

Sustainable Fiscal Policies and Institutional Framework in West African Countries

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Abstract— *A number of African countries have relied on external debt financing from multilateral institutions and ‘generous’ developed countries (e.g. through bilateral arrangements, etc.), with the intention of meeting their numerous financial needs. However, fiscal balances in West African countries have gradually declined in the last few years, following expansive infrastructural investment, coupled with weak institutions and poor revenue performance. This study examines the extent to which institutions affect fiscal sustainability in 15 West African countries (1996-2012). With the aid of the Feasible Generalized Least Squares (FGLS) estimator, and using institutional indicators of government effectiveness, political stability, rule of law, regulatory quality and control of corruption, the results, among others, suggest that regulatory quality plays the most significant role in attaining sustainable fiscal policies in West Africa.*

Index Terms—Control of corruption; Fiscal deficits; Fiscal policies; Institutions; West Africa

I. INTRODUCTION

Low-income countries (LICs), including African countries, have continually relied on external debt and ‘handouts’ from multilateral institutions and ‘generous’ developed nations, with the intention of augmenting their financial resources. Some of these countries require such sources of finance for developmental projects and plans [1]. However, this path dependency trap has provided short-term fiscal stimulations, which do not necessarily translate to long-term fiscal solutions. A sustainable fiscal policy is one that – if continued indefinitely and without modification – would keep the government solvent in its financial obligations in the long run [2]. Fiscal policy is also said to be sustainable if the present value of future primary surpluses equals the current level of debt [3]. It implies that the primary adjustment that is required to avoid a debt restructuring or outright default is feasible [1]. Sustainable fiscal policies translate in the long run to fiscal sustainability, by ensuring reduced deficits in an economy. Fiscal sustainability is often used interchangeably with sustainable fiscal policies. This is because it implies the avoidance of increased government liabilities, in terms of debt and debt service payments, which hold adverse effects for future generations [4].

However, it simultaneously involves the government’s ability to perform its role in the provision of necessary public services to its citizens [5].

The fiscal deficit cum rising debt problem is a global phenomenon that confronts both industrialized and LICs, evidenced by their ‘struggles’ with overspending issues and attempts to control an upsurge in debt levels. Fiscal balances in sub-Saharan Africa (SSA) have gradually declined in the last few years, following expansive infrastructural investment, coupled with weak revenue performance (World Bank, 2014). In Benin, overall fiscal deficit widened from 3.5 percent of gross domestic products (GDP) in 2008 to 7.3 percent in 2009 [6].

Following rising fiscal deficits, the debt-to-GDP ratio remains prominent in many countries due to an increase in government borrowing [7]. Among African countries, debt-to-GDP ratio rose from 94 percent in 2010 to 202.4 percent in 2012 in Zimbabwe, from 33.6 percent in 2008 to 44.9 percent in 2012 in Ghana, from 19.5 percent in 2008 to 30.8 percent in 2012 in Senegal. Cape Verde recorded an increase from 39.9 percent in 2007 to 66.2 percent in 2012, and a steep rise to 95 percent by 2013. This trend is attributed partly to shortsighted fiscal policies, implying that governments need to strategically engage in effective management and exercise sufficient implementation capacity in fiscal matters. The above stance is buttressed by [8] who states that increases in government debt coupled with the recent financial crisis serves as a wake-up call for policy makers to improve fiscal discipline, while also paying close attention to more concrete long-term fiscal sustainability strategies.

Looking at the evidence of high debt-to-GDP ratios across countries, it is pertinent for a country to safeguard its public investment by cutting back on its borrowing, and raising the required revenue that will enable it to adequately service its obligations so as to preclude either default or restructuring. This implies fiscal consolidation, which enables a *crowding in* of private investment. It also fosters enhanced growth, employment and economic stability, while also helping to forestall financial crisis in the future [2]. For Heavily Indebted Poor Countries (HIPC), most of which are in Africa, the main fiscal challenges include: rising debt levels, reduction in reserve capacity, corruption, in terms of funds mismanagement and lack of accountability and

transparency; poor policy implementation and poor monitoring of implemented policies; moral hazards, among others. Such countries may therefore require stringent fiscal measures in an attempt to resolve their debt issues. This implies that a sizeable fiscal consolidation is required for their sustainability, but not without huge costs [9].

