

Fiscal Space Profiles of countries in the Eastern and Southern Africa Region

Case Study Lesotho

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Fiscal Space Analysis – Kingdom of Lesotho
Final version



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List of abbreviations

CIT	Corporate Income Tax
CPI	Consumer Price Index
CMA	Common Monetary Area
CPIA	Country Policy and Institutional Assessment
ECCD	Early childhood care and development
FSA	Fiscal Space Analysis
FY	Financial Year
GDP	Gross Domestic Product
IMF	International Monetary Fund
LRA	Lesotho Revenue Authority
NSDP	National Strategic Development Plan
PEFA	Public Expenditure and Financial Accountability
PFM	Public Finance Management
PIT	Personal Income Tax
SACU	Southern African Customs Union
SARB	South African Reserve Bank
VAT	Value Added Tax

Executive summary

The greatest threats to expanding Lesotho's fiscal space are exposure to the sluggish South African economy and rising public debt. Lesotho's economic performance is dependent on its large neighbor, South Africa. Consequently, South Africa's poor economic outlook, high interest rates, continued export volatility, and declining domestic and foreign investment mean that Lesotho's growth trajectory will also remain constrained over the medium term. A moderate economic growth outlook for Lesotho therefore implies that the current upward trend of its public debt will lead to rising debt-servicing costs. These issues will restrict the country's already limited fiscal space. To reverse this rise in public debt, the government may need to curtail its discretionary expenditure.

The Government of Lesotho has remained committed to increasing spending on priority sectors – defined as education, health and social development – in recent years. Priority expenditure on children steadily rose from 12.7% to 14.6% of GDP between FY2011/12 and FY2015/16, with the exception in FY2013/14 when expenditure amounted to 15.1% of GDP. Priority expenditure on children will continue to rise if the government's plan to retrain and redeploy defense staff to the education, health and social development sectors comes to pass. On spending across the priority sectors, the Ministry of Education has the largest expenditure, which rose from 7.4% to 7.9% of GDP from FY2011/12 to FY2015/16. Similarly, the Ministry of Health's expenditure increased from 5.4% to 6.1% of GDP over the same period. Meanwhile, the Social Development Ministry, which was created in 2012, spends relatively less (under 1% of GDP in the latest fiscal year). Its expenditure is, however, expected to grow over the medium term, especially if the government increases the amount of funding for its Child Grant Program (an unconditional cash transfer program for poor families with children) and indexes the size of the benefit to inflation rates.

In a baseline status-quo scenario where economic growth is in line with recent trends, increasing spending on priority sectors based on projected needs will lead to a fiscal-space financing “gap”. The projected priority expenditure will be an average of 14.8% of GDP between FY2016/17 and FY2020/21, which translates into US\$335 per child (at FY2015/16 prices and exchange rate). The additional financing required to bridge this gap will amount to 4.1% of GDP, which will come from borrowing. As a result, under the baseline scenario, total debt will increase from 58.6% to 67.7% of GDP.

One option to enlarge fiscal space is through increasing the VAT rates applied to alcohol and tobacco products. A proposal is currently on the table to increase the rates to around 19%. Even though the VAT revenue from these products contributes marginally to the total revenue pool, this sharp increase in VAT rate would considerably enhance the existing fiscal space. As compared to the base scenario, increasing the VAT rate on these products could increase the average tax revenue-to-GDP ratio by 0.2 percentage points. If all of the additional tax revenue were to be channeled toward priority sectors, total priority expenditure would increase by 0.3 percentage points or by US\$6.20 per child (assuming debt ratios remain the same).

Growing the tourism and mining industry is another option to expand fiscal space. The government has a renewed focus on attracting more international travelers. And although the tourism industry is relatively small, more travelers could generate more revenue, even if marginal over the medium term. The mining sector, in contrast, is set to improve substantially if global demand for commodities continues to rise and prices continue to recover over time. Aside from benefiting from greater revenue, efficiency gains could also be realized by addressing governance

issues that are prevalent in the sector and lowering barriers to encourage more private sector investment. Compared to the base scenario where average tax revenue is projected to be 25.4% of GDP, the average tax revenue from increased economic activity in the mining and tourism sectors will reach 26.1% of GDP. Notably, assuming the increase in tax revenue is allocated to child-friendly sectors, priority expenditure per child will increase by US\$44.30 as compared to the base scenario.

A third potential option to expand fiscal space for priority sectors is to improve the efficiency of public sector administration. Poor budget execution, a high public sector wage bill and a highly inefficient grant system are major challenges in Lesotho's public sector financial management system. Addressing these various issues could potentially reduce waste, leakage and misuse of available resources and thereby increase actual expenditure in priority sectors without requiring additional funding.

Increasing debt, in contrast, does not appear as a strong option for increasing investments in priority sectors. Lesotho already faces a high and growing debt-to-GDP ratio, which limit its access to reasonable lending terms. At the same time, non-concessional external debt is not recommended to fund education and health expenditure as yields from these investments are only reaped over the long term, which extend far beyond the terms of these types of debt arrangements.

Despite the challenges presented by a grim economic outlook and rising public debt, Lesotho has options to ramp up spending on sectors that matter for children. In particular, increasing tax rates on "sin" products, supporting greater growth in the tourism and mining industries, and addressing existing spending inefficiencies, including poor budget execution and an egregious wage bill, can go a long way to address the fiscal gap and improve the lives of children across the country.

1 Introduction and methodology

This report analyses the Lesotho government's recent and future financial capacity to carry out expenditure on which children depend for their human development and general welfare. This financial capacity is understood to be the "fiscal space" underlying such expenditure. The fiscal-space analysis has been carried out using a fiscal-projection exercise in Excel.

1.1 Priority expenditure categories for children

This report refers to expenditure categories regarded as beneficial to children as "priority" expenditure. For Lesotho, such priority expenditure categories for children comprise the following three "institutional" expenditure categories: (i) education; (ii) health; and (iii) social development.

The composition of the government's priority expenditures for children is, inevitably, somewhat arbitrary. Government expenditure classified as "priority" includes aspects that are unrelated, or only loosely related, to children's welfare, such as higher education expenditure or expenditure on an old age grant. At the same time, some expenditure categories classified as non-priority are highly relevant to children, notably, for example, in the water and sanitation sector. This is especially important to bear in mind when considering possible scenarios to enhance priority expenditure by reducing non-priority expenditure. Future analyses of this kind may work with different definitions of priority expenditures for children. Even so, the methodological approach used in this study could work in the same way. That is, the methodological approach in itself is the fundamental recommendation.

It is also important to bear in mind that fiscal space discussion concerns only expenditure carried out by government within its budget. Government expenditure on education and health plainly constitutes the bulk of the resources dedicated to education and public health in Lesotho. Much of this expenditure is in categories that only the government carries out, or could carry out. Nevertheless, non-governmental expenditure in these sectors is also significant. Especially in the health and social development sector, some important programmes are funded by private and NGO entities, some of which receive donor support. These would not be included in the government budget. The present focus, however, is the expenditure flows in the priority sectors that flow through Lesotho's fiscal accounts and hence are recorded "on budget."¹

A final note refers to one of the key measures used in the FSA in order to examine and compare both historical spending and the variation in priority expenditure under different scenarios, namely priority spending per child. This measure takes the total spending in the priority expenditure categories and divides this by the total number of children aged 18 or younger in Lesotho. The figures on per-child priority spending obtained in this way are to be treated with caution since only a proportion of total expenditure at the institutional level benefits children directly.²

¹ While it would be possible to carry out the kind of analysis this chapter describes using an enhanced set of accounts going beyond the official budget accounts, it may prove challenging to identify and incorporate all relevant expenditure programs and funding sources.

² For instance, the old age grant, child grant and school feeding programme together constitute approximately 2.66% of GDP of which the old age grant is responsible for approximately 88.9%. However, as we do not have reliable historical data that is disaggregated to this level, we cannot isolate data strictly focussed on children in all instances. The projection exercise therefore takes all expenditure at an institutional level into account. It can be argued that even though all this expenditure is not directly focussed on children, it still has significant secondary benefits to them.

Priority expenditure ‘identity’ and analysis

To analyse fiscal space for priority expenditure, the methodology first sets from the “identity” that governs the relationship of priority spending with its underlying fiscal space.

This identity states that total expenditure (comprising current, non-interest, interest, and capital expenditure) less the sum of total revenue and external grants is equal to the overall deficit, which is in turn equal to the net flow of external and internal financing. If total expenditure is broken down into the three categories of (1) priority and (2) non-priority non-interest expenditure and (3) interest expenditure, this identity can be rearranged for any year as shown in the box.

The “below-the-line” accounts taken together constitute fiscal space for the priority-expenditure flow. For a *retrospective analysis* – that is, for analysis of fiscal performance in historical years – this structure can be applied directly to show how the below-the-line flows (the retrospective fiscal space) combined to finance the priority expenditure flows. Section 1.3 describes the historical quantitative analysis for Lesotho, for the years FY2011/12- 2015/16.

<i>Fiscal identity</i>
<i>Priority expenditure</i>
=
<i>Tax and non-tax revenue</i>
+ <i>External grants</i>
- <i>Non-priority expenditure</i>
- <i>External debt service</i>
- <i>Internal interest expenditure</i>
+ <i>External debt disbursements</i>
+ <i>Net internal financing flows</i>

For the *projection analysis*, the accounting identity is applied in a different way. For each projection year, the priority-expenditure flow is projected on the basis of programming assumptions, encompassing the various determinants of recurrent and non-recurrent expenditure in the education, health, and social development categories. Similarly, the below-the-line accounts, except for the net internal financing flows, are projected on the basis of programming assumptions. The total net internal financing flow for each year is then calculated residually, to ensure that the accounting identity is satisfied.

For any projection year, this net internal financing flow is the fiscal space “gap”, that is, the difference between the projected priority-expenditure flow and the projected financing requirements. If this gap is “too large,” then the programming assumptions, taken together, would be considered unfeasible. The criteria for “too large” include the limits on the government’s capacity to borrow in domestic financial markets and the implied increase in the government’s debt-GDP ratio. Policy-makers would presumably want to avoid having the net internal borrowing flow exceed 2-3 per cent of GDP in coming years, to avoid having the internal-debt burden rise as a percentage of GDP.

The projection exercise is formulated by applying various assumptions, together constituting a “scenario” to the historical data base. The relatively simplified, illustrative projection exercise applies scenarios to historical data (as discussed in Appendix 1). Each scenario comprises programming assumptions for the years FY2016-17 to FY2020-21, covering:

- world economic conditions;
- basic Lesotho macroeconomic variables;
- merchandise exports and imports;
- tax and non-tax revenue;
- external grants to the government;
- government expenditure in the priority and non-priority categories; and
- external and internal debt.

For each scenario, some of the assumptions lines are set as simple numbers (growth rates, percentages of GDP, etc.). Many of the assumptions, however, are constructed from other assumptions. For example, the growth rates of real GDP and of the price level are numbers that the analyst chooses based on projections by either the World Bank or IMF. It is straightforward to combine these assumptions into an assumed growth rate for nominal GDP.

