

IPPR Briefing Paper No. 13, October 2002

## Maintaining Economic Independence: Government Debt and Fiscal Sustainability

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A sound fiscal policy is vital for economic development and the maintenance of economic independence. This paper analyses fiscal policy trends from 1992/93 to 2001/02 and assesses the sustainability of Government's current fiscal path. Government has maintained a budget deficit every year and as a result public debt has increased. Foreign debt has also increased as new foreign loans have been taken on and the exchange rate has depreciated. Furthermore, it appears that government generally borrows too much because of difficulties in forecasting cash flow. Together this has meant that government has failed to meet its own debt target in the very same year it was set. This damages credibility. The paper goes on to make several suggestions about how the present approach to debt management could be improved and the independence of Namibian economic policy makers maintained.

Governments collect taxes and other revenues to finance the provision of public goods and services which the economy requires. The term **fiscal policy** is used by economists to describe the revenue, expenditure and borrowing policies of central government. If, during the course of a fiscal year, a government spends more money than it is able to collect in revenue, its budget is in **deficit** and the government has to borrow money to cover the shortfall between revenue and expenditure.

A government which produces a budget deficit in one year and is not able to achieve a budget surplus in the following fiscal year (by keeping spending lower than revenue) will not be able to repay the creditors from which it borrowed money in the previous year. A further budget deficit in the second year adds to the budget deficit of the previous year and the government starts to accumulate **debt**. Hence, a government's **stock** of debt theoretically constitutes the sum of previous fiscal years' shortfalls between revenue and expenditure.

Governments generally have three options for financing a shortfall between expenditure and revenue:

First, they can borrow from the domestic financial market. Governments borrow money from citizens who have accumulated savings. Usually, governments do not borrow directly from individuals but from financial intermediaries, such as commercial banks, pension funds, and insurance companies that have collected the savings from domestic individuals and firms in one form or another. The sum of these institutions constitutes a country's financial market. In Namibia, government borrows from the domestic financial market by means of issuing treasury bills (which must be paid back within a year or less) and bonds or internally registered stock (which must be paid back after a period longer than a year) via its financial agent, the Bank of Namibia.

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Second, governments can borrow from the central bank by asking it to print more money. However, this form of financing creates money and results in higher inflation and a decrease in the value of the domestic currency. Borrowing by printing money is not an option for Namibia, because the country has chosen to link its currency to the South Africa Rand within the framework of the Common Monetary Area (CMA), which includes Namibia, South Africa, Lesotho and Swaziland. This choice restricts monetary policy freedom and excludes the possibility of borrowing from the central bank.

Third, governments can borrow from abroad. Similarly to borrowing from the domestic market, the government accesses savings which have been accumulated by individuals in other countries. Again, funds are not borrowed directly from foreign individuals, but are received from foreign financial institutions which act as **intermediaries** between foreign savers and the borrowing country. Within the framework of development assistance, developing countries can often receive foreign funds for particular purposes under more favourable conditions than what the market would otherwise demand. Such **concessional loans** are usually extended by foreign governments and international development banks such as the African Development Bank (ADB) or the European Investment Bank (EIB).

The more favourable conditions of concessional loans compared to **commercial loans** may include lower or even zero **interest rates**, **grace periods** during which the borrowing government is not required to make repayments, and long **maturity periods** (often around 30 to 50 years) during which the loan is to be repaid. Because concessional loans are extended under these conditions, the borrowing government does not repay the full market value of the money it originally borrowed, but in effect receives part of the loan as a gift.

Namibia's borrowing from abroad is administered by the National Planning Commission (NPC), which acquires such loans to finance development projects. Foreign loans, however, are received outside the **state revenue fund**, that is, outside the official government accounting system. Thus, development spending financed through foreign borrowing is not included in budgeted government expenditure and, as a result, is not reflected in the official budget deficit calculations.

Unsustainable fiscal policies have caused many countries in the world to run into severe economic problems and to rely on the International Monetary Fund (IMF) or the World Bank for loans to achieve macroeconomic stabilisation or structural adjustment. These loans are generally conditional on painful economic reforms which are often associated with political upheaval. The problem of fiscal sustainability has by no means been confined to just African or low-income countries. In Namibia the intentions of the two main international financial institutions are widely regarded with suspicion. There is a perception that countries seeking assistance from them effectively surrender their economic independence and national sovereignty, a blow from which they rarely if ever recover.

Namibia is not highly indebted and has never had to rely on the IMF or World Bank for loans. However, for every fiscal year since Independence, public finances have been in deficit and public debt has been growing. This increase in debt raises doubts about whether the government's current fiscal policies are sustainable. This short paper describes how public debt has risen since independence and puts forward practical suggestions that will help the government reduce the cost of borrowing and ensure Namibia maintains its economic independence.

## Central government has run a budget deficit every year since independence...

Table 1 below illustrates central government's overall fiscal performance with respect to actual rather than budgeted revenue and expenditure and the resulting budget deficits from 1992/93 to 2000/01.

