ANALYSIS OF UGANDA'S GROWING FISCAL DEFICIT AND DOMESTIC DEBT ACCUMULATION

Abstract

This paper reviews the trend of fiscal deficit and how it is financed. It also explores the composition of public debt and the likely impact on the economy at large. The paper finds that while the debt levels don't raise immediate sustainability concerns, the composition of public debt and the recent pace of debt accumulation raise sustainability concern. The use of domestic debt has increased the debt service burden, risks crowding out the private sector and also presents the debt (re)financing risk as the average maturity of domestic debt is just 2.3 years. The increasing use of non- concessional loans also presents challenges including the way the loans are acquired and the associated delayed absorption. The existing legal framework presents a platform for institutional management, and there is need to leverage on that— building sufficient capacity for economic assessment of the loans. There is need to enforce measures to enhance domestic revenue, identify efficiency measures in the budget and explore alternative means of financing from private sector.

I. Introduction: Early Fiscal Reforms and Debt Relief

Uganda has a history of high fiscal deficits and debt burden, which was in part eased by debt relief in the 2000s. Fiscal (budget) deficits are defined as the difference between the government expenditure and its revenue (excluding donor grants). Cumulative fiscal deficits tantamount in public debt[1] and the effects of budget deficits on the economy largely depend on the financing sources. The financing of the loans is considered variedly from concessional, semi concessional and non-concessional.[2]

The major land mark of Uganda's fiscal policy reform can be traced back to the early 1990s with the adoption of budget expenditure restraint and reform to ensure that the Executive does not have to borrow from the domestic banking system to finance budget deficits or least, through printing money (monetisation of fiscal deficits). Since 1992 Uganda's fiscal policy entailed very strict budgetary discipline, given the dismal level of revenue at 7.5% of GDP. A cash flow management system was designed to enable the Ministry of Finance Planning and Economic Development (MoFPED) to control government spending as well as control all borrowing by spending agencies and other public institutions, such as state owned enterprises. As such, implementation of the macro-fiscal reforms (1992/93-1996/97) was associated with no borrowing from the domestic market.

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[1] Total public debt is comprised of both domestic and external public debt. Domestic debt is comprised of short-term and long term government securities (treasury bills and bonds). External debt are loans contracted by the public entities in foreign currency and from external (beyond Ugandan boarders) sources.

[2] Concessional loans are loans extended on terms substantially more generous than market loans. Concessionality is achieved either through interest rates below those available on the market or by longer *grace periods,* or a combination of these. Concessional loans typically have long grace periods, and mainly from Multi-lateral agencies with interest rate of 0.75%, with a 40 year maturity and 10 year grace period. Non concessional on the other end are acquired at higher (market) rates, with a shorter maturity. Semi concessional is a blend of concessional and non-concessional terms.

From mid 1990s, government embarked on the comprehensive poverty reduction strategies (the Poverty Eradication Action Plans), with increased expenditure focus on social sectors. This coupled with other macro-economic reforms made Uganda the 1st country to qualify for debt relief under the High Indebted Poor Countries (HIPC) initiative in 1998. The relief was worth of USD 347 million. The fiscal deficits (excluding grants) however continued on an increasing trend, nearly doubling from 6.5% of GDP in 1995/6 to 12.3% of GDP in 2001/02. Despite the donor grants increasing from 4.2% of GDP in 1995/6 to 7% of GDP in 2001/2, the deficit including grants also rose from 2.3% in 1995/6 to 5.3% in 2001/2. This left the debt levels high, leading Uganda into an Enhanced HIPC initiative in 2000, worth a net present value of USD 656 million. The surmountable decline in Uganda's debt however, only happened in 2006 when 100 % of the external debt by World Bank, IMF and African Development Bank was forgiven under the Multilateral Debt Relief Initiative (MDRI), reducing Uganda's debt stock to USD 1.3 billion from the USD 4.5 billion.

