FISCAL RISKS STATEMENT

FY 2020/21

MINISTRY OF FINANCE PLANNING AND ECONOMIC DEVELOPMENT

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INTRODUCTION

This statement, prepared by the Ministry of Finance, Planning and Economic Development (MoFPED) sets out the main fiscal risks that the government of Uganda faces in FY 2020/21 and the medium term.

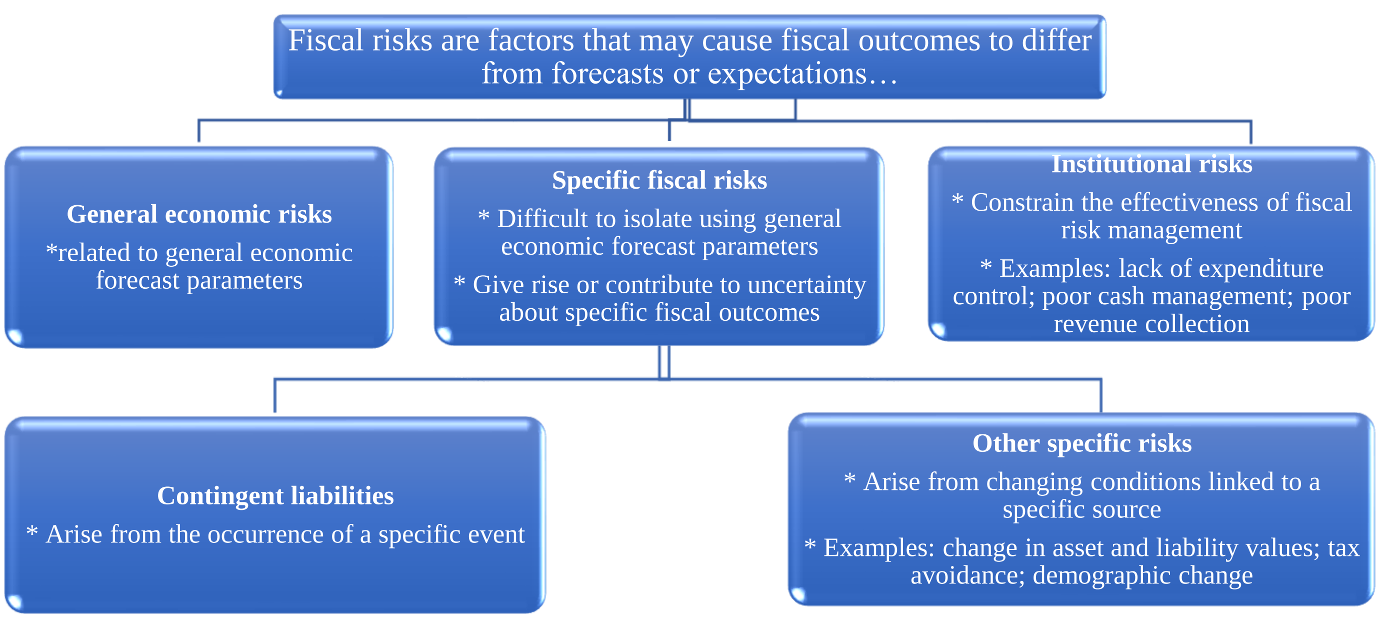
Fiscal risks are factors that may cause fiscal outcomes to deviate from expectations or forecasts. They may lead to potential shocks in state revenue, expenditure, assets, or liabilities that may not be reflected in budget forecasts. If any or all the risks materialise, it may lead to additional government obligations, difficulties in planning and budget execution, expanded public debt and refinancing difficulties or more serious fiscal events. Therefore, identifying, analysing and mitigating risks is an important aspect of fiscal planning.

The government recognises that sound overall management of public finances is the starting point for managing risk. In recent years, Uganda has made substantial progress in implementing financial reforms under the Public Finance Management Act of 2015 (PFM), improving the state's ability to raise revenue, strengthen budget credibility and increase transparency.

This statement, which covers budget outcomes for 2020/21 and examines some longer-term concerns, is Uganda's second standalone fiscal risk statement. However, in line with the PFM Act, a report on fiscal risks has always been published in the National Budget Framework since 2016. This statement expands the range of risks assessed.

The report examines various broad categories of fiscal risks as shown in Figure 1.

Figure 1: Categories of fiscal risk



MACROECONOMIC RISKS AND BUDGET SENSITIVITY

External risks

The primary external risks to Uganda's fiscal plans stem from the global economic and trade environment, regional conflict, commodity price volatility and climate change impacts.

