

## **FISCAL POLICY AND THE BUSINESS CYCLE IN THE WEST AFRICAN MONETARY ZONE**

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### **Abstract**

The Economic Community of West African States has come up with a new single currency to be used for its proposed West African monetary union. It is called *eco*. Among the West African states are a group of countries collectively referred to as the West African Monetary Zone. For the smooth running of a monetary union, fiscal policy should be sustainable and countercyclical. Main objectives of this study are to assess the relationship between fiscal policy and the business cycle and the role of institutions. Panel data of six countries for the period 2001-2018 were used. A fiscal reaction model was estimated. The cyclical component of real general government expenditure was used to represent fiscal policy while the cyclical component of real Gross Domestic Product (GDP) was used as a proxy for the business cycle. Results showed that West African Monetary Zone member countries exhibit pro-cyclical fiscal policy and weak fiscal sustainability. Also, the quality of institutions has the capability of making fiscal policy less procyclical. The policy implication of this study's finding is that these countries may not perform well if they go ahead with the single currency union. These countries must make concerted efforts to improve the quality of institutions and implement countercyclical fiscal policies. Meanwhile the proposed monetary union should be suspended.

*Keywords:* Fiscal Policy, Business cycle, Monetary Union, West African Monetary Zone, Pro-cyclical

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## **1. Introduction**

The Economic Community of West African States (ECOWAS) has come up with a new single currency to be used for the West African region. It is called *eco*. This is part of plans to establish a West African monetary union. To achieve this goal, macroeconomic convergence criteria had been laid down and it is expected that all criteria be satisfied as a precondition for membership. The West African Monetary Zone (WAMZ) is a subset of ECOWAS. It comprises six countries namely: Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone; all working towards the realization of the monetary union.

In a monetary union, all members give up control of their monetary policy, leaving them only with fiscal policy to direct the economy. Countries all over the world experience the business cycle and they react to the ups and down of the cycle differently. A fiscal policy can be defined in relation to the actual policy steps taken at various stages of the business cycle experienced in a country. When there is an economic boom and the Gross Domestic Product (GDP) increases, if the government cuts back on expenditure and saves more, such a policy is said to be counter-cyclical. Also, when the economy is in a recession and the GDP declines, if the government spends more and saves less, such a policy is counter-cyclical. A counter-cyclical fiscal policy is designed to stabilize fluctuations in the macroeconomic variables.

Contrary to this is the pro-cyclical fiscal policy. As the name implies, such policy actually amplifies fluctuations in the macroeconomic variables. When the economy experiences a boom and GDP rises, government spends more and saves less. However, when there is a recession, government cuts back on expenditure because they never saved or didn't save enough during the good times. This has the tendency of prolonging or aggravating the state of recession. The ideal and preferred fiscal policy is the countercyclical one.

The WAMZ and indeed the whole of ECOWAS are finalizing arrangements for the introduction and use of the new single currency. The main objective of this study is to assess the relationship that exists between fiscal policy and the business cycle for WAMZ member countries. A second objective is to examine the role of fiscal rules and the quality of institutions in reducing or amplifying the cyclical nature of fiscal policies.

## **2. Literature Review**

The theoretical and empirical literature informs us that countercyclical fiscal policies are much more beneficial than procyclical fiscal policies yet it is observed that several countries still implement procyclical fiscal policies. McManus and Orkan (2015) carried out a study to find out if it matters whether a country practices a procyclical or countercyclical fiscal policy. Using annual time series data for one hundred and fourteen countries from 1950 – 2010, the study analyzed the consequences of implementing either of these policies. Specifically, they tried to measure the impact of these policies on economic growth, inflation and volatility of output growth. Empirical results provided evidence to support the fact that procyclical policy has harmful effects on economic growth, inflation and volatility of output growth.

Reasons often cited for having procyclical policy are: government's refusal to save during the good times and the lack of access to financial markets during recession. For example, Aygun and Guzlar (2017) examined the cyclicity and determinants of effective government spending. Forty-five countries including developed and developing were sampled. The effectiveness of government spending was proxied by the cyclicity of fiscal spending. Government spending was adjudged effective if it was countercyclical. Panel data for the period 1996 – 2013 was sampled and a panel data fixed effect model was used. From the results of the analysis, the authors could deduce that the quality of economic institutions were significant in determining the effectiveness of government spending in developed countries. As for the developing countries, access to financial markets was found to be the major determinant.

