td>57 Preparatory (private)</td>
<td>13 JSS</td>
</tr>
<tr>
<td></td>
<td>91 JSS (public)</td>
<td>2 SSS</td>
</tr>
<tr>
<td></td>
<td>5 JSS (private)</td>
<td>1 Vocational</td>
</tr>
<tr>
<td></td>
<td>2 SSS</td>
<td></td>
</tr>
</tbody>
</table>

Source: District Profiles prepared for the National Poverty Reduction Programme

♦ Participation. It is the consensus that if projects and programmes are designed without taking into account the views, needs and constraints facing the intended beneficiaries the expected results are unlikely to materialise. It is important that the necessary institutional structures are in place to facilitate the contribution of the intended beneficiaries into the design of the projects and programmes. In Ghana a number of institutions are in existence that may make this possible.

♦ The first is parliament, where the representatives of the people in the constituencies take decisions and influence the policy making process. Can it be taken for granted that parliamentarians represent the interests of the poor and therefore vote into place projects that are poverty reducing?

♦ The second institution is the decentralisation process. Is the District Assembly the framework within which it can be assured that the interests of the poor will be taken account of? It has the potential to be the appropriate framework but a number of risks exist that can undermine its effectiveness. The district assembly could be captured by the local elite whose interests may not necessarily coincide with that of the poor. Related to this is the second risk that the poor may not be able to sanction members of the district assembly. Even if their voices are heard at the level of the district they may not be able to get their voices to the centre to air their grievances. The third risk is that of inadequate resources at the district level. If the responsibilities of the district far exceed the resources (financial and human) allocated to it from central government the ability to effectively tackle policy reduction will be severely constrained. Is the limited number of health facilities in the Bongo district because the citizens of Bongo do not consider health to be a
priority or is it because the communities are not able to internally generate the needed resources to establish and run health centres and hospitals?

♦ Earmarking Revenues. This is a method that is used to protect certain types of expenditure. Thus the concern about adequate funding for poverty reduction may be addressed by earmarking a certain proportion of the central government and district level revenues for that purpose. Earmarking revenues has been adopted in Ghana in the funding of the district assemblies common fund for example. The success of earmarking revenues will depend on the extent to which governments are committed to ensuring that the earmarked funds are released. If there are no mechanisms to ensure that the allocation of the stipulated amount is automatic and/or if there are no sanctions facing a government that does not release the funds then it is likely that there will be slippage when it suits central government as was the case in Ghana in 2000 when funding was only released to the Districts for the first quarter and half of the second. Article 252 of the Constitution of Ghana states:

(1) There shall be a fund to be known as the District Assemblies Common Fund.

(2) Subject to the provisions of this Constitution, Parliament shall annually make provision for the allocation of not less than five percent of the total revenues of Government of Ghana to the District Assemblies for development, and the amount paid into the District Assemblies Common Fund in quarterly instalments.

The District Assemblies Common Fund (DACF) came into existence after the enactment of Act 455 in 1993. The Fund consists of monies allocated by Parliament under section 2 of the Act and any interests and dividends accruing from investments of monies from the Common Fund. Under Section 2 of the Act, Parliament is required to allocate not less than 5% of the tax revenues of Ghana to the Fund. It would appear therefore that in 2000 there was a contravention of the Constitution of Ghana when there was a failure to make the quarterly instalments. Neither the District Assemblies nor any other member took the Government up on the matter or presented it to the Supreme Court for a pronouncement. At the district level 20% of the common fund is earmarked for “poverty reduction schemes”. However as the table below shows in 1999 very few of the districts met the requirement. At the regional level the proportion that was allocated to poverty alleviation was less than the stipulated 20%. In many instances this was by a wide margin. It is important to understand why most districts were not able to meet the requirement. This requirement was introduced in 1997 because it was noted that the projects being funded by the DACF were not those that directly promoted an expansion in production and employment. Thus in order to “...remove the obstacle of lack of access to credit for self-employed micro, small and medium scale entrepreneurs and to promote the development of micro, small and medium scale enterprises...constrained by lack of access to formal finance....District Assemblies may allocate 20% of their respective yearly shares of the District Assemblies Common Fund to create a line of credit in each District". The poverty alleviation fund is therefore a credit line. The failure to meet the 20% target may be because there is no demand for credit on the terms provided by the DACF, applicants cannot meet the requirements to access the credit, or else credit is not the binding constraint of employment and production. Although no answers have been provided here
what the evidence suggests is that prior to earmarking revenues it must be clear that there is a demand or need for the service the funds are being earmarked to finance.

Table 2. Disbursement of DACF by Region

<table>
<thead>
<tr>
<th>Region</th>
<th>% Poverty Alleviation Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western</td>
<td>9.8</td>
</tr>
<tr>
<td>Central</td>
<td>13.6</td>
</tr>
<tr>
<td>Greater Accra</td>
<td>16.5</td>
</tr>
<tr>
<td>Eastern</td>
<td>12.0</td>
</tr>
<tr>
<td>Volta</td>
<td>3.8</td>
</tr>
<tr>
<td>Brong Ahafo</td>
<td>9.9</td>
</tr>
<tr>
<td>Ashanti</td>
<td>5.2</td>
</tr>
<tr>
<td>Northern</td>
<td>12.0</td>
</tr>
<tr>
<td>Upper West</td>
<td>5.0</td>
</tr>
<tr>
<td>Upper East</td>
<td>9.4</td>
</tr>
</tbody>
</table>

Source: District Assemblies Common Fund.

Will a Pro-Poor Public Expenditure Programme be at the Expense of Economic Growth?