**Table 1: Actual revenues, expenditures and budget deficits since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
Revenue	3,025	3,117	3,662	4,081	4,676	5,690	6,187	7,272	8,343
Expenditure	3,425	3,478	3,857	4,525	5,567	6,129	6,936	7,953	8,708
<b>Budget deficit</b>	<b>400</b>	<b>361</b>	<b>195</b>	<b>444</b>	<b>891</b>	<b>439</b>	<b>749</b>	<b>681</b>	<b>365</b>
Revenue (% of GDP)	35.4%	31.6%	30.9%	30.7%	30.3%	33.0%	32.1%	34.1%	34.6%
Expenditure (% of GDP)	40.1%	35.3%	32.6%	34.1%	36.0%	35.5%	36.0%	37.3%	36.1%
<b>Budget deficit (% of GDP)</b>	<b>4.7%</b>	<b>3.7%</b>	<b>1.6%</b>	<b>3.3%</b>	<b>5.8%</b>	<b>2.5%</b>	<b>3.9%</b>	<b>3.2%</b>	<b>1.5%</b>
GDP at current prices	8,539	9,864	11,838	13,282	15,447	17,263	19,266	21,336	24,120

Source: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03, GDP figures taken from the preliminary National Accounts 2001

For every fiscal year from 1992/93 to 2000/01 expenditure has exceeded revenue and government has had to finance budget deficits. Revenue as a percentage of Gross Domestic Product (GDP) decreased from 35.4% in 1992/93 to a low of 30.3% in 1996/97, but thereafter increased to reach 34.6% in 2000/01. For the fiscal year 2001/02 and beyond, a revenue contraction is expected due to decreasing SACU revenue. The Ministry of Finance has so far not released any actual data on the last fiscal year to verify this trend.

Expenditure as a percentage of GDP sharply decreased from 40.1% of GDP in 1992/93 to 32.6% of GDP in 1994/95, a fiscal year with a very low budget deficit. For the following six fiscal years until 2000/01, the level of expenditure has fluctuated around 36% of GDP. Despite an expected revenue contraction, the expenditure level for 2001/02 has been forecast to reach 38% of GDP in the revised budget 2001/02.

**Chart 1: Government finances**

revenue, expenditure and budget deficit as % of GDP

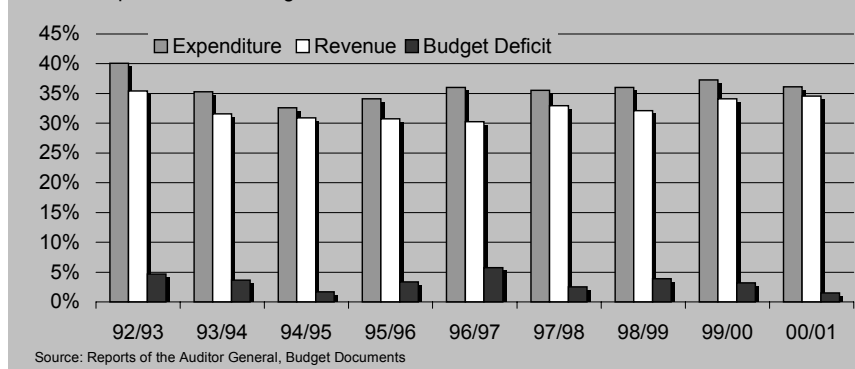


Chart 1 shows how government revenue, expenditure and the budget deficit have changed since 1992/93. Over the entire nine year period budget deficits have averaged 3.4% of GDP, which is slightly above government's own budget deficit target of 3% of GDP set out in the First National Development Plan (NDP1) and the more recently announced target of 3.2 % of GDP. Actual budget

deficits tend to differ considerably from the estimates presented in the main budget since actual revenue and spending turn out to be quite different from the original estimates (IPPR, 2001).

## ...and debt has increased accordingly...

As explained above, if a government runs a budget deficit every year, the stock of debt accumulated will increase. Table 2 and Chart 2 below illustrate how central government debt has increased during the ten financial years from 1992/93 to 2000/01. These figures are taken from the Commonwealth Debt Recording and Management System (DRMS) located in the Ministry of Finance which contains a comprehensive database of central government debt.

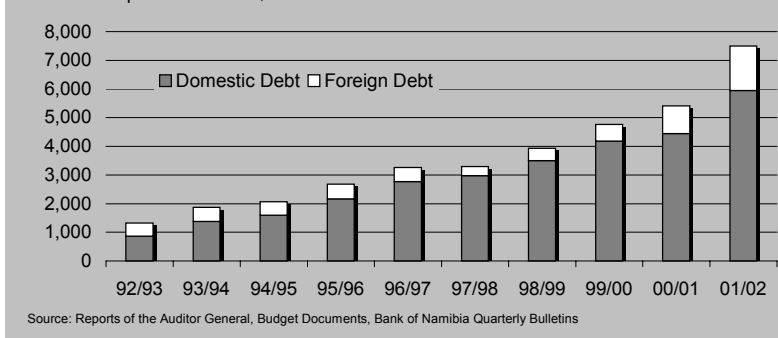
**Table 2: Central government debt since 1992/93**

