IFS' Assessment of 2019 Mid-Year Fiscal Policy Review

On Monday July 29, the Finance Minister, Ken Ofori-Atta, presented the mid-year review of the 2019 budget statement and fiscal policy to Parliament. Notable fiscal policy changes that were announced include energy and communication tax hikes and a request to spend more money (supplementary expenditure estimates) relative to the initial 2019 budget appropriation.

Prior to the mid-year budget, the Institute for Fiscal Studies (IFS) had reviewed the economy's performance and provided recommendations to the government to address challenges identified. In what follows, we assess the notable developments in the mid-year review and make further recommendations to safeguard fiscal stability, which has come under threat from both revenue and expenditure management difficulties.

Revenue mobilization

Revenue mobilization continues to experience missed targets, with a shortfall of 15.5% (GH₵4.2 billion) recorded in the first half of 2019. This is not surprising as the revenue forecasts have always looked overoptimistic, given projected real GDP growth and inflation rates, as well as tax revenue giveaways that were not matched by strong offsetting revenue measures. An example is the reduction in benchmark import values in April, which narrowed the import tax base and contributed to a 17.5% (GH₵1.2 billion) shortfall in customs receipts in the first half of the year.

To salvage the fiscal program that was under threat from weak revenue collection, the government raised the communication service tax (CST), road fund levy, energy debt recovery levy, and price stabilization and recovery levy. Together, the hikes are expected to yield less than GH₵400 million in additional revenue from the affected tax handles in 2019. Other revenue measures are the planned sale of electromagnetic spectrum and collection of telecom licence renewal fees to shore up non-tax revenue, which performed poorly in the first half of the year. With these measures, as well as the pledge of stronger tax enforcement, the revenue forecast for the whole year has been more or less maintained at GH₵58.9 billion.

In tackling the revenue shortfall, the mid-year budget was silent on when (or whether) the Exemptions Bill that seeks to curtail widespread exemptions in the tax regime would be passed into law. This is puzzling, especially when the President, in his 2019 State of the Nation address, portrayed a dire picture of the tax exemptions regime, describing it as "an Achilles heel in the management of the economy, and a growing threat to fiscal stability and revenue generation," which the government was going to deal with. Moreover, the government itself has estimated that, if the Exemptions Bill is passed, it stands to save GH₵500 million of revenue that otherwise would be lost to tax exemptions in 2019. This amount is more than the yield of the tax increases that have been announced. Failure to take action on exemptions is therefore costing the nation dearly and prompting the resort to tax hikes to plug revenue shortfalls.