Achieving an increase in economic growth must be a component of any poverty reduction package. Without economic growth it will be impossible to implement the increase in the supply of infrastructure and basic services that is needed to address poverty. Thus the pro-poor programme must be designed to ensure that maximum growth targets given the targets for poverty reduction are attained. It is quite possible that if poverty reduction is not a target the patterns of public expenditure will be different and the maximum growth rate could be higher. If society values poverty reduction it may be willing to trade-off some amount of growth to ensure a reduction in poverty. Pro-poor expenditure policies need not be associated with zero or declining growth. However it is possible that pro-poor expenditure policies may have register in the short-run lower growth rates.
Why the Limited Impact of Social Sector Spending on Poverty Reduction in Ghana?

By
Anthony Tsekpo
ISSER, University of Ghana, Legon

A paper presented to the ISSER and CEPA Workshop on Macroeconomic Stability, Growth and Poverty Reduction in Ghana
I  Introduction
The key role of governments in development finance is supposed to be ensuring macroeconomic stabilisation, which is a precondition for medium- to long-term growth. The value of a stable macroeconomic environment became topical after the experience of many developing countries in the so-called lost decade of the 1970s. During this era characterised by high inflation, overvalued exchange rates, high interest rates and worsening balance of payments, many developing countries experienced low or negative growth. The Ghanaian situation has been extensively discussed. Having underscored the importance of short-term macroeconomic policies we observe that for medium- to long-term growth, governments face the task of introducing incentives that make resource allocation and use efficient and optimal. At the same time resource allocation would need to embrace equity considerations (World Bank, 1983: 41). Evidence from developing countries that have experienced significant growth and progress in human development show that effective public spending on the social sector constitute the key to poverty reduction. It has been demonstrated that the high achievers share of spending on education and health was always above that of countries in their income bracket. Ghana’s own history is consistent with the above observation hence the increased government expenditure on social sector programmes in the immediate past.

However, it is difficult to say that we have witnessed the maximum impact of the social sector programmes/expenditures. In this paper, we present evidence of expanded social sector spending during the immediate past. The paper then raised some of the issues that may have contributed to the limited impact of the social sector expenditure programme.

II  Government Priority Sectors
The cost benefit analysis and cost effectiveness criteria were used as a tool for project selection in the context of the public investment programmes (PIP). However, prior to identifying individual projects and programmes, government decides through mainly political means, which sectors merit support (Campos and Pradh, 1996: 6). At that stage the degree of influence wielded by the bureaucrats and politicians in particular sectors is vital although the process is to take into account the characteristics of public goods and macroeconomic parameters and/or targets.

A review of policy documents suggests that spending policy was guided by the principles of efficiency in resources use and targeting of so called key sectors. The highlights of the social sector agenda as set out in policy documents reviewed are summarised in the following matrix (Table 1):

Numerically we can observe the outcome of budgetary strategies and policies in the government account. The government account gives a record of public resource allocation. A careful analysis of the account should indicate trends in budgetary resource allocation and use. Thus the analysis of the account can expose the consistency or otherwise of resource allocation and use with policy pronouncements.
Table 1: A Matrix of Government Priorities by Sector

<table>
<thead>
<tr>
<th>SECTOR (MDAs)</th>
<th>AGENDA</th>
<th>HIGHLIGHTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social &amp; Administrative Services</td>
<td>• Rehabilitation and improvement of social infrastructure and delivery systems.</td>
<td>• Reform of basic education and introduction of cost sharing in tertiary education</td>
</tr>
<tr>
<td>Education</td>
<td>• Restructure and upgrade of the Public Administration System</td>
<td>• Emphasis on primary health care and introduction of cash and carry in drugs.</td>
</tr>
<tr>
<td>Youth and Sports</td>
<td>• Increase the effectiveness and output of the public administration system</td>
<td>• Provision of large scale rural water supply and low cost sanitation projects</td>
</tr>
<tr>
<td>Health</td>
<td>• Model the public administration system to provide an enabling environment for private sector development.</td>
<td>• Supplementary feeding programmes</td>
</tr>
<tr>
<td>Labour &amp; Social Welfare</td>
<td></td>
<td>• Providing incentives to private estate developers</td>
</tr>
<tr>
<td>Information</td>
<td></td>
<td>• Improved local building materials project</td>
</tr>
<tr>
<td>Interior</td>
<td></td>
<td>• Enhancing opportunities for women in development</td>
</tr>
<tr>
<td>Defence</td>
<td></td>
<td>• Non-Formal education.</td>
</tr>
<tr>
<td>Legal Services</td>
<td></td>
<td>• Civil Service reforms</td>
</tr>
<tr>
<td>Office of National Security</td>
<td></td>
<td>• Establishment of the National Development Planning Commission</td>
</tr>
<tr>
<td>Office of the President</td>
<td></td>
<td>• Redeployment in the public service</td>
</tr>
<tr>
<td>Foreign Service</td>
<td></td>
<td>• Reform of Ghana Investment Centre and Investment Code</td>
</tr>
<tr>
<td>Office of the Head of Civil Service</td>
<td></td>
<td>• Continuous revision of all legislative and administrative practices which affect commercial and industrial activities</td>
</tr>
<tr>
<td>Public Services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commission</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commissions and Councils</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Statutory Organisations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regional Organisations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower levels of Government</td>
<td>• Democratisation, decentralisation and devolution of government.</td>
<td>• Establishment of District Assemblies</td>
</tr>
<tr>
<td>Local Government</td>
<td></td>
<td>• Establishment of unit committees and regional co-ordinating councils.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Establishment of district assemblies common fund</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Creation of decentralised departments</td>
</tr>
</tbody>
</table>