In recent years, the global economy has been marked by rising geopolitical tensions – including trade conflicts – alongside higher debt levels in both developed and developing economies. The global economy continues to face incidences and further threats of rising protectionism, a sharp increase in risk premiums or reversal in capital inflows owing to tightening global financial conditions, and a faster-than-anticipated slowdown in China and in the euro area. If this continues it is likely to have negative impact on both primary and secondary income balances for the country. These trade tensions, which affect a range of Uganda's major trading partners, could put pressure on foreign investment and remittance inflows, with negative consequences for the exchange value of the shilling.

At the regional level, Uganda is a signatory to the East African Monetary Union protocol, which plans to establish a single regional currency by 2024. The convergence criteria for monetary union include benchmarks for debt, inflation, fiscal balances and external reserves. At present there are significant imbalances within the region, and the pace of achieving and maintaining these benchmarks could lead to future fiscal risks.

Additionally, civil strife in the South Sudan, Congo and Burundi has severely disrupted trade and welfare in those countries and still poses a serious risk to increased trade with Uganda. These conflicts have created both economic and fiscal costs, including loss of earnings, property, employment, and remittances. Before the conflict, South Sudan accounted for about 20 percent of Uganda's exports, and was one of the leading remitters of income into the country.

Volatility in global commodity prices can have a major impact on economic growth, with knock-on effects for the public finances. Rising oil prices would impose large costs on Uganda given our level of oil imports. Subdued global prices for export commodities such as coffee and cotton – and increased competition from other commodity producers – creates greater uncertainty and risks to foreign earnings and the value of the currency.

The government recognises these risks and works to ensure that prudent management of the public finances provides a buffer to changes in the global economic environment.

Forecast Performance and Analysis

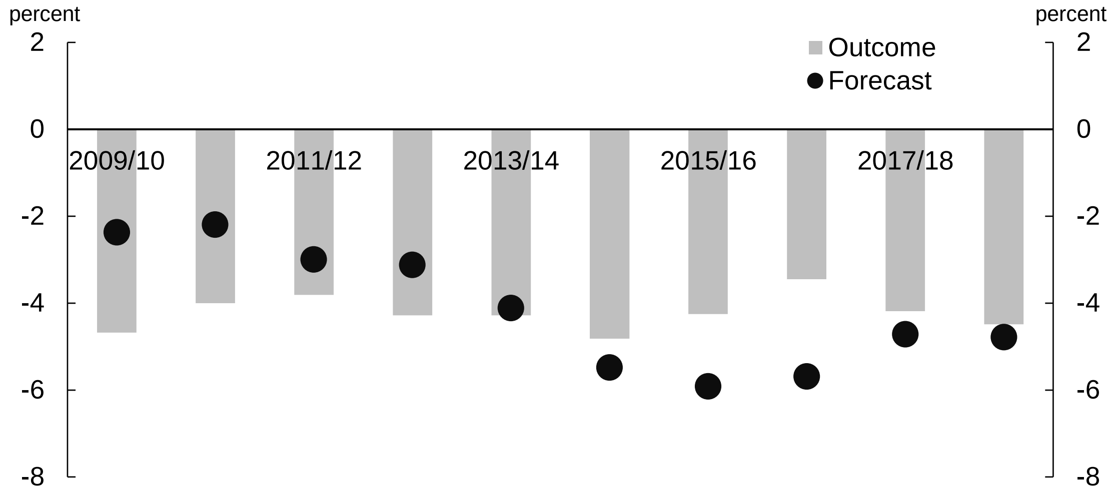
A range of factors – both external and domestic – can cause fiscal outcomes to diverge from forecasts. Historical analysis comparing projections with outcomes can identify possible systemic issues in the macroeconomic and fiscal forecasts, and assess confidence in current forecasts.

The Uganda Bureau of Statistics (UBOS) completed a thorough revision of the national accounts in October 2019, moving the base year from 2009/10 to 2016/17 to accommodate changes in sectoral weights, and improving the quality and coverage of data based on recent business and consumer surveys. The exercise has affected key macroeconomic indicators that depend on GDP.

Overall balance

Figure 2 compares forecasts and outcomes of the overall fiscal balance since 2009/10. The deficit has in the past two years been closer to the forecast, reflecting the impact of the GDP rebasing exercise on the forecast performance. The deficit was notably larger than forecast in 2009/10 and 2010/11 because of higher-than-expected expenditure related to elections in 2011/12 and a large depreciation in the shilling.