There is a rising interest in the sustainability of fiscal policy. This was induced largely by the global financial crises of 2007-2009 that amounted to a number of bank bail-outs, coupled with the United States fiscal cliff trepidation of 2012, as well as the European sovereign debt crisis (Eurozone crisis). The effectiveness of a country's fiscal policy reforms are however largely determined by the political economy, which is responsible for the design of the institutional framework governing such policies. Therefore, achieving a robust and sustainable fiscal policy will require that the political economy is able to exercise better judgment in taking policy decisions. However, this is only plausible where political leaders possess the political will and are committed to building strong institutions. This is following the works of institutional theorists that economic progress and performance is vested on the quality of institutions, such as corruption and governance, among others. Although various scholars and researchers, particularly in Europe, Asia and America, have explored this issue, there remain narrow studies that specifically focus on Africa's sustainability strategies. A number of these studies have addressed various institutions that can support a more sustainable fiscal path, with the most common being budget and fiscal institutions.

This study differs from other studies by providing another perspective to the sustainable fiscal policy debate as well as giving more insights to the understanding of the extent to which the quality of institutions within the political economy framework affect fiscal sustainability in West Africa. The focus of this study is centered on political institutions, because of the intricate role it plays in determining a country's fiscal performance. The study also analyses whether the influence of institutions on fiscal sustainability varies with debt-relieved countries. This is with a view to assessing the advantages of the HIPC initiative among West African countries, and how similar initiatives can be maximized in the future.

Debt build-up is a function of the political economy, in that poor decision making among policy makers can mar fiscal performance. For instance, when current governments choose to ignore the adverse effects of deficits on the economy in the long run when they will no longer be in power, it poses a threat to fiscal balances. In such cases, they are primarily concerned with their political aspirations while in office, and their chances of being re-elected. This follows [10] who found fiscal adjustments launched in emerging market economies where the governments did not face imminent elections, to be more successful than where elections were looming. [11] also expounded that myopic fiscal policies are sometimes implemented where governments seek to

increase their chances of remaining in office. They either delay taxes or escalate spending to buy political support, thereby increasing deficits. Some even believe that persistent budget deficits arise as a result of a rational choice by self-interested political actors [12]. This may not be the case in the more developed economies; however, in a continent like Africa, this type of incidence is not far-fetched. Since the political economy determines and controls fiscal policies, a comprehension of political institutions becomes imperative in a bid to improve fiscal discipline in African countries. To this end, the main research questions for this study are: (i) how germane are political institutions to the sustainability of fiscal policies in West Africa? (ii) to what extent does the effect of political institutions on the sustainability of fiscal policies vary among West African countries that have received debt relief?

The study is divided into five sections. Section one is the introduction, while section two provides some insights from the relevant literature. In section three, the empirical model used in the study is presented. Section four encapsulates the presentation of results from the estimation techniques and discussion while the last section concludes with some recommendations for policy and further research.

II. SOME INSIGHTS FROM EXTANT LITERATURE

The political economy literature studies the institutional processes that explain the mechanism through which certain groups of economic and political elites influence the allocation of scarce productive resources, whether for personal benefit or for the greater good [13]. It involves the relationship between political and economic institutional arrangements regulating the affairs of a country, while highlighting the role of power in economic decision-making. These arrangements may come in the nature of policy reforms, rules, traditions, laws, property rights, constitutions, or authorities, and are necessitated to ensure good governance in various sectors of the economy. They are generally referred to as institutions, which [14] defines as humanly devised formal and informal constraints that structure political, economic and social interaction. These institutions present the rules of an economic game, provide the incentive structure of an economy, and overtime, the structure largely channels economic change towards growth, stagnation, or decline [14]. Political institutions in this paper therefore hinges on the institutional decisions and behaviour that are expected to bring about an improvement (or deterioration) of sustainable fiscal policies among West African economies. This is in adherence to [15] who affirmed that the formal institutions comprising rules and regulations, which control the existence of a system, are grouped into economic and political institutions.