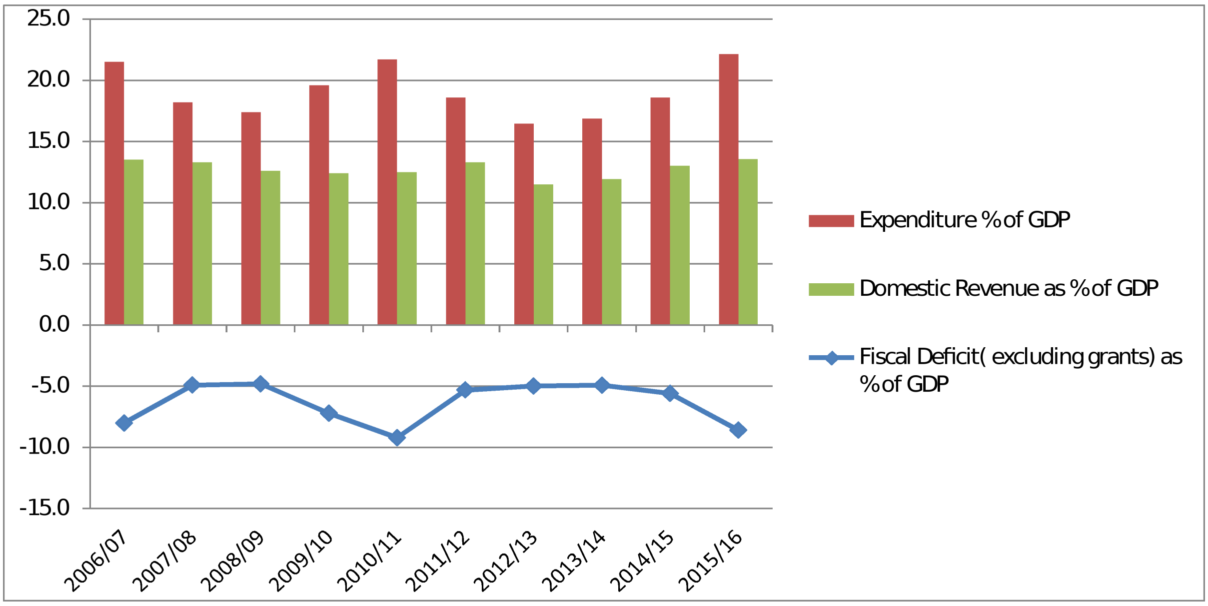
II. Post Debt Relief

Fiscal deficit has largely been driven by dismal revenue generation over the last decade**.** The average fiscal deficit between 2006/7 and 2015/16 was at 6.3% of GDP, owing largely to low levels of revenue that averaged at 12.8% of GDP. Notably the average government expenditure of 20% of GDP is by and large low compared to other regional counterparts. Uganda's total expenditure for FY 2015/16 is at 22.1% of GDP compared to Tanzania's 23%, Rwanda 29% and Kenya 30.6%. Uganda's overall deficit[3] as a share of GDP for FY 2015/16 budget is highest in the region at 7% compared to 6.5% in Kenya, 4.2% in Tanzania from (4%), and 4.6% in Rwanda from (5.9%), which is indicative of low revenue collections relative to its regional counterparts. In all countries, the deficits are to be financed by domestic borrowing, external loans, and foreign direct investments. The fiscal deficit corresponding to the National Development Plan (NDP1) 2010/11 to 2014/15 were rising largely driven by the increased expenditure focus on the infrastructure. The successor Plan NDP II pays even more attention on the infrastructural investments, with the fiscal deficit expected to reach 9% of GDP before fiscal consolidation in 2019/20. The expenditure is expected to average 22% of GDP and key infrastructural projects[4] expected to be financed by non-concessional borrowing.

<u>Figure 1: Fiscal deficit (excluding Grants) as share of GDP (2006/7 – 2015/16)</u>

[3] Protocol on the establishment of the East African Community Monetary Union. Particularly; Article 2 (b) to attain the macroeconomic convergence criteria in article 6 (2) a ceiling on fiscal deficit, excluding grants, of 6% of GDP must maintained for 3 consecutive years before the establishment Monetary Union in 2024.

[4] 12 key infrastructural projects are expected to cost USD 9-12 billion, of which 80% will come from non-concessional funding source.



External Debt has been growing but largely concessional. External public debt exposure (disbursed and undisbursed) has been growing exponentially at an annual average of 30% since 2007, increasing from USD 2.45 billion to USD 6.27 billion(25.1% of GDP)[5] by February 2015. The undisbursed external debt has incrementally been growing annually from USD 0.98 billion in 2006/7 to USD 2.09 billion in 2014/15 which has resulted into an increase in the commitment fees on the paid on, committed but undisbursed loans, from USD 1.75m in FY 2007/08 to USD4.7m paid out in FY2011/12, and eased[6] to USD2.8m during the FY 2014/15 as at end of February 2015. Most of the external debt is contracted on highly concessional terms[7] and is owed to largely multilateral creditors, accounting for 85 % of the total external debt portfolio. During FY 2014/15, China accounted for 70% of total new borrowing for the Country, of which 41% was from the CHINA-EXIM Bank concessional window while 29% was form the Preferential Buyer's Credit of the Bank. These are defined as semi concessional terms.[8] The semi concessional loans also take a form of tied aid, where there is no competitive public procurement or independent parallel evaluation. As result of a mismatch between concessional loans and increased infrastructure investments, Uganda like many developing countries has encountered increasing semi concessional and non-concessional loans, which increases the debt service pressure. The approved Budget 2015/16 is expected to be financed by project loans to a tune of USD 1.5 billion, of which 70% will be from non-concessional loans.