Figure 2: Budget balance*



Source: MoFPED calculations
*Including grants

Nominal Gross Domestic Product

Figure 3 compares nominal GDP growth forecasts with outcomes. Forecasts have tended to be optimistic, although the error margin has declined over the past three years. Figure 4 shows nominal growth performance, anticipated nominal growth in FY 2019/20, and confidence intervals based on historical forecasting errors (the shaded areas). Growth is forecast to be 10.7 percent in 2019/20. Given historical forecast errors, there is a 70 percent chance that growth will fall between 4.0 and 10.4 percent in 2019/20.

Figure 3: Nominal GDP growth forecast and outcome*

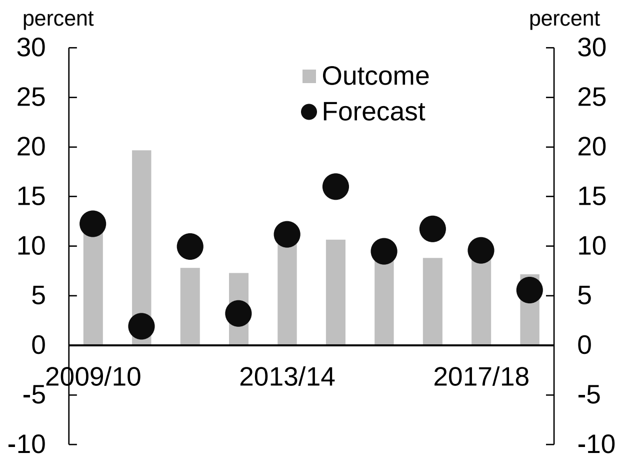
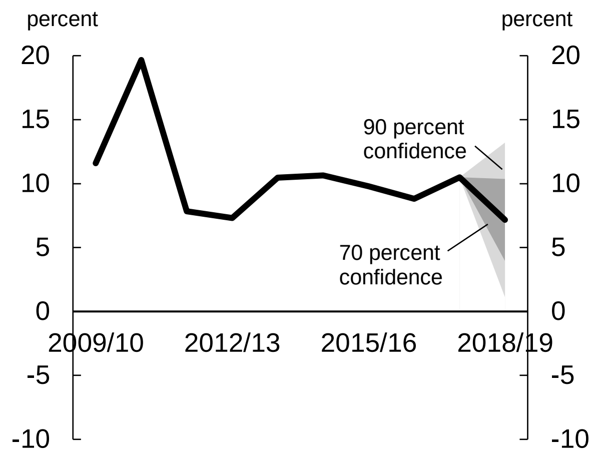


Figure 4: Nominal GDP growth and confidence intervals



Source: National Statistics Office and MoFPED calculations
* Adjusted to 2016/17 base

Revenue

Figure 5 compares total revenue growth forecasts (including grants) and outcomes since FY 2009/10. The elevated error margin in FY 2010/11 was the result of unanticipated revenue from oil exploration licences. The years with high error margins reflect a shortfall in grants. However, the gap between forecasts and outcomes narrowed in 2018/19. Figure 6 charts revenue as a percentage of GDP since 2009/10, and presents the anticipated level and confidence intervals based on historical forecasting errors. Total revenue/GDP is forecast to be 15.3 percent in 2019/20. This is consistent with the Domestic Revenue Mobilization Strategy. Given historical forecast errors, there is a 70 percent chance that revenue as a percentage of GDP will fall between 13.0 and 15.0 percent.

Figure 5: Revenue growth (including grants): Forecast and outcome

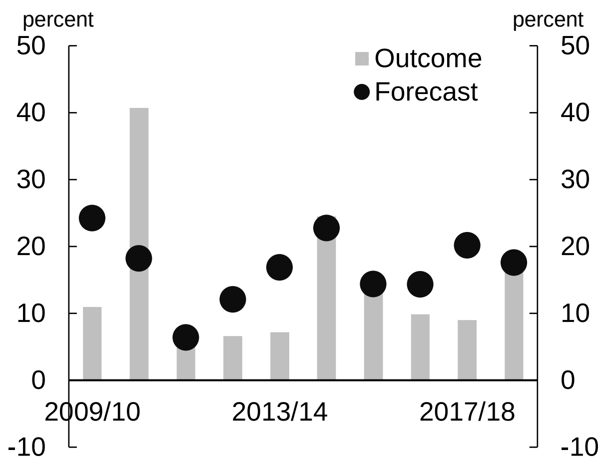
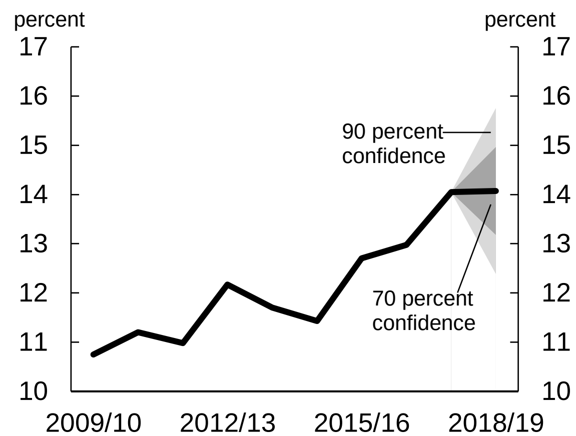