<i>N\$ million</i>	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
<b>Total Debt</b>	<b>1,326</b>	<b>1,867</b>	<b>2,065</b>	<b>2,672</b>	<b>3,259</b>	<b>3,290</b>	<b>3,927</b>	<b>4,768</b>	<b>5,416</b>	<b>7,504</b>
Annual Change	461	541	198	607	586	32	637	960	648	2,088
Debt as % of GDP	15.5%	18.9%	17.4%	20.1%	21.1%	19.1%	20.4%	22.3%	22.5%	27.2%
<b>Domestic Debt</b>	<b>867</b>	<b>1,378</b>	<b>1,595</b>	<b>2,169</b>	<b>2,768</b>	<b>2,979</b>	<b>3,496</b>	<b>4,181</b>	<b>4,446</b>	<b>5,947</b>
annual change	468	512	217	574	599	211	517	685	265	1,501
as % of GDP	10.2%	14.0%	13.5%	16.3%	17.9%	17.3%	18.1%	19.6%	18.4%	21.5%
as % of total debt	65.4%	73.8%	77.2%	81.2%	84.9%	90.5%	89.0%	87.7%	82.1%	79.3%
<b>Foreign Debt</b>	<b>459</b>	<b>488</b>	<b>470</b>	<b>503</b>	<b>491</b>	<b>311</b>	<b>431</b>	<b>587</b>	<b>970</b>	<b>1,557</b>
annual change	-7	29	-18	33	-13	-179	120	276	383	587
as % of GDP	5.4%	5.0%	4.0%	3.8%	3.2%	1.8%	2.2%	2.8%	4.0%	5.6%
as % of total debt	34.6%	26.2%	22.8%	18.8%	15.1%	9.5%	11.0%	12.3%	17.9%	20.7%

Sources: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03, Bank of Namibia Quarterly Bulletin June 2002

Reports of the Auditor General and budget publications for 2002/03 indicate that over the nine year period from 1992/03 to 2000/01 total government debt increased from N\$1,326 million, or 15.5% of GDP, to N\$5,416 million, or 22.5% of GDP. A debt level of 22.5% of GDP is still relatively low by international standards (see, for example, p.116 of *The Economist* September 28<sup>th</sup>-October 4<sup>th</sup> 2002). However, estimates published in this fiscal year's budget documents predicted a sharp increase in public debt for the end of the fiscal year 2001/02 while the Bank of Namibia's latest Quarterly Bulletin for June 2002 shows a clear upward trend in the stock of central government debt. It indicates that by the end of March 2002 total government debt stood at N\$7,504 million, or 27.2% of estimated GDP. As a result, government exceeded its own debt target of 25% of GDP by the end of the 2001/02 fiscal year which the Minister of Finance had only announced during his 2001/02 budget speech.

**Chart 2: Public debt**  
breakdown of public debt in N\$ million



There are two reasons for the substantial increase in government debt for the fiscal year 2001/02. First, the government expected to finance a considerable budget deficit of about 5.3% of GDP. Second, the depreciation of the exchange rate which took place in the fourth quarter of 2001 led to a significant re-valuation of foreign debt in Namibia dollar terms. It should also be remembered that the latest ratio of

debt as a proportion of GDP depends also on an estimate of GDP for 2002 which, at this stage, is unlikely to be particularly accurate.

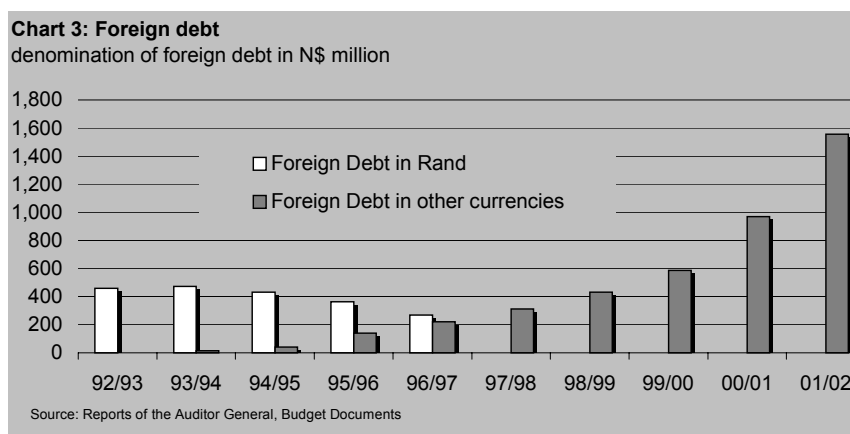
### ...despite the writing off of inherited debt.