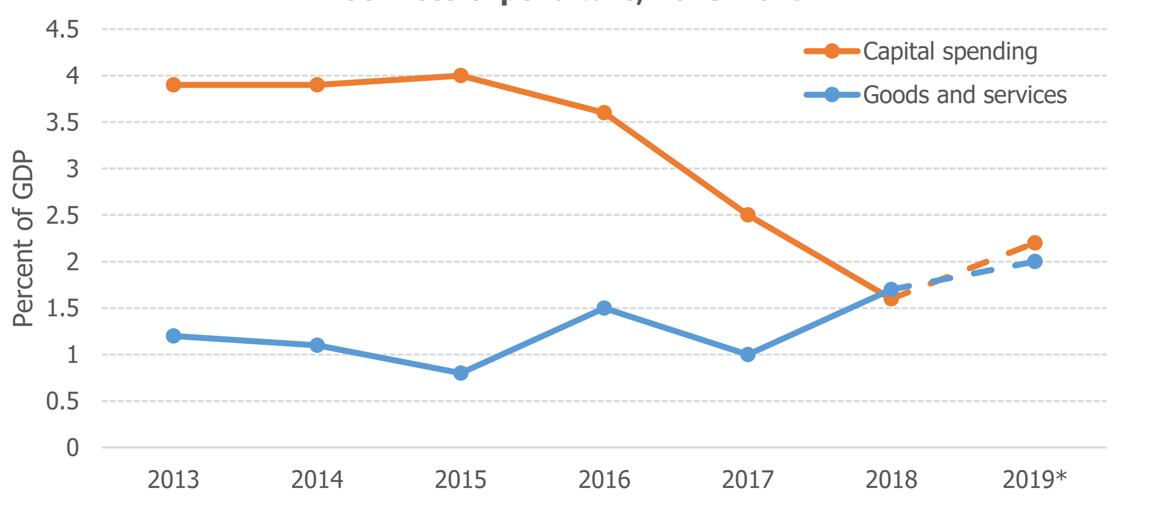
Expenditure

Projected expenditure (including arrears clearance) in 2019 has been increased by GH₵1.2 billion to GH₵74.6 billion, representing an extra 0.3% of GDP that will send the total to 21.6% of GDP. In view of the revenue forecast being maintained, this will lead to a rise in the deficit by GH₵1.2 billion to GH₵15.7 billion, raising the deficit ratio from 4.2% to 4.5% of GDP. Additional allocations have been made to goods and services (GH₵605.0 million), grants to other government units (GH₵235.8 million), and interest payments (GH₵952.7 million).

Because capital expenditure is critically needed to ensure increase in productivity in all sectors for accelerated and sustained growth and development of the Ghanaian economy, in the past, IFS has been very concerned about declines in central government capital expenditure as a ratio of GDP. This is because the declines in the ratio resulted from slower growths in the nominal values of capital expenditure relative to growths in the nominal value of GDP. In recent years, however, the behavior of capital expenditure is simply alarming. This is because the nominal values of capital expenditure itself are declining at a fast pace. Standing at GH₵7.7 billion in 2016, the nominal value of capital expenditure declined to GH₵6.3 billion in 2017, and further to only GH₵4.6 billion in 2018. This is unprecedented in the Fourth Republic. It was therefore a real relief when the 2019 Budget Statement projected capital expenditure at GH₵8.5 billion. However, in the mid-year budget, the government has slashed this amount by one-tenth (GH₵819.9 million) to GH₵7.7 billion, about its 2016 level.

The fall in central government capital expenditure as a proportion of GDP has, therefore, become worse in recent years. This is illustrated in Figure 1, where capital expenditure fell from 4.0% of GDP in 2015 to a low of 1.6% of GDP in 2018. It is projected to be 2.2% of GDP in 2019, which is only slightly more than half of the 2015 ratio. Over the same period, expenditure on goods and services grew from 0.8% of GDP to a projected 2.0% of GDP in 2019, which is nearly as much as what is going into capital investment. What this means is that, whereas fiscal consolidation has contributed to the reduction in capital investment, another important factor is the growth of goods and services spending, which has been driven in recent times by the many new policy initiatives the government is pursuing.

Figure 1. Central government capital spending versus goods and services expenditure, 2013-2019