Figure 6: Revenue as percent of GDP and confidence intervals

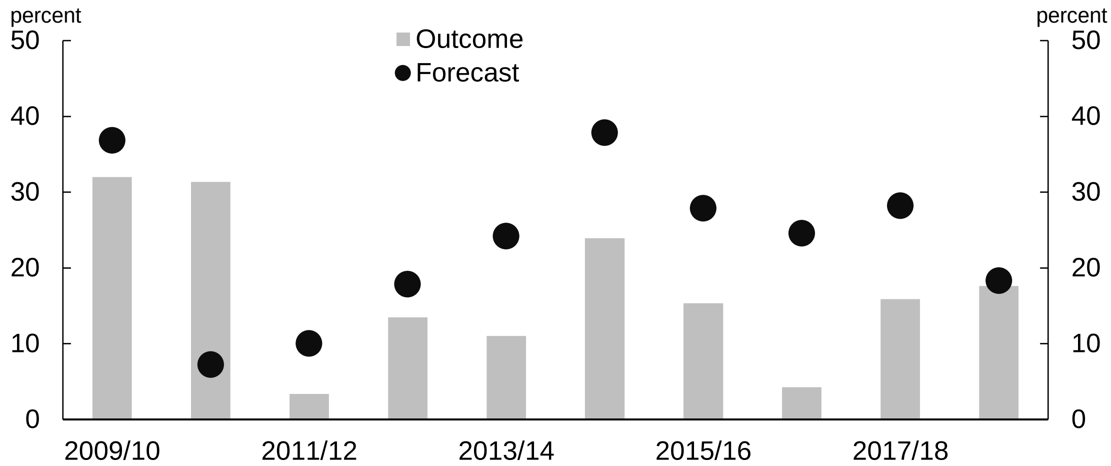


Source: MoFPED calculations

Expenditure

Figure 7 compares expenditure growth forecasts and outcomes since 2009/10. Outcomes were below projections in all years except FY 2010/11. This is usually due to low disbursements tied to key projects. The resulting delay of these projects reduces government expenditure and lowers GDP growth. Expenditure in FY 2010/11 was higher than projected given unanticipated election costs and exchange rate depreciation. Nonetheless, FY 2018/19 forecasts were closer to the outcome.

Figure 7: Expenditure growth forecast and outcome

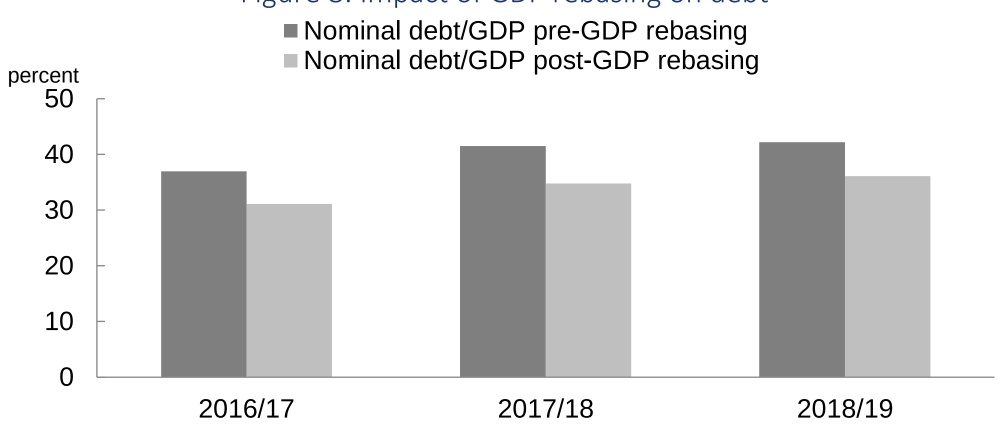


Source: MoFPED calculations

Debt forecast Performance

Due to the rebasing exercise, the public debt-to-GDP ratio as at the end of June 2019, fell from 42.0 percent to 36.1 percent. This has apparently created more fiscal space for the Government and may encourage additional borrowing. Figure 8 shows the revisions on debt to GDP due to rebasing. This will create potential fiscal risk if the borrowing is not productive.