Source: Tsekpo (1998): Table 1
III The Annual Estimates

The estimates for this analyses were obtained from the Controller and Accountant General’s Department. One important consideration which should guide any attempt to compare budgetary estimates with the out-turn is the inconsistent and transient nature of estimates. The estimates were reviewed so frequently that the use of later versions of estimates in the comparison of estimates and actual out-turn will amount to comparison with moving targets. Apart from the moving targets the comparison of budgetary resource allocation and spending outcome encounters the difficulty of obtaining data on actual public spending. The information about actual expenditures are simply not available within any reasonable timeframe. It is reasonable to assume that there exists a 3-year lag between expenditure and the availability of expenditure returns. For this study, the expenditure data were collected in 1997 and the most recent figures obtained were those for 1994. Different explanations have been offered for the failure of MDAs to account for actual spending. They include misapplication of resources, the long hierarchy involved in the spending process in the social sector and also the high number of cost centres involved in the social sector (Toye and Jackson, 1996: 56). For example the number of educational and health institutions that draw money from the consolidated fund is very high. However, the accounting and reporting system is such that these institutions have to submit their expenditure returns through district offices, to regional offices then to their head offices who in turn submit the returns to the Controller and Accountant General’s Department.

IV The Analysis of Budgetary Resource Allocations

Government spending affects the very structure of the economy. The level of government spending relative to available resources dictates the general economic framework and hence private sector response and performance in the economy. For the purpose of analysis, Ghana’s spending sectors have been categorised into four groups. These include productive services, economic/infrastructure services, social and administrative services, and local government.

An observation about the classification presented here is in order. They are not directly comparable to the standard classification produced by Ghana Statistical Service. The Ghana Statistical Service classifications include General Services, Community and Social Services, Economic Services and “Others”. Productive services in our classification are a subset of the standard Economic Services. Economic/Infrastructure services in our classification combines social and economic infrastructure. Social and Administrative Services combine the standard General Services (public order and safety, general public service, defence) with the social sector services.

As mentioned above, social and administrative services is made up of spending on education, youth and sports, health and social welfare - traditionally described as the social sector and also spending on standard general services. General Services refers to general public services, defence and public order and safety, which in Ghana’s budgetary classifications cover ministries of Interior, Information, Justice, Foreign Affairs, Finance, Defence and other statutory organisations. Also included in this section is the
Government Machinery. Government Machinery is a concept, which embraces the constitutional view of the office of the President as the seat of Government and also the operations of those organisations, which fall outside the traditional areas of sectoral responsibility. Thus Government Machinery is technically the Office of the President as the central organ of government decision making process and the activities of institutions for which the Castle has direct responsibilities. Its components comprise the following: Office of the President, Office of the Head of Civil Service, Scholarships Secretariat, Public Services Commission, Commissions and Councils, Office of National Security, and Regional Administration and Regional Budget Offices. One observation about this classification is relevant. With the emphasis on decentralisation the inclusion of Regional Organisations i.e. Regional Administration and Regional Budget Offices in this sector appears inconsistent. To further the decentralisation programme of government, regional organisations should have been part of the local government set-up. This classification has a bearing on the human development and governance programme.

Local government was separated for consideration as a sector because of the government’s declared mission of administrative and political devolution. Traditionally this sector was classified as part of the social and administrative services. It is often argued that the objective of decentralisation, particularly fiscal decentralisation, may conflict with the immediate aim of stabilisation (Ter-Minassian, 1997; Tanzi, 1996; Estache and Sinha, 1994; Prod’home, 1994). This may have explained the cautious approach to decentralisation despite the high political commitment. It is important to note that the data presented in the analyses are inclusive recurrent plus development expenditure to the MDAs. It would have been ideal to undertake this analysis with projections in respect of the development budget. But every effort to obtain the data in a format that differentiated between development and recurrent expenditures failed.

Projected spending on social and administrative services witnessed a phenomenal growth between 1986 and 1988 when its share in spending rose from about 28 percent in 1986 to approximately 65 per cent in 1993 (Figure 1). This followed the UNICEF evaluation of the stabilisation programme and the appeal to give a human face to structural adjustment. It led to the introduction of Programme of Action to Mitigate the Social Cost of Adjustment (PAMSCAD) and the provision of safety nets to cater for the disadvantaged in the health sector. Expenditure on primary education as well as informal education was increased. The share of the sector in planned spending then remained relatively stable until 1994, when despite the general growth in planned aggregate spending its share in planned spending dropped to approximately 60 percent of projections. The relative stability of the social sector could also be established from the number of PIP projects in the Sector. However, Hutchful, (1994: 573) indicated that the sector suffered most severely from shortage of counterpart funds.
Figure 1: Planned Expenditure Allocation by Sectors in 1977 Prices

![Graph showing planned expenditure allocation by sectors in 1977 prices.

Figure 2: Actual Expenditure by Sector in 1977 Prices

![Graph showing actual expenditure by sector in 1977 prices.]}
The allocations to the local government sector had remained at approximately 2 percent of projected spending (see Figure 1). This perhaps is an indication that government is only paying lip service to decentralisation. As a result the decentralisation programme is way behind schedule because the centre is finding it difficult to decentralise. In informal discussion with directors at the Ministry of Finance some express doubt about the ability of decentralised departments to control spending which has been the central objective of the government stabilisation policy.

With the aid of Figure 2 we examined the trends in actual spending. This Figure, a percentage area graph, also has attached to it the data table on actual spending by sector. The comparison of Figure 2 and Figure 1 shows that actual spending mirrors planned government expenditure i.e. the distribution of the shares of the different sectors in planned expenditure is approximated by the distribution in actual expenditure. With the aid of Figure 2 it could be concluded that government expenditure was consistent with its declared intentions to move away from direct production.