1.2 Limitations of the data

This analysis is based on budgetary data covering actual figures (budget outturn) for the Fiscal Years (FY) 2011/12- 2015/16. The main data source is the Ministry of Finance. Additional data sources include the Bank of Lesotho, UNICEF, as well as the World Bank/ IFC and the IMF. Despite a substantial data-collection effort, the quantitative analysis presented in the sections below is subjected to an important caveat. Namely, data on spending in the priority-expenditure categories is limited. Functional level breakdown of data was not available in more detail, in particular, associated expenditures classified under the economic budget classification could not be obtained. Thus, as noted before, for the modelling exercise, which looks into aspects such as increases in staff levels, priority expenditure categories were taken to be those of the main government institution responsible for the respective area. Since detailed data were not available for more detailed expenditure categories, we could not produce more refined definitions and calculations for scenarios involving relevant sub-categories.

1.3 Organization of the FSA

The remainder of this report is organized as follows. Chapter 2 summarizes Lesotho's present macroeconomic and fiscal circumstances; it also analyses the budgetary process and the general efficiency of the fiscal framework and looks at the recent evolution of priority expenditure flows in the categories of priority expenditure and outlines some specific challenges in the various areas relevant for expenditure on children. Chapter 3 discusses various options available to policy makers to enhance fiscal space with an illustrative projection exercise for the priority expenditure flows and fiscal space that would fund them for the years FY2016/17-FY2020/21. The exercise consists of a base scenario, comprising a broad range of macroeconomic and fiscal policy assumptions, and various alternative scenarios. Chapter 4 presents the main findings from the analysis. Further projection details are included in Annex 1.

2 Defining fiscal space

2.1 Macroeconomic and fiscal characteristics

Table 1 and Figure 1 shows some of the basic macroeconomic indicators for Lesotho for the fiscal years FY2011/12-FY2015/16.

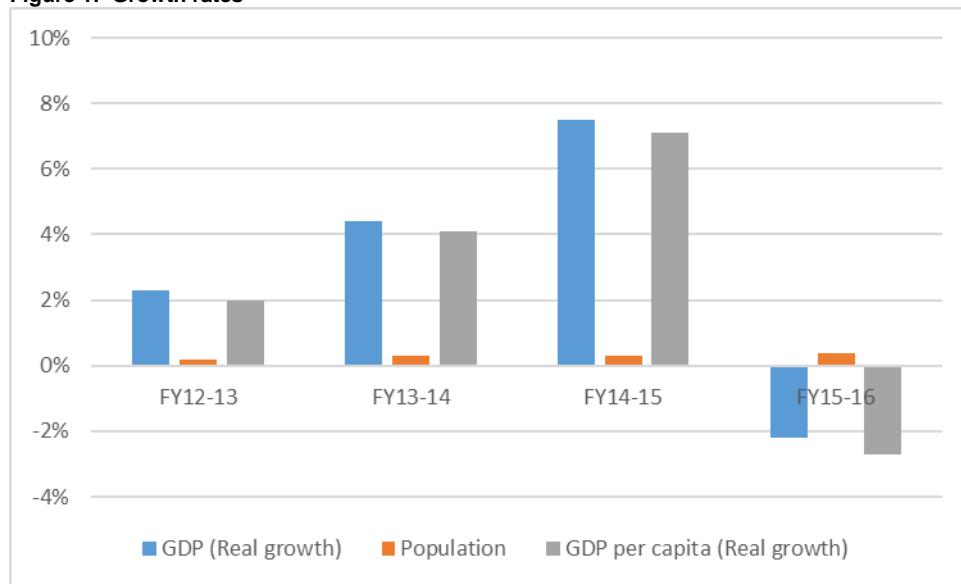
Table 1: Selected macroeconomic indicators, FY2011-2016

	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16
Gross domestic product*	23 530.50	4 078.20	25 44.70	27 031.9	26 424.5
<i>Per-capita:</i>					
Gross domestic product*	12 395.50	12 643.70	13 156.90	14 090.00	13 716.40
Non-government consumption**	10 724.80	11 108.90	11 184.80	11 154.20	10 643.60
<i>Per cent of GDP:</i>					
Gross fixed capital formation	23.90%	24.70%	28.30%	32.30%	33.20%
Fiscal balance	-2.20%	-6.30%	-4.70%	-6.30%	-4.90%
Merchandise-trade balance	-56.70%	-52.20%	-53.40%	-53.70%	-52.30%
<i>Growth rate:</i>					
Consumer prices (December)	7.70%	4.50%	5.10%	3.60%	5.10%
Exchange rate (December)	19.50%	5.70%	20.10%	10.40%	30.80%
<i>Growth rate:</i>					
Headcount poverty incidence	59.70%	n/a	n/a	n/a	n/a

* National Currency at 2015/16 prices.

Sources: (The World Bank, 2017) (International Monetary Fund, 2017) (Ministry of Finance, 2017)

Figure 1: Growth rates



Source: (Ministry of Finance, 2017)

2.1.1 Recent economic developments

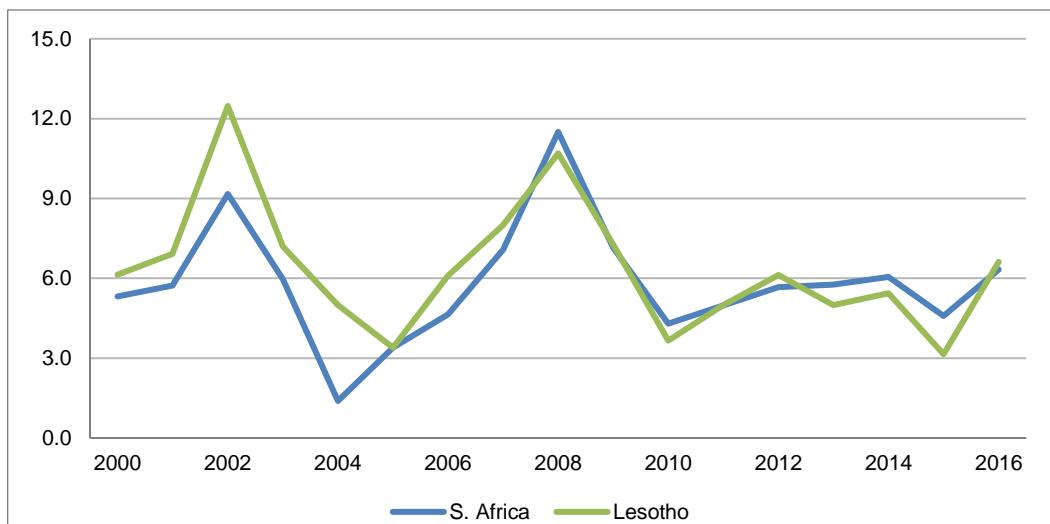
As illustrated in Figure 1, Lesotho's economy grew consistently between FY11-12 and FY14-15. Figure 1 also shows that real GDP growth was greater than population growth over this period

leading to consistent GDP per capita growth. This was primarily driven by the performance of the mining and construction sectors which account for roughly 15 and 7 percent of GDP respectively. The negative economic growth in real terms experienced in FY15-16 reflects that these sectors are struggling to increase output. Some of the key challenges include increased uncertainty around Lesotho's level of access to the U.S. market, increased global competitiveness and decreasing public and private investment, specifically, in the construction sector. Moreover, drought conditions in the Southern African region between 2015 and 2016 impacted agricultural sector performance, further hampering economic growth.³

Besides the domestic economic challenges, Lesotho is also susceptible to global and regional economic conditions, especially the economic conditions in South Africa. Lesotho, together with Namibia and Swaziland, falls under the Common Monetary Area (CMA), which follows a currency arrangement at parity with the South African Rand. This arrangement exposes these countries to South Africa's volatile but overall consistently depreciating currency (as evidenced in Table 1 above, the Loti depreciated 31 percent in 2015). The CMA is effectively managed by the South African Reserve Bank (SARB), therefore the ability for each of these countries to set an independent monetary policy is somewhat limited.

The SARB's main monetary policy objective is to anchor annual CPI inflation between 3 and 6 percent. Due to various upside risks to inflation,⁴ since July 2015, the SARB has increased the repo rate by 125 basis points.⁵ Consequently, Lesotho's interest rates have been on the rise.⁶ Lesotho's inflation is however heavily influenced by South Africa's (as illustrated in Figure 1) and even if independent, Lesotho's monetary policy would most probably track that of South Africa. Nevertheless, the recent upward rate cycle would have constrained Lesotho's recent economic growth performance.

Figure 2: Annual Inflation, FY 2000/01-2016/17



Source: Lesotho Bureau of Statistics (2017), Statistics South Africa (2017)

³ (International Monetary Fund, 2016)

⁴ Includes increasing electricity prices, a weakening exchange rate and a severe drought that substantially influenced food prices (National Treasury, 2016)

⁵ (South African Reserve Bank, 2016)

⁶ Unlike the Central Bank's of Namibia and Swaziland, which have different policy rates from the SARB, Lesotho's policy rate follows directly from the SARB.

Although South Africa's inflation has stabilised, there is still substantial uncertainty around what will happen going forward as inflation remains above the upper band of the target. Political risks also continue to contribute to exchange rate depreciation.

Just as the upward repo rate cycle would have negatively influenced Lesotho's historical economic growth, the direction of the future repo rate will significantly influence Lesotho's growth trajectory. Not only will the higher repo rate depress consumption, but the private sector will be more likely to invest excess cash in interest-bearing accounts rather than investing in business expansion. This has a direct effect on unemployment rates as businesses storing cash are unlikely to expand their employee numbers. The impact of South Africa's monetary policy on Lesotho is therefore substantial. It directly affects the performance of the construction and manufacturing sectors, Lesotho's most prominent sectors, as well as other sectors that rely heavily on infrastructure investment.

Another avenue through which South Africa's economic performance influences Lesotho's is through remittances. Although it has declined substantially over the last 25 years, Basotho households are still heavily reliant on remittances of Lesotho residents working in the South African mining sector. In 2015, income from remittances stood at about 16% of GDP, which is significantly lower from 2010 when it reached 25% of GDP. Besides the obvious benefits of remittances to GDP through increased private domestic consumption, remittances are an important safety-net for Basotho households and significantly decrease the burden on the Lesotho government's social wage bill. Research by the Central Bank of Lesotho has found that about 14% of the remittances are spent on health and education, a significant proportion of which is on children.⁷ The decrease in remittances over time at least partly explains the decrease in per capita non-government consumption presented in Table 1.

South Africa's poor economic outlook, rigid and high interest rates, export uncertainty, especially related to the U.S, and decreased domestic and foreign private and public investment means Lesotho's growth trajectory is set to remain subdued over the medium term. It is likely that Lesotho's economic performance is set to fall substantially below the National Strategic Development Plan's target growth rate of between 5-7 percent.⁸ The World Bank projects growth to average just under 3 percent over the next few years⁹ while the IMF is more optimistic, projecting growth at approximately 3.5% between 2018 and 2022.¹⁰

2.1.2 *Fiscal performance*

The table below shows the tax rates of the main sources of tax revenue in Lesotho.