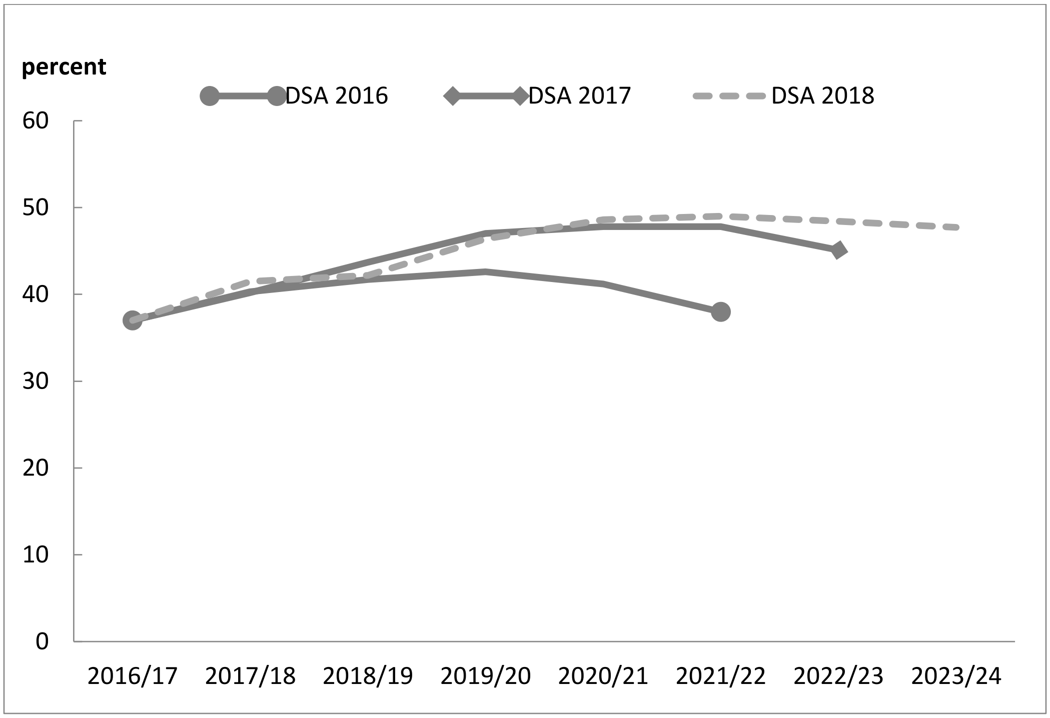
Figure 8: Impact of GDP rebasing on debt



Source: MoFPED calculations

It has also been noted that there have been variations in projections of debt to GDP across the various the Debt Sustainability Analysis exercises (Figure 9).

Figure 9: Variations in Debt to GDP forecasts



Source: MoFPED

Budget Sensitivity

Variations in macroeconomic conditions can have an impact on the fiscal accounts. Revenue estimates are mainly sensitive to these variations given the effect on the tax base while expenditure is generally sensitive to changes in prices. Table 1 summarises the sensitivity of the key fiscal forecasts to changes in real GDP growth, inflation, and the exchange rate.

Table 1: Fiscal Sensitivity to Key Macroeconomic Variables, FY2020/21(UShs Bn)

Percentage of the Baseline GDP - FY 2020/21 (UShs Bn)			
	Revenue	***Expenditure***	***Budget Balance***
One Percentage Point reduction in Real GDP	*-219.3*	*0.0*	*-219.3*
One Percentage Point increase in Inflation Rate	*172.3*	*125.3*	*47.0*
10% depreciation in Exchange Rate (Ushs/US$)	*172.3*	*814.4*	*-642.1*
10% increase in the Price of merchandise imports	*-219.3*	*375.9*	*-595.2*

Source: MoFPED

- A one percentage point reduction in real GDP would lead to a decrease in revenue of UShs.219.3 billion. Since expenditure remains rigid in the short term, the higher fiscal deficit would have to be financed by increased domestic borrowing because external financing cannot be easily obtained on short notice. However, in the medium-term expenditure increases as higher borrowing feeds into interest payments.