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[5] This excludes loans approved by Parliament in FY 2014/15 and are yet to be disbursed, amounting to USD 2.74 billion.

[6] World Bank waived off the payment of commitment fees since 2012.

[7] These are loans extended on terms substantially more generous than market loans. Concessionality is achieved either through interest rates below those available on the market or by longer *grace periods,* or a combination of these. Concessional loans typically have long grace periods. Typically a loan is considered to be concessional if the grant element is at least 35 per cent; see http://www.imf.org/external/np/pdr/conc/.

[8] Preferential window attracts 2% interest and 20 year payment period and grace period of 5 years, while the Export Credit Buyer's Window attracts London interbank market rate(LIBOR) plus 3.5% payable over 15 years with a grace period of 5 years.

Domestic debt growth over the last 5 years increases Uganda's debt burden. Domestic debt (excluding arrears) is composed of domestic securities bills and bonds. As of end June 2015, the total stock of outstanding government domestic debt, at cost, was UGX 9.93 trillion (or USD 3.31 billion) compared to the stock of Shs.7.2 trillion (USD 2,823.9 million) as of end-June 2014, this represents an increase of 38% in the stock of domestic debt. Since 2012/13, Uganda has used domestic securities explicitly for the fiscal policy purposes, and domestic debt stock has been on an upward trend an average growth rate of nearly 30%. The total domestic stock at end of June is higher than the total revenue collected in FY 2014/15 of UGX 9.72 trillion (USD 3.28 billion). Treasury bill comprised of 91 day, 184 day and 364 day tenor account for the 32.6%, and the short term bonds of 2, 3 and 5 years account for 51.3%. This implies that nearly 84% of the existing stock has maturity of less than 5 years, which increases the financing or refinancing issue.

III. Economic Impact and Sustainability of Uganda Debt Pattern

The current stock public debt present limited debt stress[9] but the recent fiscal deficit[10] trend and composition of debt posits economic and sustainability risks. The impact can be wide ranging;

- Today's debt is equivalent to the future taxes, which implies the use of costly domestic debt will increase the burden on the tax payer in the long run. All domestic debt (government securities) is non-concessional and attracts market interest rates. Bearing in mind the existing stock of domestic debt was contracted at varying rates, Bank of Uganda estimates their average interest rate at 14% which is way higher than the average interest rate of 2.5% on external loans. Uganda's yields to maturity (interest rates on government securities) are relatively high compared to the other regional countries, even when the inflation differentials are factored in. This increases the debt service burden and according to the Budget FY 2015/16, interest rates on domestic debt contribute to 82% of the overall debt service costs. The domestic interest rate payments are nearly equivalent to approved domestic borrowing in budget for FY 2015/16, which illustrates the Ponzi nature of funding our domestic borrowing to offset interest payments.

- The use of short term domestic securities also increases the fiscal risk of refinancing (rollover) of the loans. The average time to maturity of the existing stock is 2.3 years, of which 57% of the existing securities are expected to mature in less than a year and this has led to the rollover of UGX 4.9 trillion (USD 1.63 billion) as appropriated in the budget for FY 2015/16. This too is expected to exert pressure for upward swings in interest rates as has been witnessed in recent months. Resultant high interest rates tend to depress the vile of economic activity and risk increasing the level of non-

[9] According to joint IMF and WB Joint debt sustainability assessment, Uganda's public debt which includes both external and domestic debt, is sustainable and is under no debt distress with Public debt to GDP at 30% and projected to remain below 50% in the medium term factoring in the NDP pipeline projects.

[10] A recent empirical study by Lwanga and Mawejje (2014) finds that fiscal deficits constrain growth through higher interest rates and exacerbate current account deficits.

performing loans, which stood at UGX 390 billion or 4.1% of the total gross loans at end of December 2014.

- Domestic debt also has two profound economic hazards of crowding out the private sector and money creation especially when the budget is skewed towards the recurrent nature activities of the budget. The 2015/16 budget is 48% recurrent and arguably the development budget execution has been susceptible to corruption if the preliminary findings of Uganda National Roads Agency commission or least the corruption perception index are to go by. The size of the domestic debt as share of private sector credit is over 75%, the maximum threshold set out in the Public Debt Management Framework 2013 (PDM2013), which is indicative of the private sector crowding output.

- External debt is contracted in foreign currency and the average time to maturity of existing stock is 19 years, which does not present an immediate exchange risk associated with the recent rapid depreciation of the shilling against major currencies. On long term trend, the shilling has been on a depreciating trend since the early 1990s, which reemphasizes the exchange risk in the long term perspective.