Public debt prior to 1997/98 also included debt inherited at independence from the previous regime, and not only debt accumulated by the post-independence Namibian government. Inherited foreign debt gradually decreased during the first half of the nineties until the remaining N\$269 million was finally written off by the South African government during the course of the 1997/98 fiscal year. Inherited domestic debt in the form of a loan facility at the Bank of Namibia continued to increase slightly until N\$862 million too was written off in 1997/98. Thus, the total amount of pre-independence debt written off during the 1997/98 fiscal year was N\$1,130 million.

### Foreign debt has increased in importance...

Whilst government continues to borrow most of its debt domestically, the share of foreign debt as a percentage of total debt has increased steadily since 1997/98 exceeding 20% of total debt by the end of the fiscal year 2001/02. A growing share of foreign debt in relation to total debt increases government's exposure to exchange rate risk, particularly since the surge in new foreign debt after 1997/98 is a result of borrowing from outside the Common Monetary Area (CMA) in currencies other than the Rand. Borrowing from outside the region entails an exchange rate risk since the Namibia dollar and the Rand are subject to considerable fluctuations against major world currencies such as the US dollar and the Euro. In theory, this risk can be reduced by *hedging* but, as far as is known, Namibia does not presently hedge its non-Rand denominated debt.

It is, therefore, useful to differentiate the total debt stock in debt owed in Namibia dollars and Rands and debt owed in other international currencies. Chart 3 and Table 3 show that despite a low overall level of foreign debt, foreign debt in currencies other than the Rand has been growing disproportionately. The relative, as well as nominal, decrease in foreign borrowing to below 10% of total debt in 1997/98 was a consequence of the gradual write-off of debt owed in Rand to South Africa.



If the local currency continues to experience depreciation rates higher than the regional inflation rate, government will have to carefully assess when and whether foreign borrowing is favourable compared to domestic borrowing. In addition to comparing *real interest rates* (nominal interest rates minus inflation), the potential cost of the exchange rate risk would also have to be considered.





**Table 3: Central government's debt stock in Namibia dollars, Rand and other foreign currencies since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
<b>Total Debt</b>	<b>1,326</b>	<b>1,867</b>	<b>2,065</b>	<b>2,672</b>	<b>3,259</b>	<b>3,290</b>	<b>3,927</b>	<b>4,768</b>	<b>5,416</b>
Foreign Debt: Rand	459	472	431	364	269	0	0	0	0
Foreign Debt: Other Currencies	0	16	39	139	222	311	431	587	970
Domestic Debt: Loans Facility	524	630	731	765	844	0	0	0	0
Other Domestic Debt	343	749	864	1,404	1,924	3,290	3,927	4,768	5,416

Sources: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03, Bank of Namibia Quarterly Bulletin June 2002

Not surprisingly, the increase in public debt described above has led to an increase in interest payments. Interest payments have also been determined by prevailing interest rates which rose sharply in 1998 before falling until 2001. Table 4 shows that interest payments on foreign debt have not yet exceeded N\$20 million a year. However, interest payments on domestic borrowings have grown from below 1% in 1992/93 of total expenditure to around 6% in 2000/01. To give some idea of the order of magnitude of these payments, in 2000/01 interest payments totalled more than what was budgeted for the entire Ministry of Agriculture, Water and Rural Development and almost twice the social pension.

**Table 4: Interest payments on public debt since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
Interest on domestic debt	22	70	98	128	231	345	480	501	497
As % of total expenditure	1%	2%	2%	3%	4%	6%	7%	6%	6%
Interest on foreign debt	0	0	20	16	9	5	8	10	14
As % of total expenditure	0%	0%	1%	0%	0%	0%	0%	0%	0%
Interest on total debt	22	70	118	144	239	350	488	511	511
As % of total expenditure	1%	2%	2%	3%	4%	6%	7%	6%	6%

Source: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03

## It looks as if government consistently overborrows...

When a government seeks to finance its budget deficit for a specific fiscal year, it is not necessarily the case that the exact amount of the shortfall needs to be borrowed. If a government has previously accumulated excess money on the state account into which it receives revenue and from which it pays for the provision of public goods and services, it can draw on such funds to finance the budget deficit by reducing these **cash balances**. Likewise, if a government realises that it does not have enough cash balances on the state account to smoothen the seasonal pattern of revenue and expenditure flows, it may borrow more money than that required to finance the budget deficit in order to build up its cash balances. However, other than for the purpose of managing daily flows in and out the state account, governments should not accumulate more money on the state account than necessary, because this would result in unnecessary interest costs. A general objective of efficient cash and debt management is, therefore, to keep cash balances as high as necessary, but as low as possible.

The Namibian government's public accounting system is a **cash-based** system as can be seen from the Reports of the Auditor General. This means that credit and debit transactions are recorded in the **general ledger** when they actually fall due and not when liabilities and claims



arise. The net effect of all credit minus all debit transactions is the annual change in cash balances, or the increase or decrease of cash in government's coffers available at the end of a fiscal year compared to the end of the previous fiscal year. The actual budget deficit results from all credit minus all debit transactions, excluding those related to borrowing (new issues and redemptions). Annual net borrowing, in turn, results from the total debt issued minus all debt redemptions.