- A one percentage point increase in the headline inflation rate translates into an increase in revenue by UShs.172.3 billion and expenditure by UShs.125.3 billion. This consequently results into a reduction in the fiscal deficit by UShs.47 billion.

- Depreciation in the average period exchange rate by ten percent results in higher expenditure (UShs.814.4 billion) which offsets the increase in revenue (UShs.172.3 billion). This would lead to a widening of the fiscal deficit by UShs.642.1 billion. Expenditure lines which would mostly be affected by such a shock include; external interest payment and amortization.

- A ten percent increase in the price of merchandise imports would result into lower revenues (UShs.219.3 billion), higher expenditures (UShs.375.9 billion), and subsequently a wider fiscal deficit of UShs.595.2 billion. This shock reduces revenue receipts from import duty while at the same time increasing the Government import bill.

SPECIFIC AND STRUCTURAL RISKS

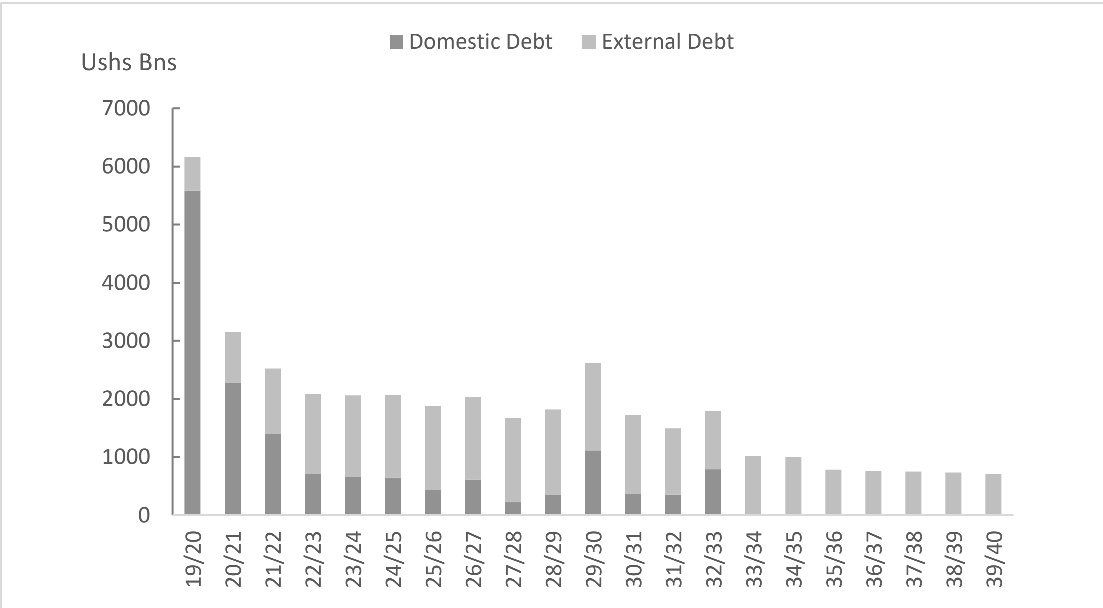
Public debt

The stock of total public debt grew from US$ 10.74 billion at end June 2018 to US$ 12.55 billion by end June 2019, of which external debt was US$ 8.35 billion (approx. UShs 30.85 Trillion), while domestic debt was US$4.2 billion (UShs 15.51Trillion). This represents an increase from 34.8 percent of GDP to 36.1 percent in nominal terms. In present value terms, the stock of public debt amounted to 27.3 percent of GDP at end June 2019. Debt as a share of GDP is expected to increase to a peak of about 49.5 percent in FY 2023/24 before starting to decline.

Foreign debt accounts for 66.5 percent of Uganda's total public debt. The main fiscal risk associated with foreign debt is the possibility of large, sustained movements in the exchange rate. A depreciation in the Ugandan shilling could result in higher debt-service costs. However, the largest share of our external debt stock (64.5 percent) is from multilateral lenders who offer highly concessional terms characterized by relatively low interest rates and longer maturities, which provide some buffer against this risk.

Resulting from government's deliberate decision to restructure the domestic debt portfolio – by shifting from shorter-dated to longer-dated securities, the share of domestic debt maturing within one year as a percentage of total domestic debt slightly reduced from 36.8 percent at end June 2018 to 36.5 percent at end June 2019. This however remains above the 30 percent benchmark established in the 2018 Public Debt Management Framework and continues to pose a refinancing risk. In addition, the practice of rolling over existing debt creates refinancing risks in the event of a rise in interest rates. Figure 10 shows the maturity profile of the existing public debt stock as at end June 2019.