Spending on social and administrative services, which constituted approximately 36 percent of total government expenditure in 1986, increased significantly to 68 percent of government spending with a considerable portion going to the health and education subsectors. Spending on social and administrative services attained the peak of approximately 68 percent in 1990. The social and administrative services sector share in total spending, however, declined by about five percentage points between 1990 and 1994.

The next important observation about the spending programme is the relative stability of spending by the local government sector. Spending by the sector has remained relatively small, about 2 percent. In 1988 and 1991, local government share of total releases from the consolidated fund amounted to 5 percent and 3 percent respectively. The contradiction that is readily seen in the policy highlights (Table 1) and spending outcome is the minimal share of local government in public spending. While the allocation to the local government sector was small in the period 1993-1994 the sector could not utilise its allocation (see Figure 3).

V Variations between Appropriations and Actual Spending
Statistical tests conducted on annual total projections versus spending and on panels of average estimates and spending for three periods, namely 1986-1989, 1990-1991 and 1993-1994 show that there is significant association between planned spending and actual spending\(^1\). Correlation coefficients were consistently above 90% when planned expenditure and out-turns were compared. This is reflected in Figures 1 & 2 above. However, comparison of the mean estimates with mean actual expenditure from year to year show that they were significantly different for some years and not for others. The mean estimates and mean spending were significantly different for the years 1986, 1987, 1988 and 1991. But test statistics show that for the years 1989, 1990, 1993 and 1994, the mean estimates and mean spending were not significantly different from each other.
For the panel averages, the mean estimates and mean actual spending were not significantly different for the period 1986-1989 and the period 1993-1994 but differ significantly for the period 1990-1991. This is consistent with the observation that policy reforms yielded a high dividend until 1989 and that there was a new era of fiscal stringency beginning in 1993.

![Figure 3: Average Variation Between Planned and Actual Spending by Sector in 1977 Prices](image)

<table>
<thead>
<tr>
<th></th>
<th>VAR86/89</th>
<th>VAR90/91</th>
<th>VAR93/94</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOCAL GOVERNMENT</td>
<td>-762.2</td>
<td>-1483.0</td>
<td>2383.0</td>
</tr>
<tr>
<td>SOCIAL &amp; ADMINISTRATIVE SERVICES</td>
<td>674.0</td>
<td>-24196.3</td>
<td>-21310.4</td>
</tr>
<tr>
<td>ECONOMIC/INFRASTRUCTURE</td>
<td>-2825.4</td>
<td>-6285.5</td>
<td>-9584.3</td>
</tr>
<tr>
<td>PRODUCTIVE SERVICES</td>
<td>97.9</td>
<td>397.2</td>
<td>3951.0</td>
</tr>
</tbody>
</table>

The comparison of means across broad sectors, show that the association between planned and actual spending was high in the annual data for all sectors except the local government sector. The correlation coefficient for the local government sector was 0.665. The implication is that the association between planned expenditure and actual expenditure in the local government sector may not be very strong. The question is whether budgeting practices were significantly different in the local government sector? The answer is definitely no. Allocations and spending in the local government sector constituted a small proportion of aggregate resource use (about 2-3 percent). Despite the small size of the allocation to the local government sector, it could not exhaust its appropriation in 1993/1994 (see Figure 3).

A further investigation revealed that the sector received an earmarked grant that was not immediately utilised. Perhaps this was the factor captured in the correlation analysis.
This explains the large difference between planned expenditure and actual expenditure in the 1993–1994 panel is responsible for the lower correlation coefficient observed between planned and actual spending in the local government sector.

The test results, indicating that across broad sectors, mean planned expenditure is not significantly different from actual expenditure for any particular sector were confirmed using the method of ANOVA. Thus it is possible to tentatively conclude that:

- Social sector expenditure and programmes expanded significantly during the period covered by the analyses presented in this paper.
- The quantum of resources allocated to local government sector did not reflect the political commitment to decentralisation.
- The statistical analyses may be pointing the possibility that the “expenditure allocation figures are pure fiction” (Toye and Jackson, 1996: 30).

**Concluding Remarks**

Despite the substantial social spending programme over the period of analyses human development indicators for Ghana remain poor. Ghana has an HDI value of 0.473 and the HDI country ranking is 133 out of 174 in 1995 (UNDP, 1998).

A fundamental issue to tackle in respect of the performance of public expenditure is that budget discipline. In this context Campos and Pradhan (1996:7) identified some key institutional arrangements that will aid government to select their priorities in the most efficient manner, namely transparency, accountability and independent evaluation.

- **Transparency** - The MDAs were provided with very little or no information as to why their activities, programmes and projects did not receive the amount of resources they require; many remarked that budgetary resource allocation was done behind the scene. The hard budget constraints were not planned ceilings but revenue determined. The Ministry of Finance could cut allocations arbitrarily after the budget has been approved depending on the inflow of revenue. Transparency was further obscured because the costs and benefits of most activities, programmes and projects were not clearly delineated. Costs and benefits were not sufficiently identified and there was little documentation in the public domain hence people doubt why some projects were selected and not others.

- **Accountability** was equally weak. To what extent politicians receive information and assume responsibility for decisions emanating from the activities, programmes and projects they sponsored is not clear. Ex-post evaluation was not consistent. The Auditor General’s Report on the use of budgetary resources was in arrears of about 4 years. Furthermore because budgetary allocations could be arbitrarily cut, it was not possible to query MDAs for uncompleted projects and they could sometimes run unauthorised arrears by allowing contractors to pre-finance projects.