To find out what other factors are responsible for this, some studies have been carried out. Talvi and Vegh (2005) investigated the nature of fiscal policy for twenty developed and thirty-six developing countries. The results showed that the G7 countries (which were a part of the 20 developed nations) had acyclical fiscal policy while the remaining developed countries had procyclical fiscal policies. As for the developing countries, they all showed a positive relationship between government expenditure and output; they were more procyclical than the non-G7 developed countries. The results were quite different from what the theory proposed. All developed countries were expected to be implementing countercyclical fiscal policies but empirical evidence showed otherwise. In a bid to address this deadlock, Talvi and Vegh introduced a political distortion into an optimal fiscal policy model. The essence of doing this was to make it difficult for governments to run budget surplus which often put pressure on the government to spend. The authors went ahead to disprove the widespread belief that the cause of procyclical policy was due to the inability of nations to access the international financial credit markets during economic downturns. In conclusion, they noted that the reasons for the procyclical nature of fiscal policy was due to high variations in the government revenue, the increased pressure on the governments to spend during good times and the government's lack of adequate saving during the good times.

Alesina, Campante and Tabellini (2008) studied fiscal procyclicality for an unbalanced panel of eighty-three countries from 1960 to 2003. The theoretical framework used was based on the political agency problem in each of the countries. Findings suggested that the reason why developing countries were experiencing procyclical fiscal policy behavior was because the voters didn't trust the corrupt government to make judicious use of resources during economic booms, so such voters demanded for increased government spending during times of economic prosperity. This makes it difficult for the government to save; rather they even resulted in borrowing. Among the other factors identified to be responsible for the governments' increased expenditure during economic boom include high income and educational inequality (see Woo, 2009), corruption and democracy (see Halland & Bleany, 2011) spread of political power and variations in the level of output (Lane, 2003).

Studies have also shown that while most of the developed countries practice a countercyclical fiscal policy, majority of the developing countries still practice procyclical policies. Evidence for this is found in the works of Kaminsky, Reinhart and Vegh (2004), Thornton (2008), Alesina, Campante and Tabellini (2008), Dessus, Diaz-Sanchez and Varoudakis, (2016) and Moharty and Mishra (2017).

Thornton (2008) assessed the link between fiscal policy and business cycle for low-income countries. He used annual data of thirty-seven low-income African countries for a period from 1960 – 2004 and carried out a regression analysis. Results showed that these African countries exhibited a highly positive relationship between government expenditure and output. Also, it was observed that the African countries that were not so corrupt and which depended on international aid were more procyclical. However, countries that were democratic and had income inequality were found to be less procyclical.

Kaminsky, Reinhart and Vegh (2004) conducted a similar study to investigate the nature of capital flows, fiscal and monetary policy for one hundred and four countries (including OECD and developing countries) using annual data from 1960 – 2003. A correlation analysis between total output and government spending in each country was carried out. Results showed that net capital flow was procyclical in majority of the OECD and developing countries; fiscal policy was procyclical for many of the developing countries while evidence suggested that monetary policy was also countercyclical for OECD countries but procyclical for developing countries.

Similarly, Dessus, Diaz-Sanchez and Varoudakis (2016) assessed the impact of fiscal rules on public expenditure in a panel of sixty-seven countries made up of low-income and lower middle-income countries (including the 8 WAEMU member countries). The sampling period was from 1995 – 2012. The main focus was on the WAEMU countries but comparisons were made with the other low-income countries. Empirical evidence provided support to show that public investment in WAEMU countries have been procyclical and there exists asymmetry of shocks in that region. The authors concluded that the region should adopt rules-based fiscal policies and provide risk-sharing mechanisms. However, it is not impossible to find out that there are also developed countries faced with procyclical fiscal policies. Talvi and Vegh (2005) and Kabashi (2014) provided evidence for this.

