

## Fiscal Policy and Public Debt Sustainability in Uganda

### Executive Statement

The level of Uganda's public debt has created doubts regarding the government's sustained ability to repay. This is because of both the rapidly increasing debt accumulation as well as share of interest payments in the national budget. The brief examines the sustainability of Uganda's public debt during the period 1981/82 to 2016/17. The results show that in the long run, government has been able to respond to past debt build up in a sustainable way. However, in the short run, government has not been responsive to the debt bulge which poses risks to debt sustainability. To guarantee future debt sustainability, the government needs to: (i) strengthen the primary balance by reducing wasteful expenditures and strengthening domestic revenue mobilisation (ii) borrow smartly and invest in projects that are productive (iii) focus on effective planning and implementation of the budget.

### 1. Introduction

Uganda's rapidly rising public debt has become a matter of great public concern. The nominal debt to gross domestic product (GDP) ratio increased from 38.1 percent in 2016/17 to 41.5 percent in 2017/18 and is projected to peak at 49 percent in 2021/22.<sup>1</sup> The increasing borrowing appetite is largely driven by external borrowing to finance infrastructure projects (MoFPED, 2018a).<sup>2</sup> The increase in public debt is also brought about by the widening fiscal deficit arising from the growing public sector expenditure due to the creation of more local government administrative units and salary increments for public servants in response to their continued industrial action. Unfortunately, the increases in public expenditures are not matched by increases in government revenue hence perpetuating borrowing. Figure 1 shows that the current debt levels obscure the debt relief obtained from the 1980s especially under the Heavily Indebted Poor Countries (HIPC), enhanced HIPC and Multilateral Debt Relief initiatives. This is because, debt increased from UGX 4,611 billion in 2006/07 to UGX 33,754 billion in 2016/17.

Furthermore, Figure 2 shows that from 2006/07 to 2016/17, the interest payments increased from UGX 236 billion to UGX 2,360 billion respectively (representing a 10 fold increase) whereas the primary balance deteriorated from UGX -162 billion to UGX -1,181 billion over the same period, the latter being explained by growth

Figure 1: Evolution of Uganda's public debt (UGX Billion): 1981/82-2016/17

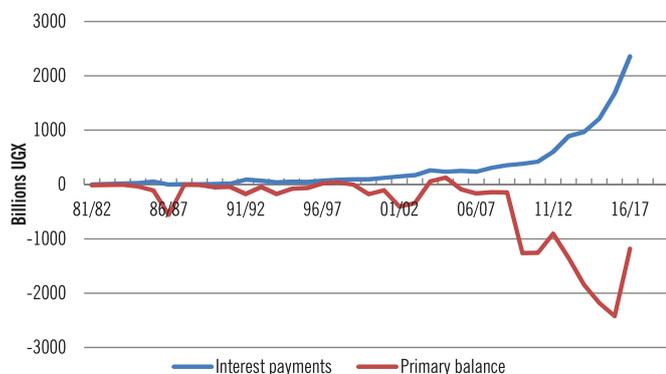


Source: Data from Bank of Uganda Annual Reports and World Development Indicators

in government expenditure, debt and deterioration in the current account balance.

Given Uganda's development aspirations and immense financing needs, borrowing remains inevitable and hence the trend exhibited in Figure 1 is likely to continue. The key question is whether the debt is sustainable. The Debt Sustainability Analysis report 2017/18 indicates that Uganda moved from moderate to low risk of debt distress (MoFPED, 2018b).<sup>3</sup> It further notes that the public debt

**Figure 2: Evolution of Uganda’s interest payments and the primary balance (UGX. Billion)**



Source: Data from Background to the budget reports

is sustainable in the medium term (and is no cause for concern) though with increased vulnerabilities and risks such as low domestic revenues, lower exports and real GDP growth, worsening borrowing terms and sustained exchange rate depreciation (MoFPED, 2018b). The fiscal rules seem to be destabilising since they make the government less responsive to growing public debt. These include a ceiling of 50 percent of GDP on gross public debt in net present value (NPV) terms and a budget balance rule (including grants) of 3 percent of GDP to be achieved by 2020/21. However, the approach employed by MoFPED to determine debt sustainability overlooks the role of fiscal policy responses in ensuring debt sustainability in the face of growing public debts. It is against this background that this brief assesses the extent fiscal policy has been instrumental in ensuring debt sustainability in Uganda. The brief is extracted from the thesis titled “Public debt sustainability: estimating the fiscal reaction function for Uganda”.<sup>4</sup>

