How Does Debt Management Matter?

The Role of Debt Management in Smoothing Tax: Evidence from Sub-Saharan Africa

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Key Messages

- Debt management plays a critical role in smoothing tax.
  - Theoretical literature
  - Empirical Evidence especially in developed countries
- Evidence from low income countries is blurred revealing mixed results.
- Some change in practice seems evident following the financial crisis.
- **Conclusion:** Debt Management does matter and the role has become even more important.
Introduction

• According to academic literature, debt management has a role in smoothing taxes during uncertainty and thus reduce any further distortions in the economy.
  o i.e. Governments can use debt management as a hedge, which reduces the need to raise taxes or cut expenditures during economic downturns.

• Although that may work for developed countries, early empirical work for developing countries have shown that taxes are not smoothed over time and that governments conduct pro-cyclical fiscal and monetary policies.

• Observation of more recent practices shows that many developing countries have been able to conduct counter-cyclical policies. This is more pronounced following the financial crisis.
The theoretical foundation of tax smoothing theory owes its origin to Barro (1979) and Bohn (1990). These postulate that:

- Short term domestic debt can be used to hedge transitory macroeconomic shocks that would result in low tax revenue.
- Debt covers government’s expenses overtime and hence minimize tax distortionary losses.
Empirical Evidence: Developed Countries

• Bohn (1990) showed that during 1973 – 1987 in USA issuing domestic debt provided hedging benefits to shock – *but not the indexed debt and foreign currency debt.*

• Missale (1997b) suggesting that issuing nominal domestic debt provided tax smoothing benefits in Italy.

• A study by C. Hawkesby and J. Wright (1997) suggests that in eight out of nine OECD countries short-term domestic debt should be issued and that tax smoothing can further be enhanced by issuing debt securities.
Empirical Evidence: Developing Countries

• Relatively no empirical studies to strongly support the theory so far.
• Observation shows that many developing countries have been borrowing perpetually. Possible reasons:
  o The countries often run budget deficits that are not transitory.
  o The domestic debt markets are not developed enough to provide adequate funds to smoothen taxes.
  o Most borrowing have been from external concessional sources.
    o Tied to conditionalities for releasing funds and hence can’t be triggered at the behest of authorities.
  o Most of the financing is towards development projects – less on recurrent expenditure. The economies are vulnerable to shocks including natural calamities that are not predictable (projectable) whereas literature suggest that tax smoothing requires reliable forecasts on fiscal performance.
Looking at SSA as a whole it appears that the counter cyclical fiscal policies have been implemented with the pattern becoming much clearer from 2009.
Evidence from Angola

Some relationship exists, the years 2000, 2001, and 2003 to 2009 seem to show the expected pattern.
The cases of Cameroon and Lesotho

**Cameroon:** No evidence except in 2009 but HIPC/MDRI resources may have distorted the picture. There could also be a sample bias due to short span covered.

**Lesotho:** Growth and borrowing patterns

No strong evidence except for a few years; Reason: Could it be political regimes?
Evidence from Ghana and Tanzania

Tanzania’s Borrowing and GDP growth

The Case of Ghana

Always Borrowing
Mozambique and Ethiopia

The case of Mozambique

The case of Ethiopia

The case of Mozambique
Botswana and Kenya

• Almost a perfect relationship exists between economic performance and borrowing in Botswana and Kenya.
• 2002 distorts the picture but 2008 and 2009 reinforce the argument for Botswana.
Exceptional Circumstances

- **Elections**: Years when general elections are held lead to higher spending on average and hence higher spending than normal (see Chart on Kenya with patterns of 1992, 1997, 2002, etc. Botswana’s lower than normal savings in some years like 2004 could be attributed to this.

- **HIPC and MDRI**: The years when countries received these have much less figures on borrowing than normal.
Reactions to the Financial Crisis
Practices Observed in MEFMI Countries

• Some countries implemented counter-cyclical fiscal and monetary policies in response to the recent global economic and financial crisis, including Botswana, Kenya, Namibia, Swaziland, Tanzania, Uganda and Zambia.

• In most of these countries, fiscal policies mostly involved increased spending, particularly in the infrastructure and social sectors in order to stimulate growth and protect the vulnerable groups.

• A few countries implemented some tax measures, including tax reductions, exemptions, or refunds on selected categories of goods and services (Tanzania, Zambia and Lesotho).
• Some countries did not implement direct fiscal or monetary interventions, but opted for fiscal tightening or alternative approaches in order to cushion the effects of the crisis e.g. Angola, Lesotho, Malawi, Mozambique

• Yet other countries implemented pro-cyclical policies, involving tight monetary policies e.g. Rwanda.