Kabashi (2014) investigated the cyclicity of fiscal policy for Central, Eastern and South Eastern Europe (CESEE) countries from 1995 – 2011. System General Method of Moment (GMM) was used in the estimation process. Results showed that discretionary policy in individual member countries was procyclical but for the region as a whole, fiscal policy was acyclical. Bikai (2015) assessed the cyclical nature of fiscal policy for the six countries that make up the Central African Economic and Monetary Community (CEMAC). The study made use of a balanced panel model and data for the period 1987 – 2010. Results showed that fiscal policy is pro-cyclical and is more pronounced in the presence of multilateral supervision. A further analysis reveals that fiscal policy is pro-cyclical during boom but, contrary to previous studies, acyclical during recession.

Strong fiscal Institutions and rules-based fiscal policy have been identified as the most effective tool against this problem (see e.g. Dessus, Diaz-Sanchez &

Varoudakis, 2016; Frankel, 2011; Frankel, Vegh & Vuletin, 2013; Guergil, Mandon & Tapsoba, 2017; Manasse, 2006). For example, Frankel, Vegh and Vuletin (2013) were able to show how developing countries with procyclical fiscal policies became countercyclical or less procyclical due to improved Institutional quality. Ninety-four countries were sampled for the period 1960 to 2009. Twenty-one countries were developed countries while seventy three were developing countries. Chile was found to be an outstanding example of a country that improved the quality of its fiscal Institutions and this in turn, helped to entrench countercyclical fiscal policy.

To further emphasize this point, Guergil, Mandon and Tapsoba (2017) analyzed a panel made up of 167 developed and developing nations in order to establish the kind of relationship that exists between fiscal rules and the cyclical nature of fiscal policies. The sampling period was from 1990 – 2012. The study employed propensity scores-matching method for its analysis. Findings revealed that fiscal rules in general, have very little impact in reducing fiscal procyclicality. The authors were quick to note that different rules had different effects; depending on how the rule was designed. Furthermore, budget balance rules were linked with countercyclical policies but debt rules had no effect. In conclusion, it was observed that flexible fiscal rules had the most impact on the cyclicity of fiscal policies.

Other solutions identified include membership of a monetary union (see Huart, 2013), having cyclically adjusted targets and stronger legal and enforcement arrangements (see Bova, Carcenac & Guerguil, 2014), and an improvement in the statistical capacity building of macroeconomic data (see Tapsoba, Noumon & York, 2017). Huart (2013) investigated the impact which the euro has had on fiscal policy stance. The study made use of panel data involving twelve Euro zone countries from 1970 – 2009. Instrumental Variables were used in the estimation process. Analysis was carried out at both the panel level and the individual countries level. Results showed that discretionary fiscal policies were more countercyclical after the introduction of the Euro in 1999 at both the panel level and in three countries namely: Netherlands, France and Ireland. It was however acyclical in the other Euro zone countries.

Meanwhile, Bova, Carcenac and Guerguil (2014) studied the relationship between fiscal rules and procyclical fiscal policy in the developing countries for the period 1995 to 2012. An unbalanced panel of one hundred and fifty-six countries (31 Developed and 125 Emerging economies) was sampled and regression analysis was used. Results showed that more developing countries embraced the use of fiscal rule than the developed countries; however, this adoption did not prevent the former from having procyclical fiscal policies. Rather, evidence suggested that having stronger legal and enforcement arrangements were capable of reducing procyclicality.

This section assessed the reasons for having procyclical fiscal policies in both developed and developing countries. Some of the reasons identified include the government's lack of saving during good times, high variations in government revenue, increased political pressure on the government to spend during good times, corruption and democracy and variations in the output level. Various solutions were also put forward including having strong fiscal institutions and rules-based fiscal policy, improvement in the statistical capacity building of macroeconomic data and membership of a monetary union.