That institutions matter to the development of an economy cannot be overemphasized. [16] assert that developing countries like Africa require relevant institutions if they are to achieve economic progress. It can therefore be said that institutions are germane to the

sustainability of fiscal policies within the economy of Africa countries. This bearing is evinced in some of the notable reasons that account for the challenges in achieving sustainable fiscal policies, which include weak institutions, ineffective governance infrastructure and ineffective public management [17]. This is because better institutions will strive towards increasing savings, while also lowering borrowing cost, and improving debt dynamics. The above underscores the vital role of institutions on the sustainability of fiscal policies.

Nevertheless, to what extent do institutions matter to improving fiscal performance among countries? Few studies in the past have addressed the position of institutions and fiscal sustainability. One of such studies is [18] who studied the effectiveness of political and fiscal institutions in promoting fiscal sustainability in the United States, and found that balanced fiscal institutions in the form of budget rules and rainy-day funds reduce deficits and promote savings respectively, while political institutions such as term limits tend to increase spending. This study was not statistical in nature, making the relationship difficult to measure. It however raises the question as to whether such findings will hold in Africa where most governments grapple to develop rainy-day funds.

Another study is [19], who focused on the quality of budget institutions in low-income countries and fiscal outcomes, using multi-dimensional indices. They assert that budget institutions aid in enhancing fiscal balances and public external debt outcomes, while stronger fiscal institutions help a country to conduct better countercyclical policies. [20] examined the nexus between public financial management and fiscal outcomes in sub-Saharan African (SSA) Heavily-Indebted Poor Countries (HIPC), making use of the Ordinary Least Squares (OLS) econometric analysis and public financial management indicators. They found that healthier public financial management leads to better fiscal outcomes. However, the OLS is largely a time series technique of econometric analysis, whereas the study was a panel data study, making OLS an inadequate tool of estimation for the study. The OLS has also been questioned in its ability to attend to the problem of endogeneity, which exists in most econometric models. [21] who also made use of OLS estimations noted that conducting panel regressions would be more interesting as it will be possible to investigate the extent to which sound institutions can promote fiscal behaviour. This present study therefore engages a different estimation technique known as the Feasible Generalized Least Squares (FGLS) estimator, in order to forestall the shortcomings of some of the methods used in extant studies ([21], [18], [20]).

[22] explained that endemic debt and deficit issues in the past have led to macroeconomic instability, which gave rise to the HIPC Initiative of the IMF and World Bank. The initiative is a form of debt relief provided to address the development needs of LICs in a bid to ensure that debt sustainability is maintained over time. Before a country qualifies for assistance from the initiative, it must

face an unsustainable debt burden, which it is unable to manage via traditional debt relief mechanisms, and it must have established reform and sound policies endorsed by the IMF and World Bank. Where it meets these and other conditions considerably, the initiative perpetrates to abate its debt to a level that is deemed sustainable.

To receive full debt reduction though, the country must implement other prior agreed key reforms [23]. It is important to note that out of the 36 countries that have enjoyed debt reduction packages under the HIPC Initiative, 30 of them are in Africa. [23] has pointed that cautious borrowing policies need to be followed to minimize debt vulnerability. A number of West African countries fall under the HIPC initiative, making this viewpoint important. This is in line with [19], who noted that while a large number of countries were able to achieve primary fiscal surpluses, supported by debt relief and reduced external debt burdens, there remained cross-country variations in fiscal performance. They suggest that institutions might have a role to play in these variations.