Table 2: Lesotho Tax rates

Tax instrument	Specifications	Rate
Corporate income tax rate*	Manufacturing companies	25%
	Non-manufacturing companies	10%
VAT rate*	Specified basic commodities	0%
	Electricity and telecommunications	5%
	Liquor	15%
	other commodities	14%
Personal income tax rate**	Income < 51 670 Loti	20%

⁷ (Central Bank of Lesotho, 1996; Ministry of Finance, 2015)

⁸ (Ministry of Finance, 2015)

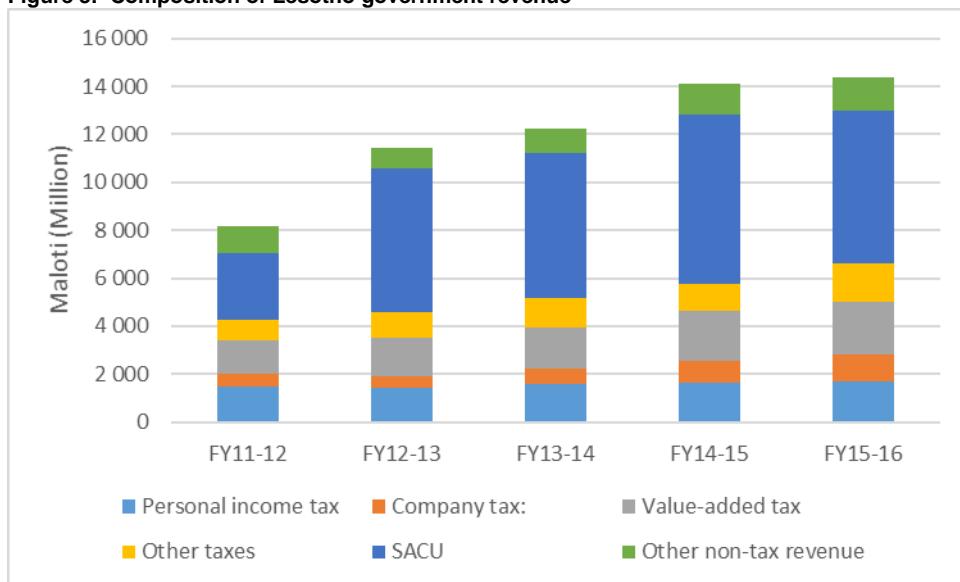
⁹ (World Bank, 2017)

¹⁰ (International Monetary Fund, 2017)

	Income > 51 670 Loti	30%
Source: * (Ernst and Young, 2016); ** (Ernst and Young, 2016)		

Table 1 shows that the Lesotho government has run an average fiscal deficit of approximately 5 percent since 2011/12 ranging between 2.2 percent and 6.3 percent. On the one side of this equation, Personal Income Tax (PIT) (11.9 percent of total government revenue in FY15-16), Company Income Tax (CIT) (7.8 percent of total government revenue in FY15-16), Value-Added Tax (VAT) (15.4 percent of total government revenue in FY15-16) and transfers from the Southern African Customs Union (SACU) (44.6 percent of total government revenue in FY15-16) are generally the largest contributors to Lesotho's revenue pool; by far the greatest of which is the annual SACU transfer. Figure 3 also illustrates the composition of the Lesotho government's revenue and the changes over time.

Figure 3: Composition of Lesotho government revenue

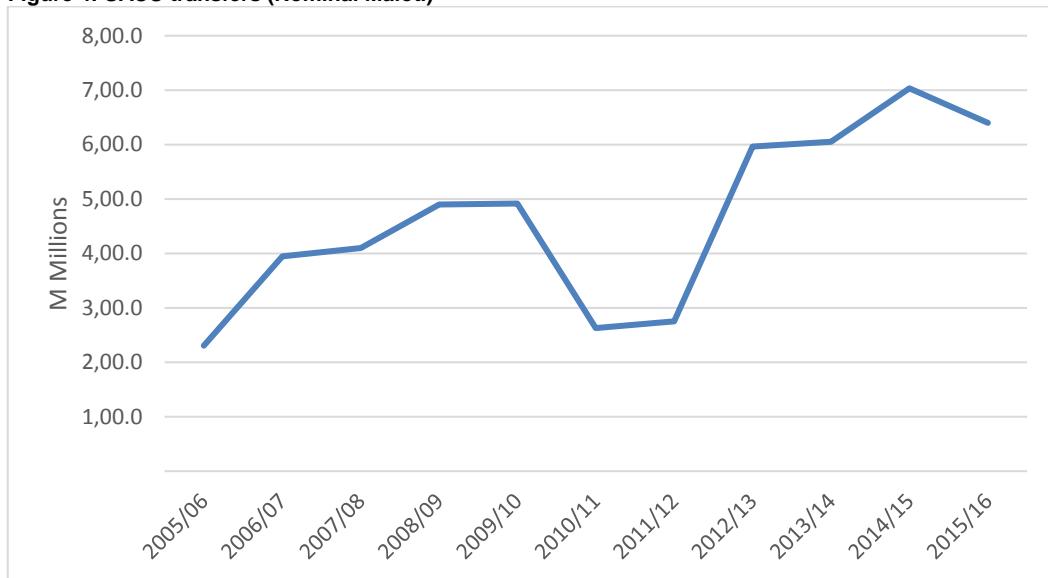


Source: (Ministry of Finance, 2017)

Lesotho, together with Botswana, Namibia, South Africa and Swaziland, is a member of the Southern African Customs Union (SACU). South Africa makes the largest economic contribution to the union – consequently leaving the customs pool at risk to the country's economic performance. So not only does South Africa's economic performance affect Lesotho's economic growth in general, it also has a direct impact on the government's fiscal position. South Africa's projected low growth outlook is set to substantially reduce the customs pool over the medium term. As per the current revenue sharing formula, given the size of its economy and the proportion of imports relative to the member countries, Lesotho consistently receives approximately 8 percent of the revenue pool.

Even though the proportion of the revenue pool received by Lesotho is relatively constant, large variance in the size of the pool leads to volatile SACU revenue flows to Lesotho as illustrated in Figure 3.. The large drop in SACU revenue after the debt-crisis of 2008 (see Figure 3) demonstrates how little buoyancy SACU revenue has and exemplifies the risk of Lesotho's reliance on this revenue source. Although it has recovered since then, South Africa's poor economic outlook likely implies a small SACU revenue pool and potentially diminished transfers to the member countries going forward. Given its large contribution to the Lesotho government's revenue pool, diminished SACU revenue flows will have a significant impact on overall fiscal sustainability and poses substantial risk to Lesotho's fiscal space overall.

Figure 4: SACU transfers (Nominal Maloti)



Source: (Ministry of Finance, 2017)

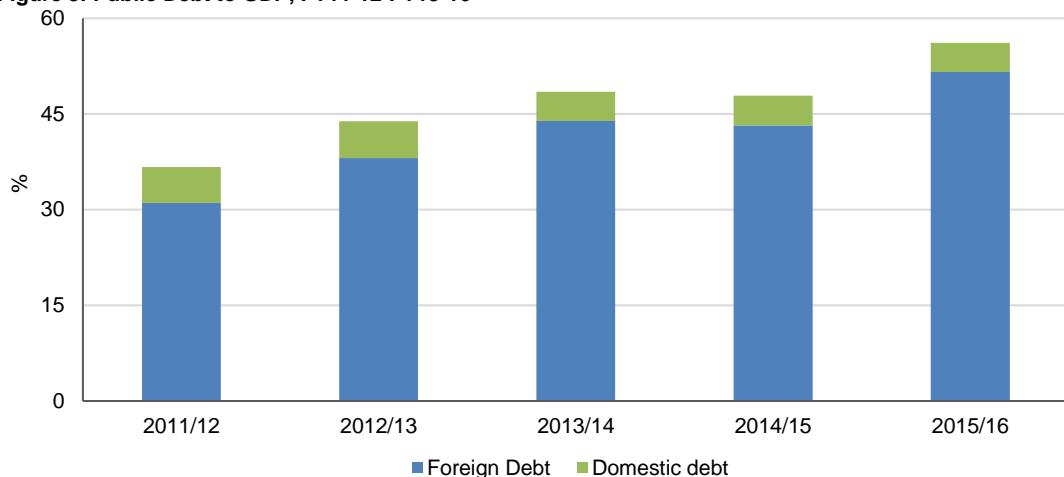
The growth in tax revenue, consisting of mostly CIT, PIT and VAT revenue has generally outpaced GDP growth over the last 5 years. The Lesotho Revenue Authority has clearly articulated its commitment and efforts to enhance the tax base, by way of introducing the Integrated Revenue Management System¹¹. Nevertheless, the rate of improvement is unlikely to be enough to significantly reduce the reliance on SACU revenues in the immediate future.

On the opposite side of the fiscal balance equation, government expenditure has gradually decreased as a percentage of GDP from 67 percent in FY09-10 to 60 percent in FY15-16. However, as GDP growth has also outpaced revenue growth over the period by a similar margin, the slower expenditure growth has not meaningfully translated into fiscal space. Considering planned expenditure on large infrastructural projects, as well as the high wage bill, it is most likely that expenditure will, at the very least, continue on its current growth trajectory over the medium term. Lesotho's government wage bill accounts for over 80 percent of recurrent expenditure and is the largest driver of government total expenditure. This is unsurprising given that government is the largest employer in the country. While growth in civil servants' wages are anchored to inflation, the expected rise in the working age population will put further pressure on government to create more job and increase expenditure on wages and salaries.

Although government revenue has been growing faster than government expenditure since FY09/-10, the growth differential has only decreased the fiscal deficit from 4.2percent in FY09-10 to 2.1percent in FY15-16. As evidenced in Figure 4, there has consequently been a rising trend in public debt over the last few years. Public debt has almost doubled in the past 5 years, reaching 56 percent of GDP in FY2015/16. This trend is largely ascribed to increases in external debt, which constitutes more than 90 percent of public debt (or 51 percent of GDP). According to the IMF's World Economic Outlook, Debt as a percentage of GDP is set to decrease over the next five years.

¹¹ (Ministry of Finance, 2013)

Figure 5: Public Debt to GDP, FY11-12-FY15-16



Source: (Ministry of Finance, 2017)

The IMF argues that the injection of funds towards major infrastructure development projects such as the Lesotho Highlands Water Project amongst others has underpinned this increase in external debt¹². Domestic debt too, albeit marginal, has been rising in recent years. While the government has occasionally drawn down on its international reserves to augment its financing needs, it finds itself in a precarious situation as it seeks to maintain international reserves of at least 3-months of import cover. In the context of already declining reserves, the ability to draw down on these assets without unduly undermining import cover will be limited going forward. In this case, the government will need to resort to domestic debt.

The medium-term outlook is likely to pose two key risks to public debt and overall fiscal sustainability. Firstly, the poor economic outlook as well as the political instability in South Africa are likely to place upside risk on the currency – in which case the cost of external debt is set to rise. Secondly, as government revenue does not seem to react significantly to economic growth, without direct intervention in the tax system through new instruments or improved efficiency, it will be difficult for Lesotho to address its annual fiscal deficit.

Furthermore, budgetary support from donor funds is quite small and declining, with grants currently sitting just under 4 percent of GDP. Issues within the country's public finance management system have resulted in a decrease in capital grants to the government as well as social assistance benefit placements¹³. Unless this is addressed, further declines in donor assistance could increase the pressure on Lesotho's fiscal balance.

2.2 Lesotho's priority expenditure and fiscal space

2.2.1 Priority expenditure and fiscal space in recent years

Reflective of the government's commitment to improving education, health and social development, priority expenditure in Lesotho has been rising over the last few years. Table 2 below provides a breakdown of Lesotho's priority expenditure as a percentage of GDP. As evidenced in the table, priority expenditure on children (with exception of FY14-15) has been rising gradually over the years, and currently stands at 14.6 percent of GDP. The education and health sectors assume the bulk of this expenditure. While the Ministry of Education spends the most as a proportion of GDP, the Health Ministry's expenditure as a proportion of GDP has been rising rapidly, from a 5.4 percent

¹² (International Monetary Fund, 2016)

¹³ (Lesotho Central Bank, 2016)

in FY11-12, to 6.1 percent in FY15-16 (compared to the education sectors share of 7.4 percent to 7.9 percent in the corresponding periods). Meanwhile the Social Development sector makes up a small share of priority expenditure (less than 1 percent). Although it is perhaps important to note that the ministry was only created in 2012, therefore could potentially grow over the years.