- **Independent evaluation** of the motivation and relevance of activities, programmes and projects put forward by bureaucrats in the MDAs – Review by counterparts in the Ministry of Finance.

Another issue that required attention but was missing over the period was the evaluation of benefit incidence and quality of service. These can influence the impact of
expenditure on poverty reduction. In the Social sectors benefit incidence valuation exercises could have been used to reveal:

- The bias of government spending towards personnel instead of service operations and maintenance. The situation is compounded by the existence of large number of ghost names on the pay roll.
- That the level of and composition of staffing are bound to produce inefficiencies. Take for instance the ration of non-formal to formal staff in some remote villages and those of non-teaching to teaching staff in some second cycle schools.
- The structure and level of service pay in both education and health sectors have impacted institutional performance and service delivery to the poor. If personnel have to take on part-time jobs to maintain some minimum standard of living, urban centres will be preferred locations and not deprived rural locations.

A regular excise in expenditure tracking could have assisted in demarcating the benefit incidence of public expenditure. Tracking could capture leakages in budgetary allocations as resources are transmitted to district centres and operational areas. Studies elsewhere indicated that substantial proportions of resources allocated to poor areas remain in the administrative machinery, having little impact on poverty reduction strategies.

1 The three periods marked specific stages in Ghana’s economic performance during the on-going ERP/SAP. National economic performance has been acknowledged to have peaked in 1989. Thus 1990-1991 were periods of declining performance towards the record low performance in 1992. We eliminated 1992 because of the tendency to consider spending in that year as an outlier (the election year expenditure boom). It is interesting to note that further to the statistical rationale, which necessitates that we drop the year 1992 from our analysis, the data provided by the Controller and Accountant General’s Department did not cover fiscal year 1992. The year 1993 therefore was the start of a new initiative aimed at fiscal prudence.
TOWARDS A MEDIUM-TERM DEVELOPMENT POLICY FRAMEWORK:

SOME ISSUES

Ernest Aryeeetey
Institute of Statistical, Social and Economic Research
University of Ghana

Paper Presented at the Workshop on
"Macroeconomic Stability, Growth and Poverty Reduction"
organised by
ISSER, CEPA and the Poverty, Inequality and Development Initiative of
Cornell University

Legon, 10-11 May 2001
TOWARDS A MEDIUM-TERM DEVELOPMENT POLICY FRAMEWORK

Ernest Aryeetey

1. Introduction

Based on various key issues and challenges identified in a number of studies of the economy of Ghana, [for example Aryeetey, Harrigan and Nissanke (2000)] as well as the review of the First Medium Term Plan under Ghana Vision 2020, the following issues are proposed for the attention of Government towards achieving a medium term goal of steady high growth that leads to poverty reduction.

- Continuing Macroeconomic Reforms
- Capacity-Building
- Development of Science and Technology Capacity for Production
- Attracting Foreign Direct Investment
- Developing Safety Nets for the Poor
- Ensuring the Effectiveness of Decentralisation
- Achieving Public-Private Partnerships.

2. Continuing Macroeconomic Reforms

Recognising that Ghana has pursued economic reforms since 1983, with considerable success in the first eight years, and significant slack since 1992, it is imperative that remedial action is taken to restore the momentum of reform and regain its credibility. In the absence of immediate remedial action, questions will continue to be raised about why progress has been so much slower than, for example, in East Asia,
which has followed a less orthodox set of development policies; and what the critical constraints to Ghanaian growth are. The policy framework should seek to pre-empt these questions.

The essence of a liberal economic regime should not be altered in the medium term. What this implies is that markets should essentially continue to determine the prices of goods and services in both input and output markets. Thus, in the labour markets, wages should essentially be determined by the productivity of labour in an increasingly competitive market, while in the financial markets the returns to capital should continue to be freely determined by the demand and supply of funds. The same will continue to hold for foreign exchange. The rationale behind such an approach is basically to provide market incentives for the owners of various resources in order to mobilise such resources for the common good.

Government should, however, recognise the fact that when markets are far from perfect, as they are in Ghana, the capacity of the market to efficiently allocate resources is often severely compromised. Such situations call for interventions, based on sound judgement and good information. One of the lessons learned from Ghana’s reforms so far is that policy reform can hardly be adequate. In the face of structural and institutional bottlenecks to the pursuit of economic transactions, transaction costs rise enormously and discourage otherwise necessary transactions. Ghana thus faces a major collective action problem. Potential gainers need to act together and take the necessary steps to promote the establishment of efficiency-enhancing institutions (including effective private markets), that would bring transactions costs to a more manageable level and help put the economy on a dynamic growth path.

Achieving this dynamic growth path has enormous political economy dimensions that point to a potentially crucial role for the government in taking bold social and economic initiatives, including legal measures, that can help remove existing risks and

---

1 The ideas presented here form part of a proposal submitted to the National Development Planning Commission as part of a “Second Step Medium Term Policy Framework Document for Ghana Vision"
uncertainty in the economic environment. Action needs to be taken to create an effective functioning of private markets and non-market institutions. In this context the issue of corruption needs particular attention. People must become convinced that the predatory state is a thing of the past. What is required is not extreme forms of deregulation but a regulatory redesign that promotes competition where it is viable and ensures that monopoly power is not badly exploited when competition is absent.