To account for the disparity in the debt patterns of African countries, this present study takes on a different approach from extant studies in that it explores the variation of the effect of political institutions on fiscal sustainability in debt-relieved African countries.

III. EMPIRICAL MODEL AND DATA

In specifying the model, we glean insights from [21], who expressed the effect of institutions on fiscal outcome as:

$$y = \alpha_0 + x\beta + \gamma q + \varepsilon$$

Where: y represents the measure of fiscal sustainability, x is a vector of exogenous explanatory variables, and q is institutional quality. Following this model, the econometric model for this study may be specified explicitly as:

$$Fiscal_Sustainability_{it} = \beta_1 + \beta_2 Institutions_{it} + \beta_3 Covariates_{it} + \varepsilon_{it}$$

The dependent variable, fiscal sustainability, is measured as debt-to-GDP ratio ($Debt_GDP$). This measure is accepted by the World Bank as suitable for explaining the level of fiscal sustainability in a country [24]. It has been used by [11], [25]; and is in sync with [26] who defined a sustainable fiscal policy as one whose debt to output ratio reverts to its initial debt level. Other tests of fiscal sustainability are the government inter-temporal budget constraint, the ratio of the primary deficits of the central government to GDP [2], the primary gap indicator and the tax gap indicator [27].

The key explanatory variables in the study are the indicators of institutions. For the purpose of this study, we focus only on political institutions. Political institutions determine the constraints on the incentives of key actors in the economy [28]. [18] used three categories of political institutions in a qualitative analysis

namely: direct democracy, term limits and separation of powers. This study employs different measures of political institutions as obtained from the World Governance Indicators-WGI dataset. The dataset entails a statistical compilation of responses on the quality of governance as obtained from a large number of respondents and expert assessments around the world. The five indicators used are; government effectiveness (*Govt_effc*), political stability (*Pol_stab*), rule of law (*Rule_law*), regulatory quality (*Reg_qlty*) and control of corruption (*CCorr*).

Pol_stab: - reflects the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, as well as politically motivated violence and terrorism.

Rule_law:- captures the perceptions of the extent to which agents trust in and adhere to the rules of society, and precisely the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

Govt_effc: -describes various agents' opinions on the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

Reg_qlty:- reveals agents' views on the ability of the government to formulate and implement sound policies and regulations that permit and promote the development of the private sector.

CCorr: - relates agents' assessments of the extent to which public power is exercised for private benefit, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

The others covariates are: real economic growth of GDP (*GDP_grwth*) and foreign direct investment (*FDI_gdp*). The data for these variables were gathered from the World Development Indicators of the World Bank (2013). *GDP_grwth* refers to the change in the volume of a country's output or in the real incomes of its residents, measured at constant prices. *FDI_gdp* is measured as net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors, divided by GDP.

To test the empirical evidence, the Feasible Generalized Least Squares (FGLS) estimator is used. This technique is known to generally provide a better estimate than the Ordinary Least Squares (OLS) estimator, particularly when heteroscedasticity persists, or when correlation is high between the observations. FGLS may however be inconsistent where there are individual specific fixed effects [29]. The FGLS has been widely used in panel data analysis to capture the unobserved individual specific heterogeneous country characteristics that occurs in most panel data studies. This study focuses on West African where the countries possess similar characteristics, making it a suitable

technique for the analysis. In addition, it is expected that our measure of institutions will exhibit some level of multicollinearity, necessitating the use of FGLS to tackle such problems. The STATA software was used for the estimation.

We analyze annual data for a sample of 15 countries in West Africa (1999-2012). The countries include: Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo. The data was collected from the World Development Indicators-WDI and the World Governance Indicators-WGI. It is worth noting that out of the 15 above listed countries, 13 of them comprising 86.67% are HIPC.