Table 3: Priority expenditure for children and its fiscal space FY2011-12 to FY2015-16¹⁴

Fiscal year	FY11/12	FY12/13	FY13/14	FY14/15	FY15/16
Per cent of GDP					
Total priority expenditures for children	12.7%	13.8%	15.1%	14.4%	14.6%
Total education expenditure	7.4%	7.8%	8.0%	7.8%	7.9%
Total health expenditure	5.4%	5.9%	6.8%	6.1%	6.1%
Total social development expenditure	0.00%	0.07%	0.27%	0.49%	0.62%
Overall fiscal space					
Tax and non-tax revenue (excl. external grants) (+)	34.8%	47.5%	48.6%	52.1%	54.3%
External grants (+)	6.1%	7.1%	4.2%	1.8%	3.7%
Total non-priority non-interest expenditure (-)	-35.6%	-36.2%	-39.4%	-35.8%	-44.5%
External-debt disbursements (+)	1.7%	5.2%	2.9%	3.9%	2.2%
External debt service (-)	-1.2%	-1.3%	-0.8%	-1.6%	-2.4%
Net internal financial flows (incl. internal interest) (+)	6.6%	-10.2%	-3.4%	-9.1%	-2.0%
Net IMF Loans	0.3%	1.6%	3.0%	2.9%	3.2%
Growth rates					
Total priority non-interest expenditure:	10.8%	14.4%	2.2%	-0.6%	
Contribution to the growth of total priority expenditure:					
Tax and non-tax revenue (excl. external grants) (+)	39.7%	3.5%	39.7%	6.9%	
External grants (+)	18.6%	19.7%	18.6%	-38.5%	
Total non-priority non-interest expenditure (-)	4.1%	29.5%	4.1%	13.7%	
External-debt disbursements (+)	214.1%	7.9%	214.1%	-42.7%	
External debt service (-)	8.0%	14.0%	8.0%	-34.6%	
Net internal financial flows (incl. internal interest) (+)	-59.3%	-224.6%	-204.4%	-74.1%	
Net IMF Loans	7555.7%	544.3%	92.6%	5.4%	

Source: (Ministry of Finance, 2017)

Table 2 above also provides a breakdown of how Lesotho's priority expenditure is financed. The following is observed:

- Tax and non-tax revenue has been increasing over the years as a percentage of GDP. While tax revenues have certainly increased over the years, this rising trend is mainly due to the performance of SACU revenues; a trend that has worryingly increased Lesotho's reliance on this volatile revenue source. For instance, in FY2011/12, where tax and non-tax revenue was at its lowest (34.8 percent of GDP), SACU revenues stood at M2.7bn. In the subsequent years, SACU revenues were significantly higher, reaching M5.9bn FY2012/13, then rising further to M7.0bn in FY2014/15, before declining to M6.4bn in FY2015/16. As mentioned earlier, the government remains committed to seeking avenues to enhance and grow tax revenues significantly in a bid to reduce its reliance on SACU's fluctuating revenue stream. The Lesotho Revenue Authority has indeed committed itself to "*the development and implementation of strategies that will optimise the collection of domestic revenues*"¹⁵.

¹⁴ Figures stated represent ministerial level data.

¹⁵ (Lesotho Revenue Authority , 2012, p. 22)

- In the three years leading to FY12-13, external grants have been on the rise, reaching a high of 7.1 percent of GDP in FY15-16. Subsequently external grants have decreased significantly, reaching a low of 1.8 percent in FY14-15, before rising to 3.7 percent in GDP in FY15-16. This trend is consistent with reduced budgetary support from external development partners. In particular, suspensions in budgetary support from the European Union and the Millennium Challenge Corporation¹⁶ following concerns of deteriorating public finance management systems.
- Total non-priority non-interest expenditure increased over the observed period. In the first four years, total non-priority non-interest expenditure remained steady within a range of 35 – 40 percent of GDP, thereafter increasing to 45 percent of GDP in FY15-16. While the government has articulated its commitment towards fiscal consolidation, the country's high wage bill, of approximately 20 percent of GDP proves to be a challenge in achieving this objective. Moreover, the rise in non-priority expenditure is further compounded by the somewhat expansionary fiscal policy that the government has adopted in a bid to implement the main objectives of the National Development Strategic Plan (NDSP). Therefore, the intention to pursue fiscal consolidation without undermining these objectives will pose a significant challenge to the government and will be heavily dependent on Lesotho's economic performance.
- External-debt disbursements have fluctuated over the years, from a low of 1.7 percent of GDP in FY11-12 to a high of 5.2 percent in the following year. In FY15-16, however external-debt disbursements reached 2.2 percent. External debt service too, has fluctuated between the years – reaching a low of 0.8 percent of GDP, to a high of 2.4 percent of GDP.
- Net internal financial flows have varied during the period of observation. These flows stood at 6.6 percent of GDP in FY11-12, and have ranged between -2 and -10.2 percent in the subsequent years.
- Lastly, apart from FY14-15 where there was a slight decline, net IMF loans have increased. Rising to 3.2 percent of GDP in FY2015/16, from as much as 0.3 percent in FY2011/12.

From the above trend analysis, it is evident to what extent fluctuations in SACU revenues affect the proportional contribution of tax and non-tax revenues to fiscal space. Moreover, the country's high wage bill, ambitious NSDP targets and decreasing external grants put additional pressure on the government's fiscal space. Nevertheless, while there are several constraints to Lesotho's fiscal space, a large share of the country's budget is currently allocated towards priority sectors.

Table 3 below provides a breakdown of child spending in priority expenditure categories. Interestingly, the average spend on priority sectors per child¹⁷ has declined between FY11-12 and FY15-16 as the child population has outgrown the growth in expenditure on priority sectors in US\$ terms.

Table 4: Per child spending in priority expenditure categories, US\$, FY 2011/12-FY15/16

US\$ per child at prices and exchange rate of 2015	FY11/12	FY12/13	FY13/14	FY14/15	FY15/16
Total priority expenditures for children	\$455.76	\$438.98	\$419.51	\$390.02	\$310.59
Total education expenditure	\$263.58	\$248.65	\$221.70	\$211.65	\$167.77
Total health expenditure	\$192.18	\$188.11	\$190.22	\$164.99	\$129.60

¹⁶ Conclusion of Lesotho's compact with the Millennium Challenge Corporation (MCC) has affected grants and capital expenditure. (International Monetary Fund, 2016, p. 5)

¹⁷ Priority expenditure per child is constructed by dividing expenditure in the respective ministry by the total number of children aged under 18 in Lesotho. Since total spending at ministerial level comprises expenditures that do not necessarily benefit children directly, the accuracy and meaningfulness of those figures is to be treated with caution.

US\$ per child at prices and exchange rate of 2015	FY11/12	FY12/13	FY13/14	FY14/15	FY15/16
Total social development expenditure ¹⁸	\$0.00	\$2.21	\$7.60	\$13.38	\$13.22

Source: (Ministry of Finance, 2017)

Given rising debt, volatile SACU revenue, perpetually increasing expenditure requirements for wages and infrastructure, slow growth in tax revenue, and decreasing donor funding, the need for Lesotho's budgetary process to ensure efficient allocation of resources becomes extremely important. The following section highlights some areas in which Lesotho's current public financial management threatens its fiscal space.

2.2.2 *Public financial management and its impact on fiscal space*

The Public Finance and Accountability Act prescribes the formal process for budgeting and specifies the responsibilities of different role-players in the budget process. Within government, there are two broad groups of role-players in the budget process: the executive and the legislature. The primary role of the executive is to draft and implement the budget in line with its policy objectives. The legislature scrutinises the draft budgets, legislates it, and monitors its execution. Once the budget is implemented, the legislature's role shifts to holding the executive to account for the public resources entrusted to them.

The budget cycle in Lesotho consists of five key stages over an 11-month period, beginning in April of each year, and ending in March of the following year. The five stages are listed below:

- Stage 1: Budget (strategic) planning
- Stage 2: Budget preparation (executive)
- Stage 3: Budget approval (legislative)
- Stage 4: Budget execution (implementation)
- Stage 5: Auditing and reporting

These five stages are for the most part aligned with international practice and would be the same in many other countries. However, as mentioned earlier, Lesotho's poor public financial management (PFM), especially in terms of medium term budgeting, has had a significant effect on its fiscal space as specifically donors are hesitant to partner with governments with poor management and governance. There is however a Public Financial Management Steering Committee operational tasked with improving the system which has recently been elevated to the ministerial level.

Besides impacting on the funds available to government, poor financial management also affects the efficiency of expenditure; a significant source of fiscal space. The budget execution phase is often viewed as the 'active' phase of the budget. Once funding is appropriated, it is spent during the budget execution phase. There are many reasons why the budget enacted and the budget implemented won't match. There may be changes required during the year as circumstances change. Good monitoring systems are needed to ensure that the budget is broadly spent as planned, and where it is not, appropriate authorizations are obtained before expenditure. Interviewed officials, and various PFM assessments point to different problems in the budget execution phase. Inadequate and weak information systems make real-time monitoring of the budget difficult. In the education, health and social development sectors, given the large amounts of public resources involved, efficient financial management systems that provide timely information

¹⁸ It is recognised that this item does not include all social protection expenditure. It is impossible, with the data that we have, to disaggregate expenditure of all other departments in order to isolate and allocate this expenditure to the social protection /development item. For the purposes of this report therefore, this item will always refer to the expenditure by the Ministry of Social Development.

on variations between actual and planned expenditure are essential. The lack of an efficient financial management system means that line ministries and the Ministry of Finance often don't have up-to-date and timely information to make decisions.

Another serious problem with the budget execution phase is the lack of controls within the government. One of the major consequences of this lack of checks and balances is the increasing levels of corruption in the public sector. Moreover, there are reports of the political executive interfering in the procurement process. As the head of the anti-corruption unit points out:

DCEO Director-General, Advocate Borotho Matsoso said it was ironic that while public procurement remained the “most vulnerable area to corruption,” procurement regulations and processes “usually do not say much, if anything at all about the ministries, yet from time to time, we get reports that Minister so and so has interfered procedurally with the procurement process”¹⁹

The Ministry of Health has been particularly vulnerable to procurement bottlenecks. Newspapers have widely reported on procurement difficulties and delays in the health sector. These procurement challenges are particularly concerning as they lead to stock-outs in clinics of essential medicines needed by children. An example of the consequence of procurement irregularities and delays is the frequent stock-outs of vaccines reported by clinics.

Procurement irregularities have also delayed capital expenditure, resulting in continuous underspending of the capital budget, as shown in Table 5. This trend is consistent with one of the main findings in a Public Expenditure and Financial Accountability (PEFA) assessment conducted in 2012, which reports that “execution of investment projects diverge significantly from the budget outlines”²⁰.