Figure 10 The redemption profile, Million UGX.



Source: MoFPED

To manage the fiscal risk associated with public domestic debt, Government will continue to restructure the debt portfolio, shifting from shorter-dated to longer-dated securities. Considering the high costs associated with domestic debt, Government will also ensure that annual domestic borrowing for fiscal purposes does not exceed 1percent of GDP.

Total interest payments as a share of domestic revenue have been on an upward trend in recent years. This reflects both increased borrowing and a recourse to non-concessional borrowing which typically comes with higher interest rates over this period. In FY 2019/20, total interest payments are expected to be about 17.8 percent of domestic revenue, with domestic interest amounting to 14.9 percent while external was 2.9 percent of domestic revenue. This is an increase from 6 percent total interest payments as a percentage of domestic revenue in FY 2010/11. This increasing non-discretionary expenditure can present a risk for the government, particularly if economic conditions change unexpectedly.

Contingent Liabilities

Contingent liabilities are payment obligations that only arise if a particular event occurs. The government's main contingent liabilities stem from loan guarantees and the debts of public corporations.

Loan guarantees

The government's main contingent liabilities are associated with loan guarantees. The government's guarantee portfolio is currently about USD 55 million (Table 2). Exposure to these guarantees stood at USD 19.9 million at the end of June 2018, equivalent to about 0.2 percent of GDP. This is a 143 percent increase in exposure from USD 8.2 million in June 2017.

Default on any of these guarantees would result in an unbudgeted commitment of funding.[1] However, despite the increase in exposure, all loans are performing well, and the risk associated with the portfolio is low.

Table 2: List of outstanding government guarantees

Source	Project	Beneficiary	Year of Signature	Guaranteed Amount of the Loan (in USD)	Exposure: Disbursed & Outstanding as at December 2018 (in USD)
Islamic Development Bank (IDB)	Student hostel project	Islamic University in Uganda	2004	4,302,676	2,328,134.88
IDB	Student hostel project- additional financing	Islamic University in Uganda	2010	983,888	727,675.63
IDA	E.A trade & transport facilitation	Rift Valley Railways	2006	10,000,000	-
BADEA (Trade Finance)	To finance import transactions from Arab countries to UDBL's eligible clients in Uganda	Uganda Development Bank Limited	2017	10,000,000	8,076,000
BADEA (Private Sector Development)	Private sector projects and trade transactions in the republic of Uganda	Uganda Development Bank Limited	2017	6,000,000	5,782,000
IDB	Private sector projects and trade transactions in the republic of Uganda	Uganda Development Bank Limited	2017	10,000,000	3,000,000
IDB	Construct a faculty of engineering, upgrade the library and purchase ICT equipment	Islamic University in Uganda	2018	13,790,000	-
Total				**55,076,564**	**19,913,811**

Source: MoFPED

[1] This type of fiscal risk was realized in 2012 when a guarantee worth USD 2.5 million to Phenix was called

Debt of Public Corporations

Public entities contribute to the country's development by providing energy, water, environmental, development finance, civil aviation and other services. In order to maintain fiscal sustainability, these need to be financially sound. Debt acquired through on-lending from the government to public corporations can create fiscal risk where these entities fail to service these debts.

As at June 2018, the stock of debt (direct domestic and external borrowing plus on-lent) of public entities amounted to UShs 8,009 billion (USD 2.06 billion), indicating a 35 percent increase from UShs 5,950 billion (USD 1.66 billion) as at June 2017. The increase was mainly attributed to the disbursements for the GoU on-lent loans to SoEs in the energy sector. It should be noted that 78% of the total borrowing in June 2018 was attributed to GoU on lending, followed by 20.7 percent from direct domestic creditors (including overdrafts & lease facilities) and 1.2 percent from external creditors.

The stock of on-lent loans increased by 70 percent from UShs 3,685 billion as at June 2017 to UShs 6,256 billion as at June 2018. The on-lent loans provided to Uganda Electricity Generation Company Limited and Uganda Electricity Transmission Company Limited accounted for more than 94 percent of the total stock.

Public-private Partnerships

Public-private partnership (PPP) projects are currently under way in the energy, tourism and infrastructure sectors. The government is conducting an in-depth assessment of the contingent liabilities associated with PPPs and will report on them in the future.

Mitigation measures for contingent liabilities

The government maintains a proactive policy stance to mitigate contingent liability risks:

i) All borrowing by public corporations and sub-national governments, and government-issued guarantees, must be approved by the Minister of Finance.
ii) All public corporations that intend to borrow, as well as entities requesting guarantees, are required to be financially sound, as determined by MoFPED
iii) All projects to be funded must be in line with the National Development Plan and sector priorities.