## 2. Approach and Data

The brief uses results from the fiscal reaction function approach to examine the extent to which the primary balance<sup>5</sup> is systematically increased when the debt level rises (Bohn, 1998).<sup>6</sup> Debt sustainability is achieved if the primary balance responds positively to increases in the debt-GDP ratio. The approach controls for temporary fluctuations in GDP and non-interest public expenditures which are unaccounted for by other key methods.<sup>7</sup> This approach also emphasises the adequacy of steady policy reactions in dealing with accumulating debts whereby debt sustainability is a consequence of the behavior of the fiscal authorities. Variables used in the estimations include: expenditure gap<sup>8</sup>, output gap<sup>9</sup> and the current account balance.<sup>10</sup> The brief also uses dummies to control for debt relief and fiscal rules. The data are from MoFPED, Bank of Uganda, and the World Bank for the 1981/82 - 2016/17 periods.

## 3. Results and discussion

Table 1 presents the results obtained from estimating equation (1). The discussion of the results is grouped into their implications for (a) long run and (b) short run public debt sustainability.

**Table 1: Determinants of the primary balance**

Variables	Coefficients
<b>Panel A: Long run</b>	
Debt to GDP	0.06***
Expenditure gap to GDP	-0.75***
Output gap to GDP	-2.83***
Current Account balance to GDP	0.43***
Debt relief	0.01**
Fiscal rule	-0.02***
<b>Panel B: Short run</b>	
Debt to GDP	-0.05**
Current Account balance to GDP	-0.20*

Source: Estimates based on the Autoregressive Distributed Lag model

### a) Long run response

*First*, the response of the primary balance to the increasing debt is significantly positive with a one percent increase in the debt increasing the primary balance by 0.06 percent. This implies that the government is systematically responding to changes in the debt by increasing the primary balance to guarantee debt sustainability. This can be interpreted as increasing the primary surplus or reducing the primary deficit. However, the government’s response is weak as shown by a very low coefficient.

*Second*, the expenditure gap has a negative impact on the primary balance with a one percent increase in the expenditure gap leading to a 0.75 percent decrease in the primary balance. This implies that government responds to temporarily high expenditures by borrowing to finance deficits as opposed to adjusting current tax levels. In the analysis, it is assumed that expenditure is financed through taxation and public debt issue. We ignore currency issuance.

*Third*, the output gap is negatively related to the primary balance with a one percent increase in the output gap leading to a 2.8 percent decrease in the primary balance. This implies that fiscal policy is countercyclical because the government responds to a recession through expansionary policies<sup>11</sup> to jumpstart the economy out of the slump.

*Fourth*, the current account balance has a positive effect on the primary balance with a one percent improvement in the current

account balance leading to a 0.43 percent increase in the primary balance.

Lastly, the brief further shows that debt relief has a positive impact on the primary balance whereas the fiscal rules have a negative impact on the primary balance.

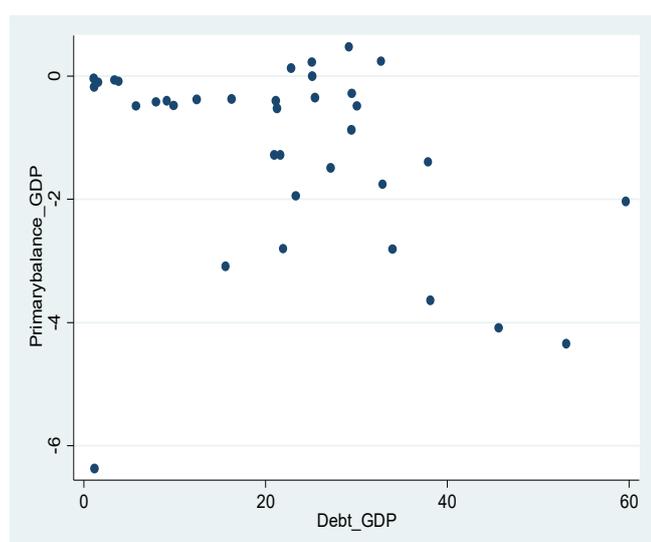
#### b) Short run response

First, the response of the primary balance to increases in the debt is negative with a one percent increase in the debt leading to a 0.05 percent reduction in the primary balance. This suggests that the government is not systematically responding to changes in the debt to GDP ratio in the short run.

Second, the current account balance has a negative impact on the primary balance. A one percent deterioration in the current account balance leads to a 0.2 percent decrease in the primary balance. This suggests that deterioration in the current account worsens the primary balance.