• Data shows that the fiscal positions of nearly all the MEFMI countries worsened during the crisis period (2008-2009) relative to the previous years (table 1).
Table 1: Fiscal Balances in MEFMI States: 2006-2010, in Percent of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>…</td>
<td>…</td>
<td>(14.4)</td>
<td>(5.2)</td>
<td>(6.1)</td>
</tr>
<tr>
<td>Botswana</td>
<td>11.8</td>
<td>4.8</td>
<td>(5.2)</td>
<td>(10.9)</td>
<td>(9.7)</td>
</tr>
<tr>
<td>Kenya</td>
<td>(1.7)</td>
<td>(3.4)</td>
<td>(3.6)</td>
<td>(6.4)</td>
<td>(4.3)</td>
</tr>
<tr>
<td>Lesotho</td>
<td>15.2</td>
<td>10.3</td>
<td>8.5</td>
<td>(3.9)</td>
<td>(5.0)</td>
</tr>
<tr>
<td>Malawi</td>
<td>(1.3)</td>
<td>(2.7)</td>
<td>(5.7)</td>
<td>(1.6)</td>
<td>…</td>
</tr>
<tr>
<td>Mozambique</td>
<td>(1.5)</td>
<td>(3.8)</td>
<td>(2.2)</td>
<td>(5.5)</td>
<td>(3.7)</td>
</tr>
<tr>
<td>Namibia</td>
<td>…</td>
<td>4.8</td>
<td>2.1</td>
<td>(2.2)</td>
<td>(5.7)</td>
</tr>
<tr>
<td>Rwanda</td>
<td>(1.8)</td>
<td>(0.5)</td>
<td>(2.5)</td>
<td>(0.5)</td>
<td>(3.8)</td>
</tr>
<tr>
<td>Swaziland</td>
<td>10.5</td>
<td>6.4</td>
<td>(0.2)</td>
<td>(7.1)</td>
<td>(12.8)</td>
</tr>
<tr>
<td>Tanzania</td>
<td>(4.0)</td>
<td>0.0</td>
<td>(4.8)</td>
<td>(7.0)</td>
<td>(6.0)</td>
</tr>
<tr>
<td>Uganda</td>
<td>(1.1)</td>
<td>(2.1)</td>
<td>(2.2)</td>
<td>(4.9)</td>
<td>(7.5)</td>
</tr>
<tr>
<td>Zambia</td>
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<td>(0.2)</td>
<td>(2.2)</td>
<td>(2.6)</td>
<td>(3.1)</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>(3.2)</td>
<td>(3.8)</td>
<td>(2.7)</td>
<td>(2.9)</td>
<td>(0.3)</td>
</tr>
</tbody>
</table>

Source: IMF staff country reports

+ is Fiscal Surplus
() is Fiscal Deficit

These deficits were financed in some cases by significant domestic borrowing.
More vigilance is necessary

- The debt Management Landscape is changing rapidly:
  - A bigger role for domestic debt;
  - Emergence of international sovereign bond issuance; and
  - Reducing proportion of concessional debt.
The Changing Landscape

Kenya: Changes in public debt composition

Kenya: Domestic & External Debt Trend

• Dramatic Increase in domestic debt:
  • As proportion of total public debt;
  • In absolute amounts; and
  • As ratio of GDP

Apart from domestic debt, countries are now contracting significant commercial debt including Eurobonds
Apart from domestic debt countries are now contracting significant commercial debt including Eurobonds. Hence, need for active debt management.
Some Notable Recent Transactions

- Debt management has become even more important in countries where debt management has traditionally not been an important element of economic management.
- For example, Botswana borrowed US$1.5 billion from the African Development Bank in 2009, relative to some net foreign repayments in the previous years. It also issued domestic debt averaging 5.8 percent of GDP during 2008-2009 compared to net repayments previously.
- Angola: Domestic debt issuance of 8.2 percent of GDP in 2009 compared to large repayments previously.
Notable Transactions

• Recently, the Swaziland has had to issue significant amounts of domestic debt in response to own fiscal crisis arising from the reduction in the SACU revenues.

• Other notable borrowing has been witnessed in Namibia in 2010, when the Government borrowed from domestic sources about 4.4 percent of GDP. This is relatively large compared to the previous years’ borrowing operations.

• The Government of Kenya also made large domestic debt issuance in 2009 (5.4 percent of GDP) to raise funds for infrastructure development & to finance stimulus programmes.
Conclusions

- In general, it can be concluded that debt management (borrowing, in particular) has provided many countries in Sub-Saharan Africa with the scope for smoothing taxes during the crisis period.
- For some countries, however, debt management does matter but not necessarily for smoothing tax rates. This is particularly true for the resource poor countries which are borrowing all the time to finance their growth and development needs.
  - Given the large financing requirements, such countries have to borrow annually regardless of whether they are in crisis or not.
- More vigilance is necessary as countries diversify their sources of financing.
THANK YOU!