IV. EMPIRICAL RESULTS AND DISCUSSIONS

As a preliminary analysis both summary statistics and the correlation test of the variables of interest were first carried out but not reported for space. The main insight from them was that all the five indicators of institutional quality are within the negative domain, which implicates the existence of weak institutional framework in West Africa. The quick inference from above is that majority of the countries in West Africa have weak institutions using the five selected indicators.

Results Econometric Estimations

Table I reports the estimations for the sample countries using the FGLS estimator. The results show that the measures of institutions had negative signs and were significant at 1 percent in their influence on debt-to-GDP ratio. This suggests that a unit increase in institutional quality will result in a decrease in a country's debt-to-GDP ratio. Putting this in empirical terms, where a magnitude of the impact of the institutional variables is considered in relation to debt-to-GDP ratio, a standard deviation increase of 0.531 of government effectiveness will induce a debt-to-GDP ratio of -0.778 (0.531×-1.466). This implies that for a country with an average debt-to-GDP ratio of 1.079, an improvement in government effectiveness will result in a reduction in debt to GDP ratio of 0.840. It can therefore be recommended that West African countries need to put in place more frantic efforts in enhancing the effectiveness of their governance, with a view to reducing the soaring debt profile as reflective of their debt-to-GDP ratios. This challenge has constituted one of the stumbling blocks to the process of regional economic integration in West Africa [30].

Considering the other measures of institutions, political stability, rule of law, regulatory quality and control of corruption, a standard deviation increase of 0.897, 0.616, 0.485, and 0.503, respectively, will induce a debt-to-GDP ratio of -0.752, -0.824, -0.923, and -0.638. This connotes that for an average West African country with a debt-to-GDP ratio of 1.079, an improvement in political stability will result in a reduction in the debt-to-GDP ratio of 0.811. That same country will experience a reduction in debt-to-GDP ratio of 0.889, 0.996, and 0.688

if the rule of law, regulatory quality and control of corruption are improved, respectively.

Table I: FGLS Estimation – All West African Countries

Explanatory Variables	Dependent variable : fiscal sustainability (Debt_GDP)				
<i>Govt_effc</i>	-1.46*** (0.000)				
<i>Pol_stab</i>		- 0.83*** (0.000)			
<i>Rule_law</i>			- 1.33*** (0.000)		
<i>Reg_qlty</i>				- 1.899** (0.000)	
<i>CCorr</i>					- 1.26** (0.000)
<i>GDP_grwth</i>	0.037* (0.093)	0.045** (0.044)	0.043* (0.051)	0.027 (0.173)	0.049* (0.034)
<i>FDI_gdp</i>	-0.019 (0.124)	-0.018 (0.151)	-0.015 (0.214)	- 0.025** (0.012)	-0.013 (0.315)
<i>Wald</i>	39.00***	35.16**	42.97**	64.47**	26.38*
<i>Prob-value</i>	0.000	0.000	0.000	0.000	0.000
<i>Observations</i>	178	177	177	192	178

Note: Constant term is included in all the estimation but not reported. The numbers in bracket are the probability values. ***, ** and * indicate significant at 1, 5 and 10 percent, respectively.

In addition to the above policy implication, West African countries should consider regulatory quality, rule of law, government effectiveness, political stability and control of corruption, as policy steps in reducing the debt-to-GDP ratio. Tying these measures to their standard definitions as enshrined in the World Governance Indicators, the regulatory quality, rule of law, and government effectiveness, are tailored towards policies that promote private sector development – attracting, retaining and sustaining investments – and shows a government’s commitment towards these policies.