To summarise, Table 4 presents an overview of expenditure relative budget estimates in the five years leading to FY2015-16. Between 2011/12 and 2013/14, the government consistently spent more than estimated in terms of operational cost. In this case, overspending reflected the weak controls on spending within the budget execution phase.

Table 5: Budget execution rates, FY 2011/12-2015/16

Operational Expenditure	FY2011-12	FY2012-13	FY2013-14	FY2014-15	FY2015-16
Compensation of Employees	106.40%	104.30%	107.70%	92.60%	96.20%
Use of Goods and services	100.20%	98.20%	95.90%	95.70%	92.60%
Interest Payments	109.50%	110.40%	124.90%	84.80%	87.50%
Subsidies	57.00%	74.30%	81.50%	73.80%	96.70%
Grants	249.30%	94.10%	105.40%	73.10%	89.10%
Social benefits	155.80%	155.60%	144.40%	147.50%	141.00%
Other Expenses	96.90%	90.70%	105.40%	87.90%	95.80%
Capital Expenditure	85.00%	78.60%	90.00%	75.90%	96.00%

Source: (Ministry of Finance, 2011) (Ministry of Finance, 2012), (Ministry of Finance, 2013), (Ministry of Finance, 2014) (Ministry of Finance, 2015)

Besides the overall threat to fiscal space posed by poor PFM in Lesotho and the country's economic prospects, individual sectors also have their own unique budgetary challenges. The section below provides an overview of this in each of the three priority sectors chosen for this report.

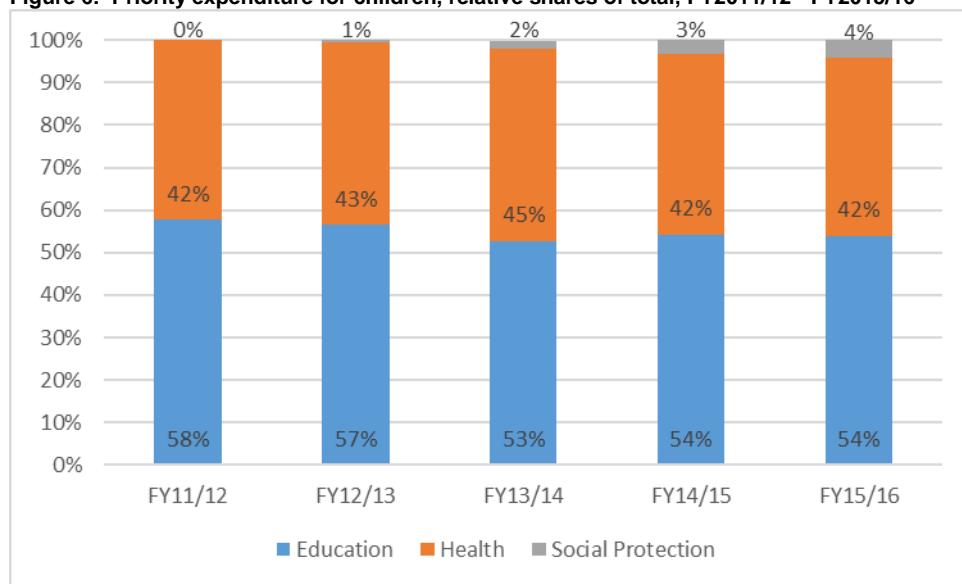
¹⁹ Invalid source specified.

²⁰ (ACE, International Consultants, 2012)

2.3 Current and future challenges and implications for fiscal space in the priority sectors

The table below provides a breakdown of the shares of total priority expenditure for FY11-12 - FY15-16. Education expenditure together with health expenditure take up the bulk of priority expenditure; over 90 percent. Education has the highest share, of about 55 percent, followed by health expenditure with a share of around 40 percent. The ministry of social development has a very small share. Nevertheless, the shares of each of these ministries have been fairly stable over the observed period.

Figure 6: Priority expenditure for children, relative shares of total, FY2011/12 - FY2015/16



Source: (Ministry of Finance , 2017)

2.3.1 Education

The Ministry of Education receives the largest share of the government budget, receiving a share of 18 percent in FY15-16. Figure 5 below presents a breakdown of the allocation of the education budget.²¹

- Primary education receives the largest allocation of the Ministry's budget. This is unsurprising given that Lesotho provides free primary school education, which includes school feeding programmes in a majority of schools²². Since the enactment of the Free Primary Education Act (2000) and the Education Act (2010), enrolment rates at the primary level have improved substantially. Since the enactment of the Free Primary Education Act (2000) and the Education Act (2010), enrolment rates at the primary level have improved substantially. Net primary school enrolment rates increased from 80.9% in 2001 to 83.5% in 2015, and the net cohort survival rate (NCSR) from 40.9% in 2006 to 65.5% in 2012.^{23²⁴}
- Secondary education however, is not free, therefore, its budget allocation is comparatively low (almost a third of primary education). This transition from free primary education to fee based

²¹ This breakdown includes programme allocation, and does not take into account allocations made to the various districts.

²² The World Food Programme (WFP) together with the Ministry of Education and Training (MOET) signed a Memorandum of Understanding stipulating that the MOET would fully fund the WFP to feed 400 000 pupils countrywide.

²³ Invalid source specified.

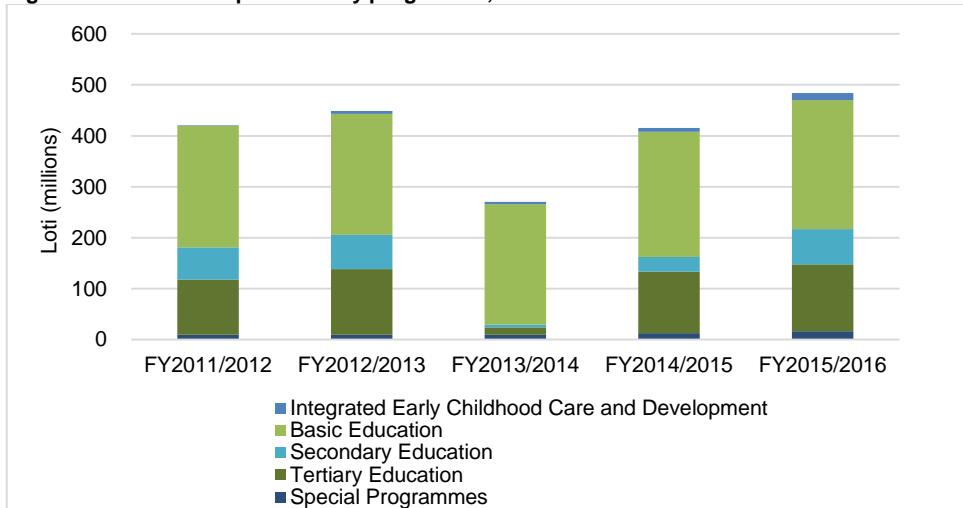
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secondary education presents many challenges to a country like Lesotho with a high rural and impoverished population²⁵. For instance, in its Education Sector Strategic Plan the Ministry of Education and Training estimates that approximately 30 percent of primary school leavers do not proceed to enrol in secondary education due to the cost of secondary education.²⁶

- Meanwhile early childhood care development (ECCD) although quite marginal, has almost doubled over the last few years. While this is indeed in line with the ministry's objective to expand the segment, rollout has been weak. For instance, only 243 of the 1400 public schools in Lesotho have capacity to offer these reception classes. While government acknowledges that it needs to construct more reception classes, it requires significant funds to not only construct the school, but also to fund the training and salaries of additional ECCD teachers.

The allocation of expenditure towards Special Programmes has increased in recent years. This programme effectively includes educational programmes geared towards the children with special educational needs (SEN). Much like the other programmes, access and quality of education remains a critical issue for these children. While the government has invested in construction and renovation of new and existing infrastructure to cater for these learners, resource constraints have slowed this process. As such capacity to absorb all these learners remains insufficient given the large demand.

Figure 7: Education expenditure by programme, FY 2011/12-2015/16



Source: (Ministry of Finance, 2017)

Despite the government's growing investment in education, issues related to access, quality and capacity are extensive. If anything, resolution of these issues will not only require significantly more resources, but the efficient use of resources such that the rate of return is maximised is essential. Although the education sector's new strategic plan is yet to be released, it is likely that the government will remain committed to providing equitable education to all. The government acknowledges the importance of basic education as a tool for improving social and economic development. Therefore, it is likely that the ensuing strategic plan will be directed towards promoting improved quality and access to schools through 'equipping schools and educational centres; reforming the curriculum; ensuring the provision of teaching and learning materials; investing in teacher training and professional development; and providing cost-effective and efficient teacher supervision and support' (Ministry of Education and Training, 2005-2015, p. 12).

²⁵ The World Bank estimates Lesotho's rural population at 73 percent of the total population. Headcount poverty rate is estimated at 66 percent.

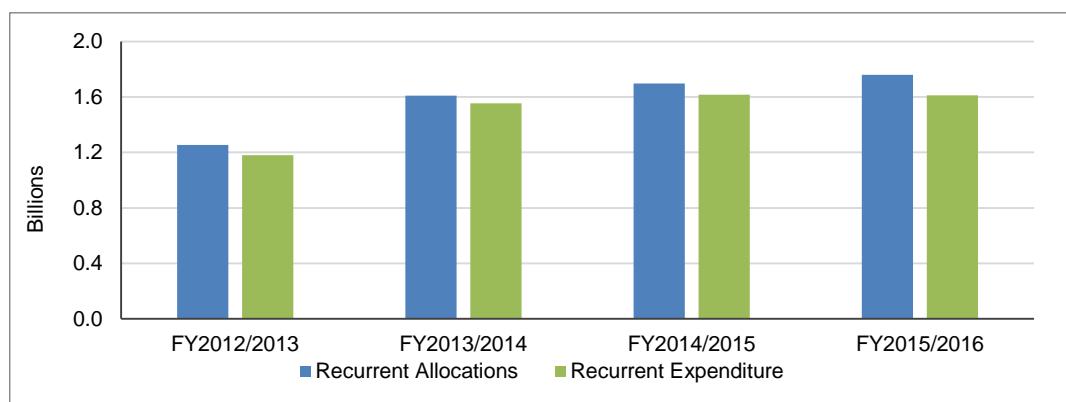
²⁶ (Ministry of Education and Training, 2005)

2.3.2 Health

The Health sector receives the second largest share of the government budget, namely 14 percent in FY15-16²⁷. This share has been increasing over the last few years, as the government together with the African Union committed to increasing funds allocated to health to at least 15 percent of the budget.²⁸ Total expenditure on health reached M1.81bn in FY15-16, from M1.46bn in FY12-13. A large proportion of these funds are allocated towards recurrent expenditure (over 90 percent).

Figure 6 below presents a breakdown of the Ministry of Health's recurrent allocations and expenditure between FY12-13 and FY15-16. In general, more than 90 percent of the recurrent budget allocations are expended between the years of observation. Meanwhile capital expenditure has been declining in recent years, from M235m in FY12-13 to M45.9m in FY15-16. This decline is ascribed to underspending in previous years.

Figure 8: Ministry of Health, Recurrent allocations and expenditure, FY 2012/13-2015/16



Source: (Ministry of Finance, 2017)

The Ministry of Health medium term objectives are articulated through the Health Sector Strategic Plan 2012/13 – 2016-17. While the NSDP is set to end this year, it will be extended by a year to 2018. It is not clear what this will mean in terms of the new health sector plan, however the new strategic plan is likely to be aligned with the National Strategic Development Plan. Broadly speaking, the ministry does not provide a detailed plan with a focus on children. Nevertheless, some of the main priorities as related to children include, Immunisation, Prevention of Mother-to-Child Transmission and Paediatric HIV treatment and Care.