The Reports of the Auditor General show how the government has financed its annual budget deficits in terms of net borrowing and the drawing down or accumulating of cash balances. This is shown in Table 5.

**Table 5: Budget deficit financing since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
Budget Deficit	400	361	195	444	891	439	749	681	365
A: Net Borrowing	298	478	118	547	521	1,065	429	829	280
B: Change: Cash balances - = increase; + = decrease	+102	-117	+77	-103	+370	-626	+320	-148	+85
Budget Deficit Financing (A+B)	400	361	195	444	891	439	749	681	365

*Source: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03*

The data shows that annual budget deficits and annual net borrowing as recorded in the general ledger have at times differed substantially. More interestingly, during every second year since 1992/93, the government has been drawing on cash balances accumulated during the previous year to finance part of the budget deficit. This suggests that the government finds it difficult to forecast how much money it needs to borrow during the course of a fiscal year in order to cover the actual shortfall between revenue and expenditure. As a result, government tends to borrow too much in one year and to reduce the accumulated cash balances in the following year. This is expensive since government pays interest on borrowings.

The mismatch between budget deficit financing and net borrowing noticeable for the fiscal year 1997/98 seems to have resulted from the write-off of pre-independence debt by the South African government. It appears that the government made provision for repaying this debt, pending a decision on behalf of the South African Government. When the latter took over this debt, the government ended up with a large increase in cash balances, which it used to finance the budget deficit in the subsequent fiscal year.

### **Economic theory suggests it is legitimate for governments to borrow...**

Is it good or bad for governments to spend more than they earn and to borrow to meet the shortfall? Theoretically speaking, public spending that carries a rate of return which covers the cost of borrowing is money spent wisely. Governments can justifiably borrow funds to undertake projects and programmes which will increase revenue in future and ensure the sustainability of the government's financial position. This is the same underlying logic that applied to a private firm taking out a loan from a commercial bank to build a new factory. The new factory increases the production of the firm and generates profits which enable the firm to repay the borrowed money. When a government borrows, it is implied that spending undertaken with the borrowed money will lead to a long-term increase in the country's GDP which will allow the debt to be repaid. Thus, it is



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legitimate for governments to borrow money to invest in the provision of public goods and services which will encourage domestic economic activity and lead to economic growth and development.

**..but it is the quality of public spending that really matters.**

Whether public spending financed with borrowed money nurtures economic growth, however, depends very much on what the borrowed money has been spent. The quality and efficiency of public expenditure financed with borrowed money is thus important in determining the sustainability of debt. If a government borrows funds and spends it on unproductive investment, taxes will have to be increased in the future in order for the government to meet its financial obligations arising from accumulated debt. This by itself can have a negative effect on the economy's growth and will make debt obligations even more difficult to meet. As a consequence, governments can be caught in a **debt trap** from which it is difficult to escape and are then obliged to turn to the IMF and the World Bank for assistance.

The challenge for government, and especially the central resource agencies (the Ministry of Finance and the National Planning Commission) is to properly assess spending proposals to maximise the likelihood that spending now leads to higher growth and revenues in future.

In theory there is an infinite number of projects and programmes on which money can be spent each with its own rate of return. The task of government is to select the ones with the highest returns, in theory those with a return higher than the cost of borrowing. Logically, the more that is spent the greater the chances are that lower return spending will be financed.

In practice, certain public projects lend themselves more easily to such assessment than others. Those commercial projects – such as a new power station or a new dam - that aim to generate direct financial returns are relatively easy to assess. The well-established methodology of cost-benefit analysis can be employed to assess the feasibility of other public goods such as roads and railway lines that have a fairly direct impact on the economy yet often yield no direct financial return. Other areas of public spending - such as the provision of schools, hospitals and law courts - are more difficult to assess in this way. Although there is ample international evidence that suggests such spending leads to higher long-term growth it is difficult to say with any certainty that a certain amount of expenditure will lead to a certain amount of future growth and revenue. Because of this uncertainty, it is prudent to err on the side of caution. Finally there is a class of spending which is not amenable to economic appraisal. This may include defence expenditure and prestige projects which are considered important for political or strategic reasons. While most countries indulge in such spending economists would advise that it be carried out within what can be sustainably financed and in the full knowledge of what other projects have to be forgone, the **opportunity cost**.

A government which borrows for spending that does not lead to higher revenues in the long-term is essentially not living within its own means and puts the burden of repaying and servicing accumulated debt upon future generations. Many countries are faced with severe debt management problems because they can only meet their financial obligations resulting from unsustainable borrowing in the past by cutting expenditure and damaging the ability to provide important public services.





## There seems to be a relationship between economic growth and debt...

Economic theory and empirical evidence (IMF, 2001) maintain that the relationship between growth and debt takes the shape of an inverted U-shape. Up to a certain debt level borrowing has a positive effect on growth, but thereafter the relationship turns negative. This implies that it is the efficiency of investment and not the quantity that matters and that large debt stocks tend to be associated with a lower probability of being able to meet debt repayments.