In sum, government intervention in the market should be designed to lead to a strengthening of the market mechanisms, instead of replacing them. Government should seek to apply a set of ‘common sense’ policies in the management of the economy, guided by the principle of ‘don’t spend what you do not have’ in order to generate macro stability. If Government must borrow, the principle must be that the economic returns justify it. At this stage, inflation can only be kept low through fiscal prudence and a focus on efficiency in public expenditures. Monetary policy should not be used to stifle the private sector of credit, and its judicious application should see relative stability in the foreign exchange market. Maintaining a stable currency should be the cornerstone of macroeconomic policy. But this cannot be done on the basis of dogma. Constant monitoring of the relationship between demand and supply of foreign exchange should be at the base of the determination of exchange rates. A long-run equilibrium position that is supported by the structure of the economy and its fundamentals can be achieved. The generation of employment from increasing private sector activity should be the anchor of development objectives, and a major departure from earlier reforms that took the generation of jobs for granted. Developing partnerships with the private sector for institutional development should be the modus operandi of the new approach to economic reforms.

2. Capacity-Building

It is recognised that over the years Ghana has basically failed to adapt its human resource development programmes towards the exigencies of changing socio-economic and
political structures. The poor capacity to deal with economic and social development problems has arisen from two main sources: (i) the lack of investment in the institutions and processes that form capacity, and (ii) the slow destruction of the enabling environment for maintaining existing capacities. Thus, as the brain-drain of the 1970s and 1980s took away necessary human capacities, the ability and willingness to continue investing in the institutions that produced them earlier was also compromised. Whatever capacity that was developed to take over the running of the economic and political life of the country soon after independence, was in no time lost through the brain-drain. Political uncertainties contributed in no small measure to the poor direction of human resource development programmes. The economic difficulties that resulted fuelled the brain-drain. Evidently, these problems have not been resolved, after almost four decades of independence.

For the medium term, it is proposed that Government tackles the capacity problem within a more comprehensive framework than has been the case in earlier attempts to develop capacity. In this light, government should accept the recommendations of the National Capacity Building Assessment Group presented to the Ministry of Finance in 1996.

It is acknowledged that capacity-building must be endogenous, involving an understanding of national values and goals by beneficiaries, as well as their stake in the exercise of capacity building. There are indications that educational institutions have not always provided appropriate and sound training in certain critical areas. The situation is likely to exacerbate the skills gap and increase the operational cost of capacity development and utilisation in the country in future.

In the development of endogenous systems, the need to preserve Ghanaian cultures must be emphasised. This requires that culture need not be defined too narrowly to embrace only “drumming and dancing”, but is broadly established to encompass the aspirations of the modern state seeking to make scientific and technological advancements within a rapidly changing world environment. The need to preserve all Ghanaian languages is paramount to the process of streamlining the educational system.
The over-arching significance of adequate remuneration to capacity building needs to be emphasised. In the short-term this might be difficult to bring about. But Government should attach priority to issues of remuneration by not being seen to be wasteful in other areas of public expenditures. In the interim, Government, acting in concert with all sectors, including civil society, should develop an incomes policy that makes clear the principles underlying wage and salary determination. The process must not be seen to be arbitrary and politically-driven. In the medium-to-long term, it is essential that workers are rewarded in relation to their output.

In order to succeed, any attempt to build capacity in Ghana will have to satisfy a number of specific requirements. These are summarised below in order to provide a general framework within which capacity building efforts will be developed.

- First, it will require co-operation between the government and donors. Structural reforms and new programmes will need to be worked out in a coherent, co-ordinated fashion.
- Second, effective capacity-building will require a well planned (and executed) sequence of policies. Specifically, sufficient capacity retention policies must be in place before new capacity formation programmes are undertaken. The major example of this is education. Improvement in education will amount to little more than a subsidy to the rest of the world if there is no clearly articulated, credible, and stable macroeconomic policy to arrest the brain-drain and retain the human capital in the country.
- Third, since resources are limited, priorities need to be set. Emphasis should be placed on programmes which will have significant spillovers, i.e., capacity development that will lead to additional capacity building. This is why education and civil service reform must be two of the cornerstones of any attempt to increase capacity.
- Fourth, there must be adequate attention to transparency, accountability, due process, rule of law and participation. There is also the need for an open society. However, in some cases, this must be tempered by the proper type of insulation
from political pressures. There is the danger that some forms of transparency can degenerate into politically-driven policy. To counter this, institutions for feedback and monitoring need to be clearly articulated and be visible. Furthermore, adequate checks and balances need to be placed on implementing agencies.

- Fifth, meritocracy, combined with equity, and together with the above, will ensure a genuinely benign environment for capacity development and utilisation.

3. Development of Research and Technology Capacity for Production

It is generally recognised that the achievement of Ghana’s long term development goal of becoming a middle income country requires the establishment of appropriate science and technology development processes and the attainment of effective outcomes from research endeavour. The strategies include

1. prioritisation of the national research agenda;
2. increasing public spending on research and technology development;
3. achieving public-private partnerships in research and technology development;
4. achieving greater interaction between researchers and research users;
5. cost-effectiveness in research and technology development;
6. addressing human capacity problems beyond remuneration, and
7. re-defining the role for donor assistance.

4. Attracting Foreign Direct Investment and Other Private Capital

The objective of attracting private capital is to initially make up for a half of the outstanding amount of Gross Domestic Investment that has to be funded from foreign savings. The need to re-vitalise exports must be seen as an essential activity to bring in FDI and other private capital. Quite a lot is known in the literature about what brings in private foreign capital. It usually goes where consistent growth has been achieved and where there is country risk minimisation, development of infrastructure, appropriate macroeconomic policies, with particular reference to stable exchange rates, etc. It is
obvious that Ghana needs to do more than achieve what is in the standard recommendations in view of the competition with other countries in the region. There are three things that Ghana must have in place in order to attract private foreign capital.