The last two measures, political stability and control of corruption, reflect the self-interest drive of public officers in terms of control of bureaucratic power, and the use of such power for private benefit. The effect of this will increase the cost of investment [28], and will further widen the resource gap in these countries. Thus, institutional mechanisms such as: adherence to the fundamentals of fiscal discipline with a view to reducing the rising budget deficit and excessive public borrowing and so on, is an essential step in ensuring sustainable fiscal policies for West African countries. The role of the Economic Community for West African States (ECOWAS) in this crusade cannot be overemphasized

Table II: FGLS Estimation – HIPC in West Africa

Explanatory Variable	<i>Govt_effc</i>	<i>Pol_stab</i>	<i>Rule_law</i>	<i>Reg_qlty</i>	<i>CCorr</i>
<i>Govt_effc</i>	- 1.742** * (0.000)				
<i>Pol_stab</i>		- 1.219** * (0.000)			
<i>Rule_law</i>			- 1.932** * (0.000)		
<i>Reg_qlty</i>				- 2.16*** (0.000)	
<i>CCorr</i>					- 1.93*** (0.000)
<i>GDP_grwth</i>					
<i>FDI_gdp</i>					
<i>Wald</i>	39.52**	48.74**	55.68**	68.13**	35.11**
<i>Prob-value</i>	0.000	0.000	0.000	0.000	0.000
<i>Observations</i>	155	153	153	166	155

Note: Same as in Table I Indicates that the variables were included.

In Table II, the second objective, which considers the effect of institutions on sustainable fiscal policies among HIPC countries in West Africa, is addressed. It is noted that the measures of institutional quality remain negative and significant, as they are in Table I. Similar conclusions can be drawn for the HIPC sub-sample for West Africa from the overall outlook in Table I. However, in this sub-sample, it seems like the order of preference for institutional measures is incoherent with that of Table I. For the HIPC countries, we suspect that the order of preference is regulatory quality, control of corruption, rule of law, government effectiveness, and political stability, respectively¹. This result exposes the extent of corruption that has permeated HIPC in West Africa. In order to deal with their fiscal issues therefore, corruption must be addressed extensively; otherwise the good intentions of the IMF and World Bank via the HIPC Initiative may not yield the required outcomes. This follows [31] who suggest that fiscal performance can be improved by tackling fiscal corruption, particularly amongst fiscal officers.

V. CONCLUSIONS AND RECOMMENDATIONS

This study examines the extent to which institutions affect fiscal sustainability in a sample of fifteen West African countries over the period from 1996 to 2012. Five measures of institutional quality – government

¹We carried out robustness check to see whether there is a possible outlier effect excluding Nigeria. However, the result (not reported) remained consistent as the behaviour of the measures of institutions was consistently negative and significant in all the columns. This suggests that the result from this study is not obscured by the inclusion or otherwise of Nigeria.

effectiveness, political stability, rule of law, regulatory quality and control of corruption – were examined using the FGLS technique of estimation. The result provides evidence that among the measures of institutional quality, regulatory quality plays the most significant role in attaining fiscal sustainability in West Africa.

It is underscored in the study that the indicators of institutional quality exert a negative and significant influence on debt-to-GDP ratio, which implicates, *ceteris paribus*, that an improvement in institutional quality will lead to a reduction in the debt-to-GDP ratio in West Africa. It can be said that improvement of institutional quality of West African countries will make their fiscal policies more sustainable. Thus, it is recommended that for West African countries to enhance the effectiveness of their governance, more frantic efforts should be put in place to improve their institutional quality, in order realize sustainable fiscal policies. Other efforts such as controlling of corruption, enhancing the rule of law, improving quality of regulation and ensuring a more stable political system are relevant in pursuing sustainable fiscal policies in West Africa. The above are crucial for a regional economic integration process as generally *preached* by the ECOWAS as the regional economic body in West Africa.

This current study is confronted with some limitations as it relies on data for institutional quality from the World Governance Indicators. Thus, complementing what has been done in this study using other indicators of institutional quality will be helpful in providing more empirical facts on the fiscal sustainability and institutional quality nexus. It is also recommended for further study to investigate the issue in other sub-regions in sub-Saharan Africa such as Central, East, and Southern Africa, which will provide a more comparative analysis within the broader African context.

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