Although the country has seen improvements in health outcomes amongst children, access to health care remains inadequate and unequal. In 2014, the neonatal mortality rate was 34 deaths per 1,000 births.²⁹ In other words, about “one out of 29 children die in the first month of their life”. Neonatal mortality is an important indicator for any country as it reflects capacity of the health care system to provide health services to infants and their mothers. High mortality rates are closely associated with the socio-economic circumstances faced by a new-born and a lack of access to primary health services. The country’s performance on other health indicators are equally worrying.

²⁷ It is important to note here that in Lesotho’s “Health Sector Annual Joint Review Report” for FY15-16, a decreasing trend in the proportion of budget allocated to health is shown with 11% of the budget being spent on health in FY15-16. This points to the quality of the data that is currently available in Lesotho. This report is however written from the perspective that the data we received during our field visit is correct.

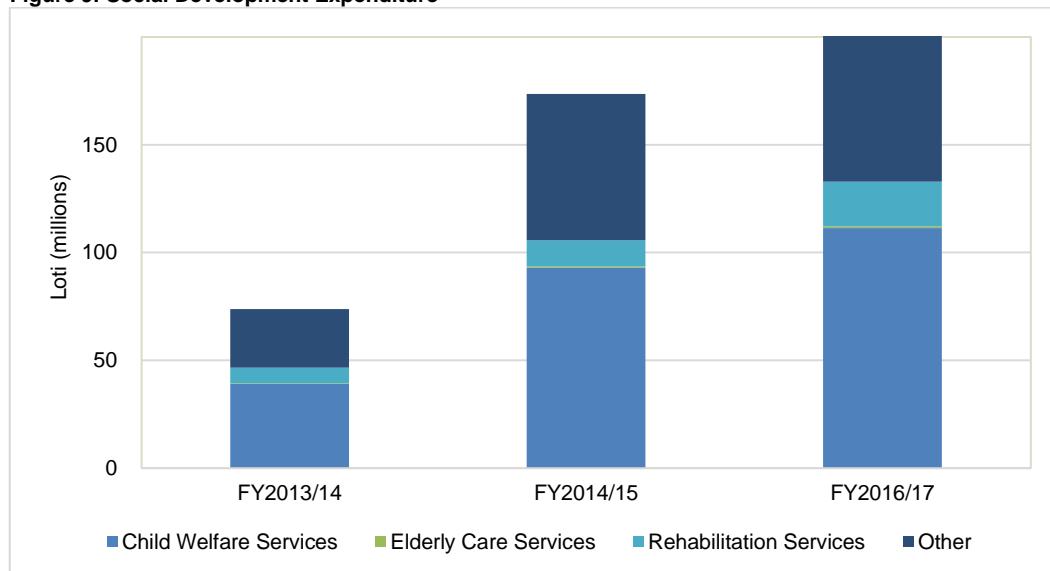
²⁸ (Ministry of Health, 2015-16 FY)

²⁹ (Ministry of Health, 2016)

2.3.3 Social Development

As evidenced in Figure 9 below, budgetary allocations towards social development have increased substantially since FY12-13. A total of M10.97m was allocated in FY12-13 (0.05 percent of GDP), rising rapidly each year, to reach a total allocation of M210.6m in FY15-16 (or 0.80 percent of GDP). While the Ministry's share of the budget is indeed a fairly small portion, it should be noted that the allocation towards the ministry has increased substantially since it was formally established in 2012. Previously, matters pertaining to social development were administered under the Department of Social Welfare which was placed within the Ministry of Health³⁰. While there were existing social programmes prior to the new ministry's establishment, the ministry has increasingly assumed a larger responsibility of the social programmes. It will be extremely important for the department's budget to grow further in line with the functions and responsibilities it assumes going forward.

Figure 9: Social Development Expenditure



Source: (Ministry of Finance, 2017)

The Ministry of Social Development is responsible for several programmes which span across the different population age groups. The ministry has two main programmes related to children, in particular, the Infant grant as well as the Child grant. By the end of its term, the NSPS seeks to achieve a universal infant grant to all pregnant women and mothers to children under the age of two, as well as scale-up its poverty targeted child grant to 30 percent of poor households. While certainly ambitious, the government has reached several milestones in recent years. One such milestone is the Child Grants Programme (CGP) which the government took full financial responsibility of in FY2013/14. Previously, this programme was supported and funded by development partners since its establishment in 2007³¹.

Despite the ministry's impressive achievements, the Ministry is not without its challenges. In the context of a somewhat limited resource envelope one of the biggest challenges posed to the ministry has been related to funding. While the budget allocated to the ministry has increased over the years the ministry receives less than 2 percent of the national budget – which is comparatively low relative to 18 percent and 13 percent for the ministries of education and health respectively. As it stands, just under 30 000 households receive the child grant with an estimated transfer of less than M50 per child a month. In order to accommodate the ministry's target of increased distribution of child grants, as well as scale up the transfer to M100 by the end of its term, the budget allocated

³⁰ Changed from the Ministry of Health and Social Welfare.

³¹ (Oxford Policy Management, 2014)

to the Ministry of Social Development will need to be increased substantially. Moreover, the ministry has faced a number of capacity constraints over the years. In effect, the ministry has not been growing fast enough to accommodate most of its objectives. This dynamic, alongside a relatively small resource allocation and ambitious targets, is likely to inhibit the ministry's ability to realise its ambitious targets over the medium term.

In addition to the CGP there are a host of other social protection programmes which seek to be up-scaled over the medium term. These targets are set out in the National Social Protection Strategy 2014/15 – 2018/19. In particular, the government seeks to "roll out the universal infant grant of M100 per infant under 2 years per month to all pregnant women and mothers, establish a national seasonal employment guarantee scheme to offer public works to the working age poor in need, reduce the old pension eligibility to 65 years at a fixed rate of M500 per person per month, issue the disability grant of M250 to all with severe disabilities, as well as reform the discretionary public assistance grant at a fixed rate of M250 per month to all requiring short-term support (estimated at 0.5% of the population)" (Kingdom of Lesotho, 2014, p. 7). Realisation of these targets will require a large amount of resources (financial and administrative), as well as collaborative effort not only from the Ministry of Social Development, but the other ministries.

3 Lesotho's options for enhancing fiscal space

The first part of this chapter discusses a multiannual projection in Excel of Lesotho's fiscal space under a set of "base-scenario" assumptions. (Appendix 1 describes the base-scenario assumptions in detail.) The second part describes alternative scenarios and the consequences of the options they embody on fiscal space, as determined quantitatively by the projection exercise. While each option takes account of Lesotho's specific circumstances, it is important to remember that the projection results are based on specified, quantitative programming assumptions. In no case should the results be regarded as forecasts.

3.1 Base Scenario and fiscal space "mapping"

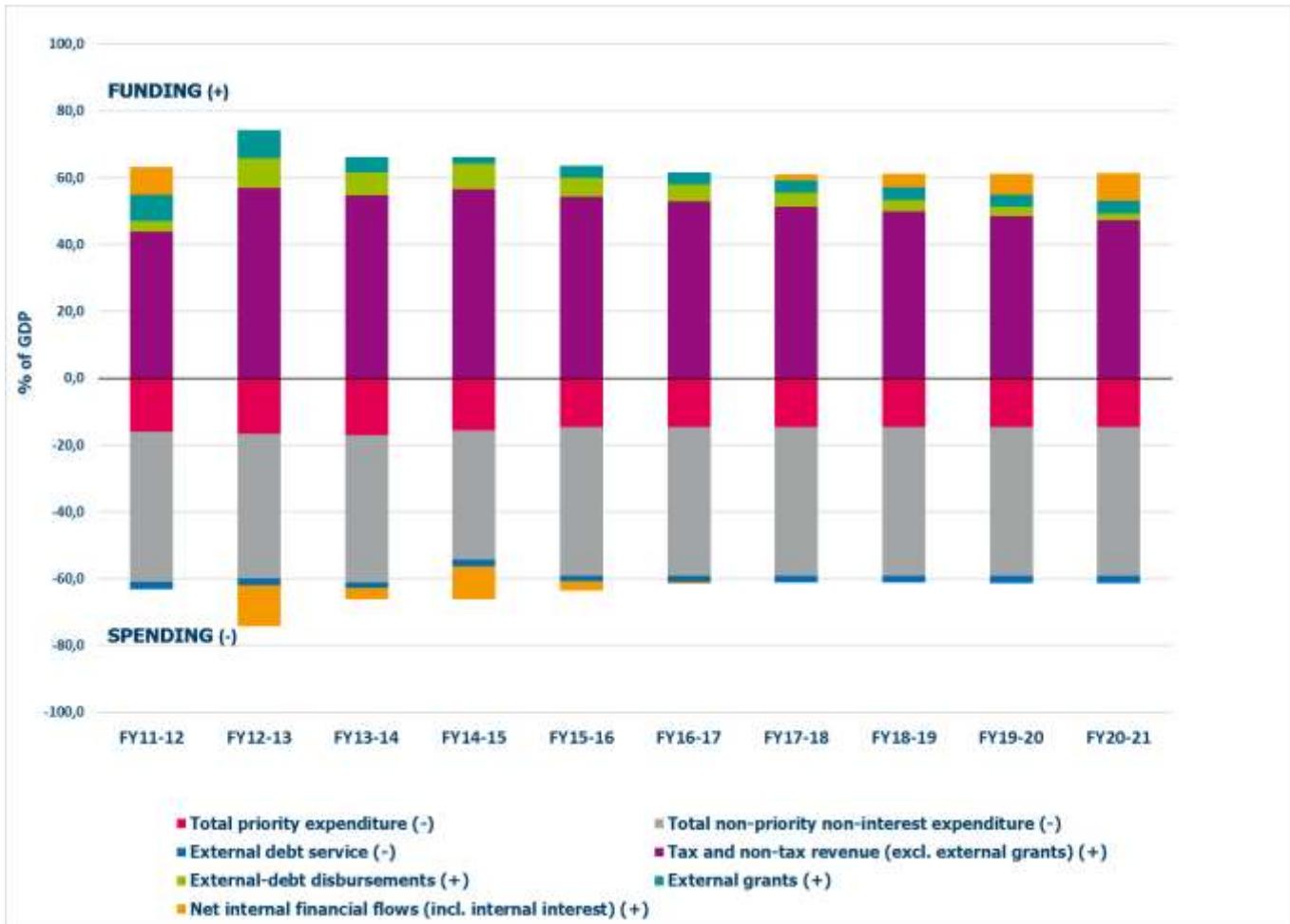
In presenting the base scenario, Appendix 1 describes the programming assumptions and characterises the projection results. The real-GDP growth rate (in Lesotho Maloti) is assumed to be 3% per cent over the projection period as per the World Bank's predictions. Most of the remaining programming assumptions are intended as "neutral", non-controversial, base-line assumptions that would produce no significant changes in the fiscal structure as the real economy grows. The results of the base scenario provide a basis for comparison with alternative scenarios incorporating different assumptions.