### **3. Data and Methodology**

This study made use of annual data from 2001-2018 for a panel of six countries namely Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone. It was a balanced panel data. This period was chosen mainly due to the availability of data and because it was in the year 2000 that WAMZ was established. Data was sourced from the West African Monetary Institute and ECOWAS convergence reports, International Monetary Fund Global debt database, World Economic Outlook, World Governance Indicators and the Fiscal Rules dataset. The variables that could be used to represent fiscal policy include the primary balance as a percentage of GDP or government expenditure and its component parts. For the business cycle, one could use the GDP, its growth rate or the output gap (obtained by using the HP filter). According to Kaminsky, Reinhart and Vegh (2004), using fiscal policy variables as a percentage of GDP may yield biased results because the cyclical nature of output may dominate the fiscal stance. For this reason, the natural logarithm of both the government expenditure and the real GDP is used.

The dependent variable is the cyclical component of the logarithm of real general government total expenditure. The independent variables include the output (GDP), an indicator for the quality of institutions, a fiscal rule dummy, an election dummy, the lag of the dependent variable and the lagged public debt as a percentage of GDP. The cyclical component of the logarithm of real GDP (Output) is used as a proxy for the business cycle. The cyclical components of both the real government expenditure and the real GDP are computed using the Hodrick-Prescott (HP) filter ( $\lambda=100$ ). The model and approach selected, as shown in equation (1) is in line with Aygun and Guzlar (2017), Frankel, Vegh and Vuletin (2013) and Kaminsky, Reinhart and Vegh (2004).

$$\log GEC_{it} = \omega + \theta \log GDP_{it} + \lambda QI_{it} + \Omega Fr_{it} + \beta Ele_{it} + \delta (\log GDP_{it} \# QI_{it}) + \Omega (\log GDP_{it} \# Fr_{it}) + \log GEC_{it-1} + \psi Deb_{t-1} + \eta_i + \varepsilon_{it} \quad (1)$$

Where  $\log GEC_{it}$  is the cyclical component of the logarithm of real general government total expenditure,  $\log GDP_{it}$  is the cyclical component of the logarithm of real GDP (Output),  $QI$  is an indicator representing the quality of institutions. It was computed by taking the average of the six components of the World Governance Indicators (WGI). This approach of getting the quality of institutions is in line with Aygun and Guzlar (2017). The components of the WGI are Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of law and Control of Corruption. Each indicator ranges from -2.5 (the lowest and least desired) to 2.5 (the preferred).  $Fr_{it}$  is a dummy for fiscal rules, 1 for the presence and 0 for the absence of fiscal rules,  $Ele_{it}$  is a dummy for election, 1 for election year and 0 otherwise,  $\log GEC_{it-1}$  is the lag of the dependent variable and  $Deb_{t-1}$  is lag of public debt as a percentage of GDP.

Interaction terms were also introduced between output and the quality of institutions and between output and fiscal rules. This was done in order to assess the impact which they might have on the cyclical nature of fiscal policy.

#### **4. Results and Discussion**

In this section, estimation results are presented and discussed. The model was estimated using the instrumental variable-fixed effects (IV-FE) estimator. The choice of the IV-FE estimator was because of the potential endogeneity problem that would arise due to reverse causality inherent in the relationship between the dependent variable, the real government expenditure and the real GDP. As such, the first and second lags of the real GDP were used as instruments for the real GDP. The study also made use of the General method of moments (GMM) estimator but the results were not reliable and hence not reported. The reason for this was because the instruments were much more than the group of countries, leading to an over identified equation. As part of measures to check robustness of the results, this study estimated model (1) without time effects, result is presented in column 1, model (2) with time effects, result is presented in column 2 and model (3) using a different dependent variable, which is primary balance-to-GDP ratio and introducing output gap as one of the explanatory variables to replace real GDP.

From the theoretical and empirical literature, fiscal policy is procyclical when an increase in output (GDP) leads to a rise in government expenditure. It is countercyclical if there is a negative relationship between output and government expenditure. The explanatory power of all 3 models estimated is good judging by the goodness of fit. In model 1, R-squared was 0.62 while in model 2 it was 0.71 and in model 3 it was 0.37. F test results for the overall significance of the models: Model 1 has a value of 546.17 (prob. > F = 0.0000), model 2 has a value of 186.35 (prob. > F = 0.0000) while model 3 has a value of 40.82 (prob. > F = 0.0000). In model 1, the variable of interest, real GDP, had a positive coefficient of 0.639 and it was statistically significant at the one percent significance level (p-value 0.000). It means a 1% rise in real GDP leads to a 0.64% rise in the real government expenditure, while holding other variables constant. The result is in line with findings in the empirical literature that have shown that fiscal policy is generally procyclical in the developing countries such as Aygun and Guzlar (2017).