Although countries are also exposed to external factors such as changes in world market prices or exchange rate volatility, which can have a severe negative impact on a country's financial position, comparative research (Easterly, Rodriguez and Schmitt-Hebbel, 1994) has shown that external factors cannot sufficiently explain the severity of debt in highly indebted countries. The fundamental underlying cause of debt crises is unsustainable fiscal policy resulting from high public sector deficits.

## There are useful rules of thumb which could be applied to government debt...

Economic theory suggests a variety of sophisticated ways to determine a country's fiscal sustainability (Cuddington, 1996), taking into account a range of different variables such as domestic and foreign interest rates, exchange rate changes and inflation rates. For a more hands-on approach, particularly in the absence of good data and macro-economic projections, two simplified definitions of fiscal sustainability are often used.

A widely-known "rule of thumb" which is often referred to in Namibia postulates that governments should cover **current expenditure** from current revenues and should only resort to borrowing for the financing of **capital expenditure**. Capital expenditure typically includes development expenditure such as investment in infrastructure, but also the purchase of equipment and machinery which can be utilised for a period exceeding a year. In general, it refers to any expenditure which increases and improves the value of physical assets. It has already been emphasised that budget deficits are economically justifiable if borrowed money is geared towards increasing the economic capacity of the country. This sustainability definition implies that all capital expenditure carries a long-term rate of return that makes such spending financially sustainable and profitable, whilst current expenditure would lack such a rate of return.

**Table 6: Capital spending, budget deficits and net borrowing compared since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
Capital spending	550	486	412	577	624	779	737	948	961	1,311
Budget deficit	400	361	195	444	891	439	749	681	365	N/a
Budget deficit as % of capital spending	73%	74%	47%	77%	143%	56%	102%	72%	38%	N/a
Net borrowing	298	478	118	547	521	1,065	429	829	280	N/a
Net borrowing as % of capital spending	54%	98%	29%	95%	83%	137%	58%	87%	29%	N/a

Source: Ministry of Finance Budget Statements 1992/93-2002/03

Can such an assumption be made? The "rule of thumb" definition is based on the belief that capital expenditure per se constitutes spending which generates the necessary rate of return to



ensure repayment and servicing. Research, however, has shown that whilst capital accumulation has a positive impact on economic growth in the short-run, this does not necessarily hold for the long-run. Not all capital expenditure can be assumed to be sustainable. Again, it is the quality and efficiency of public investment matters, and not the quantity. Research on why some countries grow and others do not emphasises that certain current expenditure as well as institutional development are also essential for an economy's long-term growth prospects. These include qualitative spending on education, the development of an efficient public administration and management system and adherence to the rule of law.

In conclusion, the argument that a country's fiscal policy is sustainable because borrowing is only undertaken to finance capital expenditure is, unfortunately, based on an outdated and empirically contested belief. It is not sufficient to focus on the mere quantity of capital expenditure. The quality of different capital projects with respect to how they contribute to the country's long-term growth potential needs to be examined. Table 6 shows that capital spending has been financed largely by borrowing. However, although it may be argued that government only borrows to finance capital expenditure, this is not a sound economic argument.

A second and more useful simplified concept of fiscal sustainability postulates that governments should maintain a constant ratio of the stock of debt to the size of the economy. This may be a target such as the Minister's target of 25% of GDP. In order to maintain a stable debt to GDP ratio, the value of government debt cannot grow at a faster rate than the value of GDP.

**Table 7: Annual growth in nominal GDP and total government debt since 1992/93**

	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
Increase in GDP	15.8%	15.5%	20.0%	12.2%	16.3%	11.8%	11.6%	10.7%	13.1%	14.3%
Increase in debt	53.2%	40.8%	10.6%	29.4%	21.9%	1.0%	19.4%	21.4%	13.6%	38.5%

*Source: Reports of the Auditor General 1992/93-1998/99, Ministry of Finance Budget Documents 2001/02 and 2002/03, GDP figures taken from the preliminary National Accounts 2001*

Table 7 shows that debt has grown faster than GDP. GDP measured in current prices (**nominal GDP**) has only grown by 13.9% on average over the ten-year period from 1992/03 to 2001/02, whilst the debt stock has on average increased by 21.2%. The fact that nominal GDP has grown by less than the debt stock suggests that expenditure undertaken with borrowed funds has so far not rendered the necessary returns in terms of contributing to higher nominal GDP growth.

By the end of the fiscal year 2001/02, Government had exceeded its debt target of 25% of GDP, logically implying that in order to maintain a constant debt to GDP ratio from now on, government will have to insure that its debt stock does not increase faster than nominal GDP.

### **... but fiscal targets should be consistent...**

In the past, the Namibian government has put forward two main fiscal targets: not to exceed a debt level of more than 25% of GDP, and to achieve a budget deficit target of 3% of GDP. This latter target has become rather more vague over time. It is now 3.2% of GDP in the medium-term. For the present fiscal year and the medium-term, it has added a third fiscal target: to reduce the level of public expenditure to GDP to 30% of GDP over the medium term.