- While arrears are NOT included in the domestic debt accounting, they are legally binding and have to be paid off. The accumulated arrears are estimated at UGX 583.585 billion (USD 216 million) as at 30th June 2014. This stock has been growing and poses an increasing liability to the government and the composition of these arrears includes a big proportion of these debts arising from court awards which attract interest until fully paid. This increases both the refinancing and interest rate riskiness of the debt. The same goes for government guaranteed loans to private operators. In FY 2012/13, government was called upon to honour its obligations to the guarantee of Phoenix logistics limited amounting to USD 5.5million.

- According to the office of Auditor General's Value for money Audit of the management of public debt, out of the 35 sampled loans, only two (2) loan proposals had been technically evaluated and analysed by the middle office in MoFPED. Lack of technical evaluation in particular to recent non concessional loans could further lead to destabilisation of the National loan portfolio and threaten the sustainability of the debt as the debt managers are not fully aware of the implications of the new loans acquired. Lack of detailed feasibility studies is one of the causes of low absorption of funds. Out of a portfolio of 70 active loans, 55 loans (77.14%) had a low rate of absorption below 50% as at December 2014.

IV. Institutional and Regulatory Framework for Debt Management

Uganda has strong institutional, regulatory and policy environment but some institutional weaknesses prevail. Uganda has established legislative safeguards to control public borrowing. The 1995 Constitution states that all borrowing by government must be approved by Parliament. The other legislative framework includes the Treasury Bills Act 1969, the Bank of Uganda Act 2000, the Budget Act 2001, and the new Public Finance Management Act 2015, which repeals Uganda's Public Finance and Accountability Act of 2003. In April, 2015 the Medium Term Debt Management Strategy (MTDS) 2015/16–2019/20 for the Uganda was published, which aims to operationalize the Public Debt Management Framework 2013 (PDM2013). MTDS provides a financing to meet the medium term fiscal financing requirement that would minimise debt servicing budgetary costs and the risks exposure to government while at the same time endeavouring to maintain our debt sustainable in line with objectives set out in PDM2013.

However, the World Bank 2014 Country Policy and Institution Assessment (CPIA) frame work ratings of Uganda moved below the threshold for 'strong performer' status 3.75 to 3.73. Another year with a score below the threshold could see the country downgraded. While the Institutional arrangements for debt management in Uganda largely conform to principles of international best practice, MoFPED still operates a fragmented Debt management unit despite its attempts to create an independent Directorate of Debt and cash management. The development of the 2015 PFM Act regulations will come handy in addressing this challenge. While, Parliamentary role as enshrined in the legislative framework, is to provide checks and balances on the loans before approval, it is arguable that Parliament does not undertake sufficient checks and balances given the findings of Auditor general on the management of public debt indicating the approval of loans that lack technical feasibility studies. In some cases, The auditor general has noted in the recent reports that Parliament has provided retrospective approvals of loans and guarantees in contravention with the law. Both MoFPED annual report and an Auditor general value for money audit reports were submitted to Parliament in April, 2015 but there is no evidence of debate of the reports. This reiterates the need for parliamentary follow up on the public debt audit recommendations. In line, with the 2015 PFM Act, Parliament approved domestic borrowing[11] to a tune of 20% of the budget 2015/16 without sufficient debate, as this information was submitted to Parliament two weeks to statutory deadline for budget approval of 31st May. The hasty approval can also be encapsulated in the recent approval of loans on 3rd September 2015, where parliament was recalled from recess.

V. Conclusion

Uganda faces economic risks related with the reduced exports and a depreciating Ugandan Shilling against the dollar (over 30% this year), which coupled with the growing trend and composition of debt risks, there is also a risk of stress which can affect future sustainability. Had it not been for the debt relief initiatives, Uganda would certainly be under debt stress. While, the liquidity indicators suggest that interest cost relative to revenue is still low, where the debt stock is compared to revenue or exports, the indicators are worrying. For example

[11] Prior to that, domestic borrowing did not require Parliamentary approval.

the total public debt to domestic revenue is at 300% and the domestic debt stock at end June 2015, alone was larger than the annual government revenue at the time.

The solutions lie in a realm of key actions;

1. Ensuring efficiency in government budget planning and spending. This will require taming unnecessary and unaffordable spending related for example to the creation of districts as suggested by MoFPED. Sequencing of large infrastructural projects and rebalancing of priorities is imperative. Effective planning and project appraisal of loan projects is key as well curbing corruption. Similarly, debt management institutional building is also essential.

2. Revenue enhancement measures (policy or administrative) are essential.

3. Explore alternative measures of financing as well as exploring private public partnerships will go a long way towards addressing the debt sustainability issues. Today's misused debt is a burden on future generations.

4. Parliament has a role to play across the entire value chain of budget planning, execution and approval of loans. Simply put, approve ready and feasible projects, whose return is higher than the interest rates. Approval of loans is one end of the equation; the usage is another, so Parliament has secondary roles to execute in line recommendations 1-3 above as well as follow up on audit recommendations.

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