- Ghana must have a strategic framework for industrial development that will indicate how foreign participation will be utilised, and that has to be reflected in the various incentive packages that are to be prepared.
- Ghana must have a fairly stable macroeconomic regime, governed in a transparent manner that keeps exchange rates stable.
- The financial system must be made more robust and in tune with global developments.

5. **Developing Safety Nets for the Poor**

Reducing poverty significantly will not be a simple outcome of macro-economic reform and institutional interventions only. It is therefore important to understand that even after policies and public expenditures have been put together in a broad growth strategy, some people will still not be able to take advantage of the economy’s income-earning opportunities. These will include some disabled persons, the aged, and other vulnerable persons who are excluded by the usual social and economic practices from making sound economic choices, including many rural women. The principal issues will be providing from public sources to meet essential food, health and shelter requirements. These might lead to safety net provisions for individuals who may be in temporary or chronic need because of their own circumstances and/or provisions for regions/districts facing disaster, such as drought.

In general, this requires that each MDA shows in its development programme how its expenditures are going to benefit the poor. MDAs will be expected to be guided by the following questions in making any budgetary allocations from public resources:

- How much is being spent, on what?
- Who is it being spent on?
- How efficient and cost-effective are these expenditures?
- How well are services being delivered?
• Is there a role for the private sector and/or NGOs?
• How are the expenditures being financed? Are they sustainable?
• How effective is the safety net?

6. Ensuring the Effectiveness of Decentralisation

It is generally acknowledged that while Ghana's efforts to achieve a decentralised framework for administration and planning is laudable, it has been hamstrung by a number of difficulties. The biggest problem facing the decentralisation exercise has been the difficulty of drawing adequate resources. But decentralisation is acknowledged to be the only means by which effective rural development can be made possible.

The medium-term policy response to the current problems of district assemblies and other units should be to make it easier for decentralised units to raise the resources required for their operations. While it may be easy to legislate what proportion of public expenditures need to be administered and controlled by district assemblies, on account of their resource requirements in relation to the national budget, there is every indication that they may have substantial capacity problems in handling such resources. This suggests caution in the exercise of expanding the scope of resources for decentralised units.

The capacity problems notwithstanding, it is fair to propose that all the residents of each district must pay a certain tax directly in relation to their personal incomes to the assemblies. That makes it possible for the Internal Revenue Service to collect that district income tax directly on behalf of the assemblies. Considering that in most districts, incomes are derived from farming, an effective way of taxing agricultural incomes will have to be worked out, with a view to generating steady incomes for assemblies without burdening households unduly. It needs to be acknowledged that the expenditures of assemblies will multiply enormously as a consequence of the drive to reduce poverty to 30% by the end of the medium-term plan. It must also be pointed out that the new income tax will not be a substitute for the District Assemblies Common Fund.
7. Achieving Public-Private Partnerships

Public-private partnerships should underscore most of the development initiatives of the medium-term. There are a number of developments that already make this an essential and still-growing part of institutional processes in Ghana. An example is cost-sharing and cost-recovery in the delivery of social and other public services. Further examples are collaboration between civil society organisations and public entities in the provision of social services. Better known elsewhere is the state going into partnerships with private sector entities to develop businesses.

The Ghana Human Development Report 1998 indicated that the combination of efforts of public and private agencies releases a synergy that needs to be nurtured. While this may be crucial for achieving human development goals, it cannot be taken for granted. It can also lead to tensions if not well co-ordinated. The co-ordination of the synergies of the public and private sectors requires institutional arrangements that provide a voice to both parties. That is what makes the creation of such democratic institutions as the parliament important. An effective legal system is also crucial to nurturing a good relationship between the public and private sectors. For the purpose of poverty-reduction, however, an even more crucial institution for mediating the concerns of the public and private sectors should be the district assemblies. At the national level, private sector involvement with NDPC will be ideal.

It is proposed that Government institutionalises the platform for dialogue between the public and private sectors at all levels using the assemblies and NDPC for the purpose. Such private sector organisations as Private Enterprise Foundation, Chambers of Commerce, Federation of Associations of Ghanaian Exporters, Ghana Association of Women Entrepreneurs, Association of Ghana Industries and Ghana Employers’ Association will all need to be included in the platform for discussions. Civil Society organisations, particularly NGOs and Churches will be most helpful in social sector development initiatives.
An area of crucial importance in the process of creating jobs, facilitating the development of exports and attracting foreign direct investment will be the development of business partnerships. Strategic partnerships in the development of business should be fostered so long as the exit strategies of the public sector are not harmful to social progress.
NOGUCHI STATEMENT ON THE MANAGEMENT OF THE ECONOMY OF GHANA

On May 10-11, 2001, a number of Ghanaian economists and other social scientists met at the Conference Centre of the Noguchi Memorial Institute for Medical Research to discuss their possible contribution to the National Economic Dialogue scheduled for May 14-15, 2001 by the Government of Ghana. The workshop at Noguchi was organised jointly by the Institute for Statistical, Social and Economic Research (ISSER) of the University of Ghana and the Centre for Policy Analysis (CEPA). The goal of the workshop was to collate the general understanding of Ghanaian economists regarding the broad theme of “Macroeconomic Stability, Growth and Poverty Reduction” and to define the parameters for developing a policy framework for the medium term. These were considered to be the most pressing current and future concerns for the management of the economy of Ghana.