The coefficient of the interaction term between the real GDP and the quality of institutions was 0.26. It was negative and statistically significant at the one percent significance level (p-value 0.000). A 1% increase in the quality of institutions will lead to a decline of about 0.26% in the procyclicality of the government expenditures while holding all other factors constant. What this means is that good institutions are associated with less procyclicality. The coefficient of the election dummy was positive, indicating that the government spends more during elections although it was not statistically significant. Fiscal rule had a coefficient of 0.271. It was positive and statistically significant at the 5% significance level. While Fiscal rule was significant in explaining the procyclical nature of the government expenditure, it did not have the expected negative sign. This is probably due to two reasons. The first reason is that many of these countries lack fiscal rules and the second reason is that the very few that have these rules in place do not follow it to the letter.

**Table 1: Results of the IV-FE and the FE estimation of fiscal policy, business cycle and institutions, WAMZ, 2001-2018**

Dependent variable: Cyclical component of log of real Government Expenditure		Dependent variable: Primary balance to GDP ratio	
	IV-FE estimator		FE estimator
	Model 1	Model 2	Model 3
Log of real GDP-cycle	0.639*** (0.107)	0.695*** (0.098)	Output gap -0.003*** (0.0004)
Quality of Institution	-0.022 (0.138)	-0.0049 (0.127)	Quality of Institution 3.127** (1.242)
Lagged real Government expenditure	0.156* (0.083)	0.112 (0.079)	Lagged primary balance ratio 0.196 (0.130)
log of real GDP cycle*Quality of institution	-0.255*** (0.086)	-0.240*** (0.086)	Inflation rate 0.120 (0.078)
log of real GDP*Fiscal rule dummy	0.020 (0.040)	-0.0067 (0.036)	Current account ratio -0.017* (0.007)
Election dummy	0.031 (0.031)	0.037 (0.030)	Election dummy -1.453* (0.715)
Lagged public debt as a percentage of GDP	0.00046 (0.00046)	0.00054 (0.00044)	Lagged public debt as a percentage of GDP 0.018*** (0.001)
Fiscal rule dummy	0.271** (0.115)	0.200* (0.108)	Constant -1.250 (1.178)
Time Fixed Effects	No	Yes	Time Fixed Effects No
Observations	96	96	Observations 102
F test	401.37	144.55	F test 40.82
Prob. > F	0.0000	0.0000	Prob. > F 0.0000
R-squared	0.62	0.71	R-squared 0.37
Anderson canonical correlation LM statistic	48.237	53.492	Country Fixed Effects Yes
Anderson can. Corr P- value	0.0000	0.0000	
Cragg-Donald Wald F statistic	46.778	48.353	
Sargan Statistic	6.821	3.740	
Endogeneity test	1.937	1.584	

Source: Author's calculation, 2020

Notes: P-values \*\*\*p<0.01, \*\*p<0.05, \*p<0.1: means variable is statistically significant at the 1%, 5%, and 10% level respectively. Country fixed effects and time fixed effects results are not reported, robust standard errors are given in brackets. Null hypothesis of the Anderson can. corr. LM test is Instruments are not relevant/under-identification while the null hypothesis of the Cragg-Donald Wald F test is instruments are weak/weak identification.