### Box 1: Credible fiscal targets must be consistent

Take an economy with a GDP of N\$20 billion in Fiscal Year 1 and a debt stock of N\$5 billion (25% of GDP). If GDP is forecast to grow in FY 2 by 15% this means nominal GDP will be N\$23 billion in FY2. To maintain a stable stock of debt as a proportion of GDP in FY2 debt can also only increase by 15% or by N\$0.75 billion. If revenue is project to amount to N\$10 billion for FY2 then expenditure can only amount to N\$10.75 billion. The budget deficit would equal the maximum permissible increase in debt stock of N\$0.75 billion or 3% of GDP ( $0.75/23 \times 100$ ). This shows that independent targets cannot be set for debt-to-GDP ratios and budget deficit.

In order to maintain a stable debt-to-GDP ratio, or to reduce the current debt ratio to 25% of GDP, the budget deficit might need to be cut to a level below 3% of GDP, unless real growth increases. The formulation of consistent fiscal policies needs to bear in mind how revenue, expenditure and debt relate to each other as shown in Box 1. The difference between revenue and expenditure is the budget deficit which should equal the annual increase in government debt.

In the past, the Namibian government was only able to set fiscal targets in this fashion, because the debt level had not yet reached 25% of GDP. As this level has now been exceeded, continuing to adhere to these targets would result in inconsistent and unsustainable fiscal policies.

### Differences between net borrowing and annual changes in total debt make the formulation of consistent fiscal policies more complicated...

Comparing figures for net borrowing (the difference between new debt issues and debt redemption in one fiscal year) indicated in the Reports of the Auditor General with the annual change in the Government debt stock reveals differences which theoretically should not occur, or at least should not be substantial.

**Table 8: Differences in net borrowing and annual changes in debt stock since 1992/93**

N\$ million	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
Annual Change: Total Debt	461	541	198	607	587	32	637	841	648
Net Borrowing	298	478	118	547	521	1,065	429	829	280
Differences	163	63	80	60	66	1,033	208	12	368

Source: Reports of the Auditor General 1992/93 – 1998/99, Ministry of Finance Budget Documents 1999/00 – 2000/01

Table 8 shows that with the exception of 1997/98, the annual change in the debt stock exceeded net borrowing for budget deficit financing. This means that debt has increased by more than the net borrowing necessary for financing the official budget deficit. There are two reasons why the data shows such inconsistencies. First, differences could be due to exchange rate fluctuations. As mentioned earlier, debt accrued in foreign currencies is re-valued when the exchange rate changes. A weakening of the domestic currency vis-à-vis foreign currencies results in an increase in the value of foreign debt even if no new foreign debt is taken on. Second, borrowing which takes place outside the state revenue fund is not captured by the net borrowing presented in the Reports of the Auditor General but is included in the debt records and, therefore, reflected in the annual changes of the debt stock.



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Ideally, countries should develop comprehensive public accounting systems, where all public funds are channelled through the state revenue fund. As mentioned above, in Namibia foreign loans are not channelled through the state revenue fund but remain outside the main budget framework. Estimates of foreign loans to be received in a particular fiscal year are captured in the development budget, but appear not to be incorporated into the main budget estimates. As a result expenditure financed with foreign loans is also not captured and, therefore, official budget deficit estimates are systematically underestimated.

The structure of the Reports of the Auditor General is based on the government's general ledger. Theoretically, the general ledger should record all payments in connection with debt servicing, irrespective of domestic or foreign debt. In Namibia, however, net borrowing only reflects domestic debt transactions. The ledger balances when the actual budget deficit equals the annual change in cash balances plus net borrowing. The change in cash balances results from all credit transactions minus all debit transactions including transactions connected to the issuance and redemption of debt, and net borrowing results from the difference between the issuance and the redemption of debt. Hence, the official budget deficit is only financed with domestic borrowing. The record of the government debt stock captures government debt in terms of outstanding principal liabilities and therefore needs to include both domestic and foreign borrowing.

For the formulation of a comprehensive and consistent fiscal policy, the fact that foreign loans are not captured within the state revenue fund has the consequence that the permissible annual increase in the debt stock in accordance with projected GDP growth has to accommodate not only the budget deficit, but additionally net foreign loan disbursements. That is, in the process of determining the overall expenditure level on the basis of given revenue estimates, expected net foreign loans disbursements would have to be deducted from the permissible nominal increase in the debt stock in order to derive at the then systematically underestimated official budget deficit.