Considering the current difficult position of the economy, the Noguchi Workshop acknowledged the need for an immediate programme of action to stabilise the economy that should begin with an identification of ‘where we are’ through a stock-taking for all macroeconomic indicators. While pursuing immediate macroeconomic stability, the workshop agreed on the need for integrating the short-term imperatives into a medium-term programme for development that leads to significant poverty reduction.

For the immediate stabilisation of the economy the following specific proposals were made by the Noguchi Workshop:

- The source of the macroeconomic instability is the unrestrained expansion of the fiscal deficit and the finance mode of domestic borrowing, including the quasi-deficits from the transactions of large para-statals such as the Tema Oil Refinery (TOR). This must be halted through a focus on the efficiency of public expenditures, including the expenditures of local government bodies and other dedicated funds of the budget;
- Studies show that an average annual inflation of 10-15% will not seriously compromise growth, and this should therefore be the target, to be achieved largely through fiscal restraint;
- It is essential to make inflation control the main task of Bank of Ghana following institutional reforms that ensure its independence, improve the accountability of the institution and make its operations transparent through regular interaction with parliament and civil society;
- For the management of the exchange rate, it is important that it is assigned the objective of creating incentives for export and maintaining Ghana’s external competitiveness. Targeting a nominal annual depreciation within the band of 10-15% will be consistent with the inflation target, using the crawling peg approach. Before that can be done, however, there is an urgent need for the
nominal rate of depreciation to be moderated with foreign exchange support from donors.

- It is important to underscore the fact that with regard to HIPC, the net benefits that will accrue to Ghana will depend solely on what is done with savings arising from debt relief. While HIPC may provide interim relief, it is definitely not the panacea to Ghana’s development problems.

In order to translate the gains from short-term stability into medium-term growth and development, the workshop suggests that considerable institutional reform and strengthening will be required. To this end,

- Poverty reduction must be anchored within a clear macroeconomic framework for the medium-term;
- Human resource development institutions must be made responsive to the changing demand for skills, while ensuring that the population is basically made literate;
- Government must strengthen the analytical base of socio-economic policy-making through improvements in the capacities of the public institutions and improve on data collection and availability for research;
- It is essential to develop and strengthen monitoring mechanisms for public expenditures in order to ensure that they reach their target destinations and generate the planned outputs;
- Decentralisation may be made meaningful through a more open system of governance that improves the capacity of district assemblies to generate revenues in addition to what is currently available from the common fund, while ensuring greater efficiency in expenditures;
- Significant improvements in total factor productivity are essential for Ghanaian production, but this requires sound support for research and technology development. This can best be achieved through greater partnership between the state and other private agents.
- Attracting both domestic and foreign private capital is essential and this calls for a strategic framework that includes both macroeconomic incentives and structural support. Strategic choices need to be made.

For the purpose of National Economic Management the workshop recommends that the activity be made as open as possible, attracting diverse but competent professional views to advise the Minister of Finance. It suggests the creation of a National Economic Advisory Committee that could draw its membership from participants at the Noguchi Workshop and a number of other very competent professionals. The committee will meet with the Finance Minister once each quarter to review the performance of the economy and suggest remedial action if necessary.
WORKSHOP ON

MACROECONOMIC STABILITY, GROWTH AND POVERTY REDUCTION

10-11 MAY, 2001

PARTICIPANTS AT THE NOGUCHI WORKSHOP

1. Prof. Ernest Aryeetey
2. Prof. Kwadwo Asenso-Okyere
3. Dr. Anthony Tsekpo
4. Dr. Wayo Seini
5. Dr. K. Appiah Kubi
6. Dr. Ellen Bortei-Doku Aryeetey
7. Dr. Joseph L.S. Abbey
8. Dr. Charles Jebuni
9. Dr. Nii Kwaku Sowa
10. Dr. Samuel Ashong
11. Ms Abena Oduro
12. Dr. Kwabia Boateng
13. Dr. Yaw Asante
14. Mr. Gideon Tsikata
15. Dr. Augustin Gockel
16. Dr. George Appenteng
17. Prof. Cletus Dordunoo
18. Dr. Mahamadu Bawumia
19. Dr. Eric Koranteng
20. Mr. K. Kattah
21. Dr. Ferdinand Tay
22. Mr. George Laryea Adjei
23. Dr. Vladimir Antwi-Danso
24. Mr. K.B. Asante
25. Dr. G.K. Agama
26. Mr. Alex Ashiabor
27. Prof. Ivan Addae-Mensah
28. Ms. Esi Sutherland-Addy
29. Mr. Kwame Pianim
30. Prof. Ravi Kanbur
31. Ms. Jacqueline Vanderpuye-Orgle
32. Dr. Emmanuel Gyimah-Boadi
33. Dr. Emmanuel Akwetey
34. Prof. Ernest Dumor
35. Dr. Asumquaye Laryea
36. Prof. Mike Ocquaye
37. Prof. Stephen Younger
38. Mr. Isaac Osei Akoto
39. Mr. G.K. Amuzu
40. Nana Juaben Boateng Siriboe

ISSER
ISSER
ISSER
ISSER
ISSER
ISSER
CEPA
CEPA
CEPA
CEPA
CEPA
Department of Economics, Legon
Department of Economics, Legon
Department of Economics, Legon
IEA
GIMPA
Bank of Ghana
Bank of Ghana
NDPC
Private Consultant
UNICEF
LECIA
Private Consultant
Former Governor, Bank of Ghana
CEO, Metropolitan and Allied Bank
VC, University of Ghana
IAS
Private Consultant
Cornell University
Cornell University
CDD
SAPRI Secretariat
Private Consultant
Department of Economics, Legon
Dept of Political Science, Legon
Cornell University
ISSER
Ministry of Finance
Private Consultant