In column 2, results of the model estimated including time effects is presented. The key variables of interest are the cyclical component of the real GDP,

the interaction term between real GDP and the quality of institutions. Both variables were robust to different specifications. The coefficient of real GDP was 0.695, it was positive and statistically significant at the one percent significance level (p-value 0.000). A 1% increase in GDP leads to a 0.85% increase in government expenditure while holding other variables constant. Similarly, the coefficient of the interaction term was negative and significant. A 1% increase in the quality of institutions brings about a 0.14% decrease in the procyclicality of government expenditure while holding other factors constant as well. The coefficient of the election dummy was positive, indicating that government spends more during elections although it was not statistically significant. Fiscal rule was positive and statistically significant in explaining the procyclical nature of government expenditure, although it did not have the expected negative sign. The likely reasons for this could be due to the fact that out of the six countries investigated, only two, Liberia and Nigeria had fiscal rules in place. In addition, while fiscal rule was introduced in 2009 in Liberia, it was introduced only in 2007 in Nigeria. It is also fair to say that the fiscal rule has not been implemented religiously in these two countries. The instrumental variable used was subjected to the under-identification test, the weak identification test and the overidentification test. Results showed that the IV was relevant, strong and not correlated with the error term.

As part of robustness check, a third model, shown in equation (2) was introduced and estimated. Results are presented in column three of table 1.

$$Pb_{it} = \alpha_i + \gamma Gap_{it} + \Omega QI_{it} + \phi Pb_{it-1} + \pi Ele_{it} + X_{it}\delta + \eta_i + \varepsilon_{it} \quad (2)$$

Where  $Pb_{it}$  is the primary balance as a percentage of GDP,  $QI_{it}$  is the quality of institutions indicator,  $Gap_{it}$  is the output gap and it is a proxy for the business cycle. Output gap is calculated by subtracting the potential GDP from the actual GDP. The potential GDP was computed using the Hodrick-Prescott (HP) filter with  $\lambda=100$ .  $Pb_{it-1}$  is the lag of dependent variable,  $Ele_{it}$  is the election dummy and  $X_{it}$  is a vector of control variables including  $Cab_{it}$  which is current account balance as a percentage of GDP,  $Infl_{it}$  for inflation rate and  $Deb_{it-1}$  is lag of Public debt as a percentage of GDP.  $\eta_i$  is the unobserved country specific fixed effects,  $\varepsilon_{it}$  is a time and country specific error term.

The dependent variable was primary balance as a ratio of GDP while business cycle was proxied using output gap and not real GDP which was used in the previous two models. From the theoretical and empirical literature, fiscal policy is procyclical when an increase in output gap (a proxy for the business cycle) is associated with a decrease in the primary fiscal balance. It is countercyclical if there is a positive relationship between output gap and primary fiscal balance. The output gap had a negative coefficient of 0.003 and it was statistically significant at the 1% level of significance. The implication of this is that fiscal policy is pro-cyclical in the WAMZ countries because for every unit increase in the output gap, the primary balance decreases by 0.003 percentage point while holding other factors constant. This result further reemphasizes the initial results obtained from model 1 and model 2 that indeed fiscal policy is procyclical in WAMZ.

With regard to the impact of the quality of institutions on fiscal policy in WAMZ, the results from model 3 also attest to the ability of sound quality institutions (such as Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of law and Control of Corruption) to reduce the procyclical nature of fiscal policies and increase primary fiscal balance. In model 3, the quality of institutions indicator has a positive coefficient of 3.127 and it is statistically significant at the 5% significance level. For every one-unit improvement in the quality of institutions, the primary balance jumps up by 3.127 percentage points while keeping other factors constant. The lagged dependent variable which is the primary fiscal balance ratio, has a positive coefficient indicating fiscal policy persistence although it was not statistically significant.

From the results presented, the following points are deduced. One, fiscal policy in the West African Monetary Zone (WAMZ) is highly procyclical. When output (GDP) increases, governments of these countries spend more and save less. This procyclical nature plays out when the study makes use of primary fiscal balance instead of government expenditure as the dependent variable in model 3. When the output gap increases (an indication that the economy is operating below optimum capacity), the primary fiscal balance goes down. Secondly, strong institutions are capable of making fiscal policy less procyclical and perhaps countercyclical. Sound institutions such as respect and obedience for the rule of law, control of corruption, high quality of government regulations, political stability and absence of violence and terrorism, giving the citizens a voice and government being accountable. Lastly, a thriving economy, whether it belongs to a monetary union or not, to a large extent depends on government implementing sound fiscal policies. It becomes even more important for countries in a monetary union because that is the only policy tool that they have control over. As WAMZ member countries brace up for the proposed West African currency union, what can they do to improve upon their fiscal policy?