### **In addition to the stock of debt, there are other growing fiscal dangers...**

In addition to the stock of debt discussed above, government has also accumulated a substantial amount of *contingent liabilities* which are not included in the normal government debt records. This is because government's obligation to repay such liabilities depends on uncertain events which may or may not occur. Two types of contingent liabilities are usually distinguished. **Explicit liabilities** are government obligations defined by law, meaning that a government is legally obliged to make a payment if and only if a specific event takes place. Explicit liabilities would include loan guarantees given by government to third parties. Government has given many such guarantees for borrowings by state-owned enterprises such as Telecom Namibia and TransNamib. **Implicit liabilities** are obligations which the government is not legally obliged to meet but for which the public would expect it to take responsibility. Thus, if a major company went bankrupt there would be political pressure to bail it out even though there may not be a legal obligation upon government to do so.

Little information is available to the public about the Namibian government's implicit and explicit contingent liabilities in general. The Reports of the Auditor General, however, contain information on government guarantees for loans to third parties shown in Table 9. This data is generally two or three years out of date. Data on loan guarantees is only available for the fiscal years 1995/96 to 1998/99 but it shows a sharply increasing trend, particularly for guarantees given to foreign financial institutions. The Report of the Auditor General for 1998/99 states that "no proper record keeping system existed to ensure that all guarantees administered by Treasury were reported by the Ministry of Finance".



**Table 9: Government loan guarantees granted to third parties**

N\$ million	95/96	96/97	97/98	98/99
to local institutions	121	125	243	330
to foreign institutions	0	139	146	504
Total	121	265	389	834
as % of GDP				
to local institutions	0.9%	0.8%	1.4%	1.7%
to foreign institutions	0	0.9%	0.8%	2.6%
Total	0.9%	1.7%	2.2%	4.3%

Source: Reports of the Auditor General 1995/96-1998/99

Government has since been guaranteeing loans from foreign financial institutions for state-owned enterprises, some of which are in very critical financial positions. These guarantees not only pose a default but also an exchange rate risk. There are strong reasons to believe that the current amount of guarantees granted by government is considerably higher than the level reached by 1998/99. This could easily undermine fiscal sustainability, if the underlying loans were defaulted upon. Questioned about the magnitude of government guarantees granted for the end of the fiscal year 2001/02 in the debate of the 2002/03 budget, the Minister of Finance refrained from disclosing the current figure. He nevertheless stated that he would “have no reservations in publishing the amount of Government guarantees in future budget statements” (second response by the Minister of Finance, 2002).

The issue of explicit and implicit contingent liabilities is of major concern. The continued proliferation of state-owned companies requiring government guarantees, especially those which may involve significant future liabilities such as the Development Bank of Namibia, means that government will have to monitor contingent liabilities much more closely if it is to avoid fiscal problems in future.

### **Maintaining economic sovereignty will require some important policy changes.**

This short paper has shown that Namibia has succeeded in rapidly accumulating a significant amount of public debt since independence, despite that fact that all pre-independence debt was written off in 1997. In his 2002/03 budget speech to Parliament, the Minister of Finance announced that the stock of public debt had breached the 25% of GDP target that he himself had set only a year before. While most of this debt has been accumulated by selling treasury bills and bonds to domestic institutions, the proportion of debt owned to foreign institutions is rising. This has come about as a result of a combination of currency depreciation and the accumulation of new foreign albeit mostly on concessional terms. The need to borrow has been aggravated by government’s inability to accurately estimate cash flow (both revenues and expenditures) which leads to over-borrowing and higher interest payments. The fact that foreign loans bypass the state revenue fund altogether makes analysis of the true fiscal situation more difficult. Whilst a high proportion of capital spending is financed by borrowing, there appears to be little convincing assessment of the quality of this expenditure, especially with regard to the question of whether it is likely to lead to increased future revenues. As far as is known, Namibia still lacks a government wide discount rate against which projects are assessed.





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At the same time the proliferation of state-owned enterprises, other public institutions and government intervention in the economy has led to a rapid increase in the magnitude of explicit and implicit contingent liabilities. The present extent of all contingent liabilities is not known but explicit contingent liabilities are likely to be much higher than the last published figures from 1998/99.

The present situation invites fiscal problems in future. Furthermore, the lack of timely and comprehensive information about, not only the stock of debt, but the extent of other fiscal liabilities means that lenders to government are not fully informed about government's ability to repay. They are therefore likely to demand higher interest rates as a risk premium.

The present approach to debt management could be improved by introducing a number of modifications to the budgeting process and by striving to gain greater credibility with lenders by meeting clear and realistic debt targets. First, foreign loans to government should be fully accounted for on both the revenue and expenditure side of the government budget. Second government should publish alongside the budget document and at the end of each quarter a detailed and up-to-date account of its actual and contingent debt situation. Third government should improve its cash flow management by forecasting revenues more accurately and seeking tighter control over expenditure with the aim of reducing interest payments on short-term borrowings. Fourth, government should clearly state its approach to borrowing and borrow only to cover expenditures that can clearly show a return. Foreign borrowings should only be for projects which can demonstrate an economic return that outweighs the cost of the loan. Finally, government should publish clear and consistent debt targets, making clear the assumptions of GDP growth required to meet those targets, and then meet those targets. Together these measures will help reduce the likelihood of future fiscal problems, maintain economic independence and reduce the cost of borrowing.

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