Under the base scenario, priority expenditures in categories relevant for children would average 14.6 percent of GDP over the years FY16-17 - FY20-21. Over these same years, in real terms, total priority expenditures for children would average US\$335.14 per child at FY15-16 prices and exchange rate (M4 593.50 per child). Under the base-scenario assumptions regarding tax and non-tax revenue, external grants, non-priority expenditure, and external- and internal-debt stocks and flows, the projected flows of priority expenditures for children would produce a fiscal-space financing "gap" that would have to be covered with internal financing. For the specific quantitative assumptions, the required internal-financing flow would average 4.1 percent of GDP over the projection years.

Figure 10 shows a fiscal-mapping chart for FY11-12 - FY20-21, with projections according to the base scenario. The projections are set out as percentages of GDP³². In the "stacked-bar" presentation, funding sources are above and expenditure flows below the horizontal axis: in effect, the sum of everything *above* the horizontal axis effectively funds everything *below*. For each year, the sum of all flows *above* the horizontal axis is precisely equal to the sum of all flows *below* the horizontal axis. Stated differently, the tax and non-tax revenue, the external grants, and external-debt disbursements, shown *above* the horizontal axis, together fund the priority expenditure, the non-interest non-priority expenditure, the external-debt service, and the (negative) internal financing flow including internal interest. The net internal financing flows include the interest on the internal debt.

³² In the Excel file, it is straightforward to select alternative units of account, such as U.S. dollars, U.S. dollars at base-year prices and exchange rate, or U.S. dollars at base-year prices and exchange rate per child.

Figure 10: Fiscal space and its components over the historical and projection period in the base scenario (FY2011/12-FY2019/20)



Source: Estimates and calculations from the projection workbook LSFS.xls

The projection exercise can be used to evaluate different policy approaches involving priority expenditure and its fiscal space. In general, if a scenario is proposed that involves an increase in the priority-expenditure flow relative to what is in the base scenario, the “fiscal gap” would presumably increase. The exercise would show an increase in the net internal financing flow to the government compared with the base scenario. On the other hand, if a scenario is proposed involving an enhancement through one or more elements of fiscal space, the exercise would show a reduction in the net internal financing flow to the government compared with the base scenario. Naturally, combined scenarios are possible, in which both the priority-expenditure and the fiscal-space flows are increased. The idea would be to determine the net consequence of the two changes. The exercise shows the multiannual internal financing flows for the whole projection period, and accumulates these flows so that the exercise shows the government’s total debt at the end of the projection period.

Since these results are quantitative, they can be discussed in terms of their feasibility: Would the net internal financing flow be likely to exceed the capacity of internal financial markets and would the government’s total debt stock rise too high too quickly as a percentage of GDP?

In principle, policy-makers could be asked to consider enhancements to fiscal space for priority expenditure by considering the following options: (1) increasing tax and non-tax revenue; (2)

increasing external grants for budget support and projects; (3) reducing non-priority expenditures; (4) reducing external debt service through agreements with creditors; (5) increasing external debt disbursements; and (6) increasing net internal borrowing flows. In general, evaluation of the alternative-scenario results suggests that the best policy approaches to securing *sustained* increases in fiscal space and so in the priority-expenditure flows appear to lie with improved tax administration. As explained below, the other approaches are likely, in the base of tax increases and reducing non-priority expenditure, to face political obstacles and may be counterproductive in the medium term, since they might reduce the GDP growth that powers the revenue flows. Debt funding for priority expenditure is inherently undesirable, because the cost of the debt is likely to exceed the return on priority expenditure, at least until the long term. Finally, agreed reductions in external-debt service are unlikely to be feasible – the international debt-reduction programs of the 1990s and 2000s are unlikely to be repeated in coming years.

Of course, other pathways to achieving improvements in fiscal space are possible as well, most notably in terms of improving allocative and cost-efficiency in the priority expenditure categories. In all priority categories, achievement of development targets and objectives falls short of the original aims. It is plausible to assume that significant resources could be freed up through improving decision-making and management through the continuous use and analysis of performance information, monitoring and evaluation in conjunction with budgetary allocation information.

3.2 Options to increase fiscal space

3.2.1 Increasing tax and non-tax revenue

Increased Company Income Tax (CIT) and Personal Income Tax (PIT) collection

Tax revenue has grown at an average annual nominal rate of 13.5 percent since FY09-10 compared to GDP growth of 9.8 percent. This growth differential between tax revenue and GDP has led to tax revenue increasing as a proportion of GDP from 20.5 percent in FY09-10 to 25 percent currently. Over this same period, PIT revenue has increased by 11.9 percent annually in nominal terms and CIT by 8.3 percent. According to the Ministry of Finance, increases in tax revenue have been primarily due to increases in the tax base rather than efficiency improvements; especially in terms of PIT. A report by the IMF states that there is an expectation that income tax revenue may increase further³³. It is expected that the ongoing modernisation of the tax system, supported by an African Development Bank study currently underway, could improve administration and could lead to better tax compliance while broadening the tax base even further.

The first “alternative” scenario, **Scenario 1**, suggests that these improvements in the tax system could bring about some reduction in fiscal space. The assumptions of Scenario 1 are the same as those for the base scenario, except that instead of CIT and PIT revenue growing at the same rate as nominal GDP, it gradually increases over time from growing at the same rate as nominal GDP in FY16-17 to growing 1.5 times as fast by FY20-21.

The projection exercise suggests that this would lead to a 0.5 percentage-points increase in average tax revenue as a percentage of GDP over the projection period, reduce the net internal debt flow as a percentage of GDP by 0.6 percentage-points, and reduce the end-FY2021 government debt stock to 65 percent of GDP from 60.7 percent in the base scenario. Given Lesotho’s government debt growth trajectory, the question remains whether this increase in revenue will lead to increased priority expenditure or rather to service debt.

³³ (International Monetary Fund, 2016)

Box A: Increased CIT and PIT collection

Results	Scenario 0	Scenario 1	Variation
Average tax revenue/GDP, FY2017-2021	25.4%	25.9%	0.5%
Average priority expenditure/GDP, FY2017-2021	14.6%	14.6%	0%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$335.10	\$0.00
Net internal debt flow/GDP, FY2017-2021	4.0%	3.4%	-0.6%
Total government debt/GDP, FY2021	67.7%	65.0%	-2.7%

Source: Estimates and calculations from the projection workbook LSFS.xls

Enhanced CIT and PIT administration and increase priority expenditure

Scenario 2 below considers the consequence of enhanced CIT and PIT administration together with an increase in priority expenditure to such a degree that total government debt as a percentage of GDP is the same as in the base scenario. In general, priority expenditure would increase to 15.1 percent of GDP over the projection period, compared with 14.6 percent in the base scenario. This is due to higher elasticity of priority expenditure with respect to nominal GDP growth in this scenario than in the base scenario. In nominal terms the average priority expenditure per child would also be \$12.60 more than in the base scenario. In line with the improved tax administration average tax revenue would see an increase of 0.5 percentage points when compared with the base scenario.

Box B: Enhanced CIT and PIT administration and increased priority expenditure

Results	Scenario 0	Scenario 2	Variation
Average tax revenue/GDP, FY2017-2021	25.4%	25.9%	0.5%
Average priority expenditure/GDP, FY2017-2021	14.6%	15.1%	0.5%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$347.70	\$12.60
Net internal debt flow/GDP, FY2017-2021	4.0%	4.0%	0.0%
Total government debt/GDP, FY2021	67.7%	67.7%	0.0%

Source: Estimates and calculations from the projection workbook LSFS.xls

Increased VAT rate on alcohol and tobacco products and increased priority expenditure

Lesotho has various VAT rates depending on the product. Besides the various VAT-exempt products, general goods and services are rated at 14%, alcohol and tobacco products at 15% and utilities and communication 5%. One of the tax proposals currently on the table in Lesotho is an increase in the VAT rate of alcohol and tobacco products to approximately 19%. Because we did not have a break-down of VAT revenue per product, we assumed that alcohol and tobacco products contributed approximately 6.9% of VAT revenue³⁴. Based on this calculation, VAT from alcohol and tobacco products constitute approximately 2.3% of total tax revenue. In the base scenario, the alcohol and tobacco products VAT rate is assumed to remain at 15% and grow at the same rate as nominal GDP. However, in **scenario 3**, we have assumed that the VAT rate increases from 15% in FY15-16 to 19% in FY20-21. This is approximately in line with the current expectation of the Lesotho government officials that were consulted³⁵.

Even though the VAT from these products contributes only marginally to the total revenue pool, it is still able to contribute considerably to fiscal space. As compared to the base scenario, increasing

³⁴ This was based on the CPI basket which gives a weight of 6.4% to alcohol and tobacco products. This value was then adjusted for the higher VAT rate by multiplying it by 15 and dividing it by 14.

³⁵ Officials spoke about a rate increase of 20% increase in the VAT rate of alcohol products, i.e. 18%, and 30% increase in the VAT rate for tobacco products, i.e. 19.5%.

the VAT rate on these products could increase the average tax revenue to GDP ratio by 0.2 percentage points. This scenario also assumes that the additional revenue is allocated to priority sectors leading to a 0.3% percentage point and US\$6.20 difference between the baseline and scenario results of average priority expenditure as a percentage of GDP and spending per child respectively.³⁶

Box C: Increased VAT rate on alcohol and tobacco products and increased priority expenditure

Results	Scenario 0	Scenario	Variation
	3		
Average tax revenue/GDP, FY2017-2021	25.4%	25.6%	0.2%
Average priority expenditure/GDP, FY2017-2021	14.6%	14.9%	0.3%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$341.30	\$6.20
Net internal debt flow/GDP, FY2017-2021	4.0%	4.0%	0.0%
Total government debt/GDP, FY2021	67.7%	67.7%	0.0%

Source: Estimates and calculations from the projection workbook LSFS.xlsm

Increased GDP growth due to greater mining activity and improvements in the tourism industry; allocated to the servicing of debt

The final scenario related to tax and non-tax revenue is one based on an improved economy driven by a recovery in the mining sector and increases in tourist activity. The mining sector is set to potentially recover as global commodity prices seem to be moving towards an upward trend. Further improvements could also be realised by addressing governance issues prevalent in the sector and lowering barriers to private sector investment. The tourism industry could also see improvements due to potential global economic recovery and a very specific policy focus on the sector. Lesotho's National Strategic Development Plan states that the factors that make Lesotho an attractive tourist destination have not been fully exploited. In 2012, government therefore targeted a 50% increase in demand to reach 500 000 tourists in 2016/17. It is unclear whether this target was met, but from our discussions during our country visit, the plan is clearly to increase demand even further in the future. Furthermore, the IMF also predicts that the commencement of phase 2 of the Lesotho Highlands Water Project could also contribute to economic growth³⁷.

Increased economic activity driven by these sectors will increase government revenue from Personal and Company Income taxes. Although there will be increases in revenue from other taxes as well³⁸, the projection exercise only takes the two largest contributors to tax revenue into account. Besides the two main sources of government tax revenue, we also include the contribution of mining royalties in the projection exercise because of its direct relationship with mining sector performance. This contribution from royalties to total government tax revenue has declined sharply over time decreasing from 1% in FY09-10 to nearly 0% in FY15-16. However, an increase in this revenue item together with an increase in CIT and PIT and an increase in economic growth driven by improvements in mining and tourism could lead to substantial fiscal space gains. As shown in Box D; representing **scenario 5**, real GDP growth gradually increases to reach 6% in FY20-21; the middle ground growth on which Lesotho's National Development Strategy is based. Similar to scenario 2, CIT and PIT revenue's growth rate increases to twice the growth of nominal GDP by FY20-21. The growth rate of royalties increases to 2.5 times the growth rate of nominal GDP as compared to equalling nominal GDP growth rate in the base scenario. As one can see in Box D, in

³⁶ It should be noted here that we have assumed perfectly inelastic demand meaning that the VAT revenue estimation is probably overstated as we assume that consumption does not react to price increases

³⁷ (International Monetary Fund, 2016)

³⁸ Such as VAT because of higher consumption levels due to increased tourism and more disposable income

this admittedly optimistic scenario, expenditure on children can increase substantially while government is still able decrease debt levels.