Wyplosz (2002) examined how best fiscal policies are to be designed and implemented. Should it be by Institutions or by rules? The study highlighted the need for having a fiscal policy that possesses the qualities of instilling long-term fiscal discipline and at the same time having short-term flexibility as the situation may demand. Using the Stability and Growth Pact (SGP) introduced in the European economic and monetary union as an example; it was observed that if the SGP was strictly made up of rules and no escape clauses, then chances are that targets set (debt and deficit) may not be achievable. At the same time, if the SGP were to give room for escape clauses, then member countries would abuse it and the set targets (debt and deficit) would also not be met, thereby destabilizing the union. The author opined that the best solution out of the situation was to have independent Fiscal Policy Councils similar to the Monetary Policy Committees. The Council would be given clear directives but they would be devoid of any political pressure and interference.

Also, Auerbach (2011) assessed fiscal institutions for a currency union. His first observation was that the idea of fiscal policy coordination, which was carried out through the Stability and Growth Pact in the Eurozone failed to prevent some countries (Greece in particular) from falling deep into crisis and seeking financial assistance. He compared this with the situation in the U.S., another single currency union, where the U.S. federal government does not impose fiscal rules upon the states

and yet the states have enjoyed good fiscal performance over the years. He highlighted the often-cited reasons given for having fiscal rules. They included: To address economic spillovers caused by fiscal shocks; to avert contagion and lastly to address the issue of Samaritan dilemma. Auerbach was able to dismiss all these reasons, making comparisons to U.S. which did not suffer from any of these problems. The study therefore called for the creation of independent fiscal policy councils. Daniel and Shiamptanis (2013) argued that the EMU crisis was not a negative outcome of the explosive fiscal rules but rather, adverse fiscal shocks.

## **5. Conclusion**

This research investigated the relationship between fiscal policy and the business cycle in the West African Monetary Zone. This became necessary as these countries are preparing to join the proposed West African monetary union. In the absence of control over monetary policy, the study sought to understand how these countries respond to the ups and downs of the economy using only the fiscal policy. With a balanced panel data of the 6 countries for the period 2001-2018, a fiscal reaction model was estimated. Results showed that fiscal policy is highly pro-cyclical in WAMZ. A one percent increase in the real GDP, all other factors held constant, would lead to between 0.639 – 0.695% increase in government expenditure. The implication of such policy is that it actually amplifies fluctuations in the macroeconomic variables. This is not good for a monetary union.

In addition to the first objective, this study also investigated the role of institutions, fiscal rules and election in making fiscal policy less procyclical and perhaps graduate into a countercyclical one. Among the explanatory variables used include fiscal rules dummy, an election dummy and an indicator to measure the quality of institutions. Fiscal rules were significant in explaining the procyclical nature of government expenditure although contrary to what was expected, it had a positive sign. This is probably due to two reasons. The first reason is that many of these countries lack fiscal rules and the second reason is that the very few that have these rules in place do not follow it to the letter. The theory and literature suggested that with good institutions in place, government expenditure and indeed fiscal policy should be less procyclical. This study interacted institutions with real GDP in the model estimated and the coefficient was negative and statistically significant. It showed that indeed good institutions have the ability to make procyclical fiscal policies less procyclical and probably even graduate to countercyclical fiscal policy. Available evidence in the developed countries supports this.

Government must put in place policy measures capable of moving the nations from being pro-cyclical to countercyclical. For instance, institutions set up to handle fiscal issues must be allowed to work independently, as much as possible and devoid of the usual and unnecessary political interference observed in many African nations. Institutions should be improved upon. Fiscal rules, such as expenditure rule, may be introduced but with a reasonable balance between rigidity and flexibility. Government might even set up fiscal councils as suggested by Wyplosz (2002), whose job it would be to study the fiscal needs of the economy and advise accordingly. Other institutions like Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality,

Rule of law and Control of Corruption should be improved upon. Until this is achieved, this study suggests that the single currency union plan be suspended.

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