Figures 3 and 4 illustrate the theoretical importance of accounting for the output gap, expenditure gap and current account balance. Figure 3 is a scatter plot of the primary balance-GDP against the debt-GDP showing that there's a negative relationship between the two variables. In figure 4, the primary balance-GDP is adjusted<sup>12</sup> for the output gap, expenditure gap and current account balance in the long run. The adjusted primary balance-GDP is plotted against the debt-GDP and it shows a positive correlation.

Figure 3: Correlation between the primary balance and debt to GDP



## 4. Conclusion

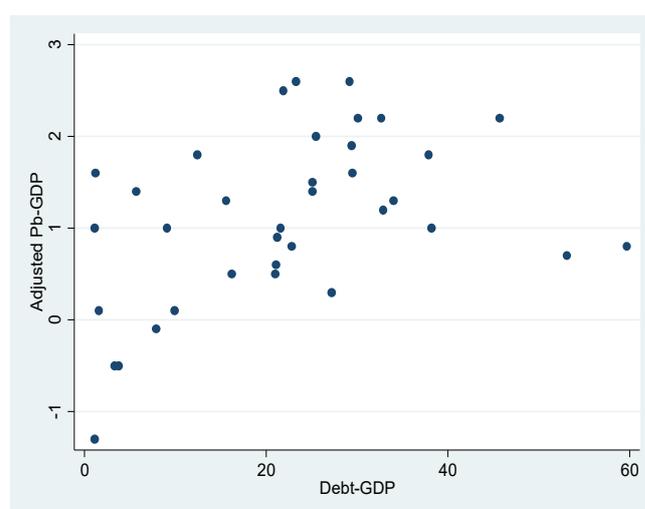
An understanding of the government's past response to debt accumulation is at the heart of assessing how it might react to the upward pressure on the public debt-GDP ratio that it is currently experiencing due to increases in infrastructure investments.

The brief shows that on average, government has positively adjusted its primary balance in response to the rising debt to GDP ratio in the long run. The positive response suggests that Uganda's debt is sustainable (evidence for fiscal prudence) for the sample period of 1981/82 to 2016/17, despite frequent primary deficits. This could be considered as a privilege, which if overused by the fiscal authorities, might heighten the impending risk of debt distress. But, the government has not been responsive to the rising debt to GDP ratio in the short run which poses risks to debt sustainability.

## Recommendations

- The primary balance needs to be strengthened further to secure future debt sustainability by reducing expenditures through curbing corruption, fiscal slippages and the creation of more administrative units which increase the funding burden of the government. Similarly, to curb instances of perpetual borrowing, further increases in expenditures must be matched by increases in revenues, thus the need to strengthen domestic revenue mobilization.

Figure 4: Correlation between adjusted primary balance and debt to GDP



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- The government should borrow smartly and invest in projects that are productive enough to enable the economy to achieve its growth potential thereby closing the output gap. This would translate into increased government revenue to repay the debt. Similarly, to prevent prospective short run insolvency, more concessional borrowing is preferred to non-concessional borrowing since this poses serious implications for debt repayment in the short run.
- There is a need to focus on effective planning and implementation of the budget. To close the expenditure gap, the available fiscal space should not be used to cater for temporarily high government expenditures that are wasteful and unproductive.

### References

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### Endnotes

- 1 This is a revision from the earlier projection of 47.8 percent in 2020/21.
- 2 MoFPED. (2018a). *Medium Term Debt Management Strategy 2018/19 - 2021/22*. Kampala: Ministry of Finance Planning and Economic Development.
- 3 MoFPED. (2018b). *Debt Sustainability Analysis Report 2017/18*. Kampala: Ministry of Finance Planning and Economic Development
- 4 Bulime (2019)
- 5 Primary balance is equal to total revenue less non-interest total expenditure.
- 6 The estimated fiscal reaction function takes the following functional form:

$$pb_t = \alpha_0 + \alpha_d debt_t + \alpha_e expgap_t + \alpha_y outgap_t + \alpha_c cab_t + \alpha_r drelief_t + \alpha_f frule_t + \varepsilon_t \quad (1)$$

- 7 Present Value Budget Constraint, Debt Stabilising Primary Balance and IMF’s Debt Sustainability Framework.
- 8 Deviation of actual expenditure from the potential expenditure
- 9 Deviation of actual output from the potential output
- 10 All these variables are scaled by real GDP
- 11 Which in this case implies running budget deficits
- 12  $pb_t - \alpha_0 + \alpha_e expgap_t + \alpha_y outgap_t + \alpha_c cab_t$

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