Natural disasters

Due to climate change, deforestation and wetlands degradation, the country is increasingly susceptible to highly devastating hydrological, geological, climatic and human-induced disasters such as drought, flooding, landslides, hailstones, windstorms, lightening, waterborne epidemics, crop and livestock epidemics and earthquakes.

These occurrences have an implication for Government operations since they usually require instant mobilization of resources to resettle the affected communities, and to provide relief assistance including shelter and food.

These disasters can also cause destruction to investment infrastructures such as roads, bridges, school buildings and hospitals. This then translates into costs to Government to rebuild these facilities and infrastructure.

Occurrence of disasters can affect economic activity in areas where they happen. This results into lower revenue collections than anticipated from such areas, ultimately impacting on the resource flows to Government. This is a risk to budget as the deficit becomes higher than planned due to the reduction in revenue collected.

For FY2019/20, Government approved UShs 128.68 billion for disaster preparedness and management. This is higher than the average of UShs 34.06 billion per annum that had been allocated for the same purpose in the previous four years. However, depending on the magnitude of disasters that can hit, this money might not be enough, posing a risk to the budget.

Legal Claims

The government continues to accumulate liabilities arising from court awards and compensation. The stock of arrears from these awards stood at about 27 percent[2] of the total domestic arrears as at end of September 2019. To deal with this, a domestic arrears strategy has been designed through preventive and remedial measures to eliminate the existing stock of domestic arrears and keep any future arrears to a minimum sustainable level.

The specific objectives of the arrears strategy therefore are threefold, namely:

(i) Mobilize resources for the gradual settlement of the existing stock arrears within the next 4 years;
(ii) Put in place measures to inhibit the diversion of arrears resources; and
(iii) Strengthen existing initiatives to stop the creation of new arrears.

Pension Liabilities

Uganda operates a non-contributory public pension scheme, which is financed from Central Government tax revenues. The public service pension scheme is designed as a defined benefit where public servants' pension benefits are indexed on to their salaries for their entire service life. With the ever-growing numbers of civil servants as a result of public administration expansion, pension arrears for retiring civil servants have reached an unsustainable level.

The stock of pension liabilities stood at about 15 percent[3] of the total domestic arrears as at end of September 2019. Based on the Auditor General's report of December 2018, this is around 0.1

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[2] This is based on the Annual Government Consolidated Arrears as at September 2019 but these are yet to be verified by the Auditor General (The audited position by Auditor General will be ready after 31st Dec 2019.)

[3] This is based on the Annual Government Consolidated Arrears as at September 2019 but these are yet to be verified by the Auditor General (The audited position by Auditor General will be ready after 31st Dec 2019.)

percent of GDP as per the audited accounts. If all the accounts are verified, this may increase to 8 percent of GDP.

To deal with this liability Government has proposed a number of pension reforms which include moving towards a Contributory Pension Scheme which is self-financing. This has far reaching positive impacts on the economy including:

a. Improved pension efficiency and sustainability in the long run, removing pressure on the budget caused by retirement benefits.

b. Increased national stock of savings, which has a positive impact on borrowing costs and capital markets development.

INSTITUTIONAL RISKS

Institutional fiscal risks arise from systemic weaknesses that prevents the Government of Uganda from achieving its objectives. These risks must be appropriately managed as a part of the overall fiscal planning process.

Institutional risks include the possibility of ineffective budgeting process, often characterized by supplementaries that are raise outside the plan/forecasts; errors in macroeconomic forecasting, especially GDP and revenue pose risks to the fiscal position; and borrowing by local governments leading to expanded public debt.

A general lack of capacity to collect quality data and make accurate forecasts can limit the ability of government to identify and analyse the impact of fiscal risks early enough. Most often, poor data storage infrastructure on all fiscal operations poses risks on provision of data on a timely manner for fiscal risks analysis.

However, the government is aware of these potential risks and has put in place the PFM Act, 2015, the domestic arrears strategy, the public debt management framework among other things. These measures have fostered fiscal sustainability, thereby mitigating most of the potential fiscal risks.

CONCLUSION

Effective analysis and management of fiscal risks is a crucial component of sound public financial management, and Uganda intends to build on the progress it has registered in this respect in recent years. While a number of external risks to fiscal plans are not within our control, the government is expanding its assessment and monitoring of fiscal risks, and putting mitigating measures in place to reduce their impact on the public finances.