Source of data: Ministry of Finance *Projected

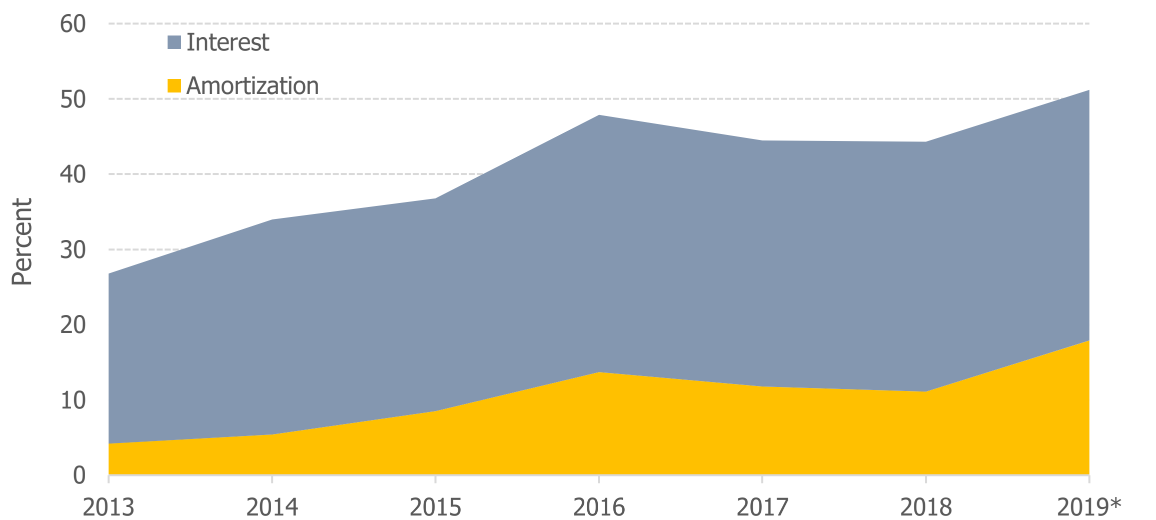
Debt

Relative to the original budget statement, government borrowing in 2019 is set to rise on the back of the mid-year supplementary expenditure request, which Parliament has since approved. This is seen in the projected increases in the budget deficit (by GH₵1.2 billion) and debt amortization spending (by GH₵5.2 billion, to pay off crystallized energy sector contingent liabilities) in the face of an unchanged total revenue projection. The total supplementary request of GH₵6.4 billion is therefore going to be funded by debt. This additional borrowing will further increase the debt stock, which hit GH₵203.9 billion in June 2019, and the debt-to-GDP ratio, which reached 59.2% in the period.

In his statement, the Minister cited the debt-to-GDP ratio being less than 60% as one of the positive macroeconomic indicators. This suggests that the fall in the debt ratio to below 60% of GDP since the rebasing of the national income accounts in 2018 has given a false sense of security about the debt position. In reality, however, there should be no comfort taken in a lower debt-to-GDP ratio in the present circumstances.

A better way to assess the debt and its sustainability is to look at what is happening to debt service expenditure in relation to government revenue. As Figure 2 illustrates, debt service expenditure, comprising interest and amortization payments, absorbed 26.8% of total revenue and grants in 2013, but this increased rapidly to 47.9% in 2016. The ratio then fell to 44.5% in 2017 and to 44.3% in 2018. With the revisions to spending in the mid-year budget, the ratio is set to rise sharply to 51.2% in 2019 — close to double the 2013 ratio. Thus, the burden of debt service expenditure on the government's finances is very high and increasing, even if the debt-to-GDP ratio is now lower because of the GDP rebasing and recalculation. This calls for urgent steps to limit further borrowing. It is also crucial to eliminate extra-budgetary expenditures and borrowing which, despite their being excluded from the budget deficit and, in some cases, the debt stock, still create debt service liabilities that must be met from the same limited revenue envelope available to the government.

Figure 2. Debt service to total revenue ratio, 2013-2019



Source of data: Ministry of Finance *Projected

Recommendations

- Revenue targets need to be set realistically, as missed targets disrupt the fiscal program and undermine effective budget execution. The Ministry of Finance should therefore strengthen its revenue forecasting. In particular, the impact of proposed revenue policy changes should be robustly appraised and realistically forecasted prior to implementation of the policies.

- The government should move quickly to curtail exemptions in the tax regime, many of which are inefficient and costly. To this end, the passage of the Exemptions Bill is critical, and the IFS stands ready to provide inputs for the bill's refinement before enactment.

- Rapidly growing expenditure on goods and services, which has come at the expense of lower capital spending, should be controlled. This means restricting the roll-out of new consumption-based policy initiatives and reviewing ongoing ones (e.g. Free SHS, Nation Builders Corps, Planting for Food and Jobs, etc.) to limit their cost and improve efficiency.

- The surge in amortization spending in the mid-year budget, on account of crystallized energy sector contingent liabilities, exposes the poor management of fiscal risks emanating from the energy sector. This situation requires decisive national attention and action, and we urge the government to provide more detailed information on the energy sector indebtedness and to consult widely regarding the best options to deal with it.

- Overall, the fiscal policy path the country is on is unsustainable, as the country's indebtedness looks likely to worsen on the basis of current spending and borrowing decisions. The government has to reverse course with a strategy that will reduce borrowing significantly in order to improve the debt dynamics, particularly with regard to the ballooning debt service costs.