Box D: Increased GDP growth due to greater mining activity and improvements in the tourism industry; allocated to the servicing of debt

Results	Scenario 0	Scenario 4	Variation
Average tax revenue/GDP, FY2017-2021	25.4%	26.1%	0.7%
Average priority expenditure/GDP, FY2017-2021	14.6%	14.5%	-0.1%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$356.60	\$21.50
Net internal debt flow/GDP, FY2017-2021	4.0%	4.2%	0.2%
Total government debt/GDP, FY2021	67.7%	63.5%	-2.2%

Source: Estimates and calculations from the projection workbook LSFS.xlsm

Increased GDP growth due to greater mining activity and improvements in the tourism industry; allocated to priority expenditure

The next scenario, **Scenario 6**, is the same as scenario 5, but instead of wholly transferring the additional funding to the servicing of debt, the funding is wholly transferred to the priority sectors. In the projection exercise, this is done by substantially increasing the elasticity of priority spending to nominal GDP growth. Under the projection period average tax revenue would reach 26.1 percent of GDP, compared to the base scenario in which average tax revenue is projected to reach 25.4 percent. More notably, priority expenditure would see a considerable increase of \$44.30 when compared with the base scenario.

Box E: Increased GDP growth due to greater mining activity and improvements in the tourism industry; allocated to priority expenditure

Results	Scenario 0	Scenario 5	Variation
Average tax revenue/GDP, FY2017-2021	25.4%	26.1%	0.7%
Average priority expenditure/GDP, FY2017-2021	14.6%	15.4%	1.0%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$379.40	\$44.30
Net internal debt flow/GDP, FY2017-2021	4.0%	5.1%	1.1%
Total government debt/GDP, FY2021	67.7%	67.7%	0.0%

Source: Estimates and calculations from the projection workbook LSFS.xlsm

3.2.2 Decreasing non-priority expenditure

Reprioritisation of non-priority expenditure to priority expenditure

During the country visit it became apparent that there are various sources of inefficiency with respect to public spending in Lesotho. The first source is related to public sector budget execution rates, especially related to capital expenditure. As already discussed, over the past five years, government ministries in Lesotho have, on average, spent nearly 15% less than their budgets on capital projects. According to the IMF, “poor public financial management has added to the under execution of the capital budget”. The IMF further states that “Severe weaknesses in public service administration have contributed to the high government wage bill. This validates a point made during the country visit that there is a large number of ghost employees in the system. The World Bank, in partnership with the Lesotho government, is currently working on a Public Sector harmonisation programme trying to address this issue through the introduction of a biometric system for all civil servants. A third source of spending inefficiency is related to the grant system. There is currently work being conducted by UNICEF to streamline this system. There are two major issues in the current system. In addition to the fact that many beneficiaries are erroneously

receiving multiple grants due to problems with registration, Table 6 shows that the number of citizens receiving pensions from the Ministry of Finance exceeds those that are eligible by approximately 30 000. This oversubscription is due to the fact that pension payments continue after the death of the recipient. At US\$423 per beneficiary, it is estimated that addressing this issue could save the state up to US\$12.8m per year. The re-allocation of this expenditure could contribute immensely to closing the coverage gap in the child grant system and the school feeding programme. If the entire US\$12.8m is redirected to child grants, at US\$38 per grant, coverage would increase from 18.5% currently to 89.3%. Furthermore, even if the school feeding programme's coverage is increased to 100%, from 98% currently, the child grant coverage could still be increased to 87.6% with the remaining savings.

Table 6: Balancing coverage

		Old age pension (70+) -- MoF	Child grants (0-17)* -- MoSD	School feeding (5-12) - - MoE
Beneficiaries	Recipients	85 087	89 000	389 000
	Eligible**	54 647	481 656	396 885
	Coverage	155.7%	18.5%	98.0%
Current expenditure	Total (USD)	36 000 000	3 360 000	15 700 000
	Per beneficiary (USD)	423	38	40
Expenditure if coverage equals 100%	Total (USD)	23 120 947	18 183 852	16 018 230
Difference in expenditure between 100% coverage and status quo	Total (USD)	(12 879 053)	14 823 852	318 230

*Assumed 52% of children poor and eligible

Source: (IMF, 2017), (United Nations, 2017), (Department of Economic and Social Affairs, 2017), (UNICEF Lesotho, 2017)

In addition to spending inefficiencies, spending decreases in specific sectors can also occur due to policy shift. Two such policy shifts are currently in discussion. The first is eliminating or significantly reducing the fuel levy. Due to the regressive nature of this subsidy and the fact that global oil prices have substantially decreased the price of fuel (in US\$ terms), this is a probable option going forward. In the data received it was not possible to see exactly what the current total expenditure is on this item. Nevertheless, there is no doubt that the scaling back or elimination of this item will contribute to fiscal space in Lesotho. The second option currently being discussed in the policy space is the retraining and redeployment of security personnel to social sectors to increase especially the numbers of teachers, medical staff and social workers.

As the projection exercise was not developed to estimate, at such a detailed level, the potential programme-specific savings because of a specific intervention, **scenario 7**, merely assumes that non-priority expenditure grows at a slower rate than nominal GDP. Savings are therefore estimated at a highly aggregated level. Although we might have an estimate for the potential savings from addressing the issues in the pension system, estimating savings due to an overall system improvement would not be possible at this stage. We therefore opt for a mere illustration of potential fiscal space implications if some saving is realised in the system.

In the base scenario, non-priority expenditure is assumed to grow at the same rate as nominal GDP growth. For scenario 6, we assume that it grows at the same rate as nominal GDP in FY16-17, but then slowly decreases relative to nominal GDP growth to grow 15 percent slower by FY20-21. In this case, we increase the growth in priority expenditure to transfer all the savings from the non-priority sectors to the priority sectors. We therefore increase the elasticity of education, health and social development expenditure to nominal GDP growth from 1.0 in FY16-17 to 5.0 in FY20-21 as opposed to staying at 1.0 over the period in the base scenario. Box E represents the results of this dynamic compared to the base scenario.

Box F: Reprioritisation of non-priority expenditure

Results	Scenario 0	Scenario 6	Variation
		6	
Average tax revenue/GDP, FY2017-2021	25.4%	25.4%	0.0%
Average priority expenditure/GDP, FY2017-2021	14.6%	15.3%	0.7%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2017-2021	\$335.10	\$351.50	\$16.40
Net internal debt flow/GDP, FY2017-2021	4.0%	4.0%	0.0%
Total government debt/GDP, FY2021	67.7%	67.7%	0.0%

Source: Estimates and calculations from the projection workbook LSFS.xls

In this scenario, approximately all the hypothetical savings in the non-priority sectors have been transferred directly to the priority sectors as the net internal debt flow and debt stock as a percentage of GDP has remained the same as the base scenario. Consequently, per capita priority expenditure and priority expenditure as a percentage of GDP is substantially higher than in the base scenario.

3.2.3 *Other options to increase fiscal space*

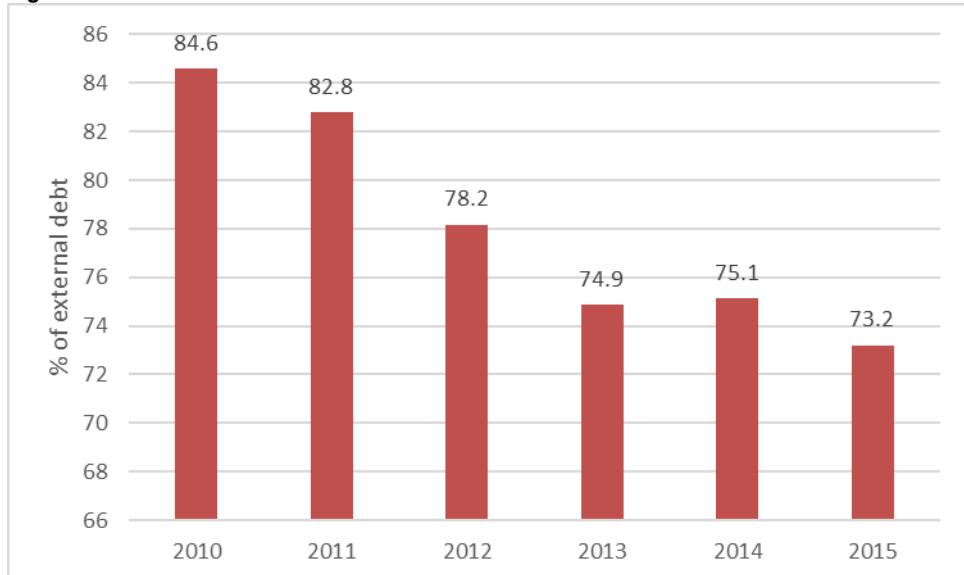
Increasing external grants for budget support and projects

As mentioned earlier, although there was an increase in donor funding in the three years leading to FY12-13, external grants subsequently decreased to a low of 1.8 percent in FY14-15, before rising to 3.7 percent of GDP in FY15-16. Even with this increase in FY15-16, it is highly likely that donor funding will decrease going forward. Lesotho's poor financial management and subsequent lack of transparency, the global economic conditions and Lesotho no longer holding the status of low-income country all point to the likelihood of this trend. A scenario in which fiscal space is created through increased donor funding is therefore unlikely and it would generally be irresponsible to base future decisions on an assumption of increased external dependency.

Reducing external-debt service through agreements with creditors

The proportion of Lesotho's concessional debt as a percentage of total external debt has been on a consistent downward trend as shown in the figure below.

Figure 11: Concessional debt as a % of total external debt



Source: (World Bank, 2017)

Furthermore, as Lesotho's Country Policy and Institutional Assessment (CPIA) score is currently under review and there is a significant possibility that the country's score has deteriorated, the country's access to concessional debt will be even more hampered in the future.

Increasing external-debt disbursements

In general, macroeconomic policy specialists concur that it is not advisable to use commercial external debt to fund education, health, or social-development expenditure. The reasoning is straightforward: eventual returns to education and health expenditure are realized over decades, but debt service on commercial external debt is generally due within a decade. Concessional debt, with multi-decade terms and near-zero interest rate, is more realistic for such purposes.

As shown in the previous section, although still high, Lesotho's concessional to total external debt ratio is decreasing.. Although Lesotho is currently facing a high and increasing Debt-to-GDP ratio, this debt is still mostly concessional and is unlikely to lead to major liquidity issues over the medium term. However, if concessional lending continues its current trajectory, Lesotho's ability to cover its maturing liabilities could be under threat. If Lesotho is therefore able to maintain or increase its proportion of debt comprised of concessional debt, further debt disbursements to increase fiscal space is a possibility. If not, it would pose a significant risk to Lesotho's debt sustainability.

Increasing net internal borrowing flows

In the analytical structure of the projection exercise, net internal borrowing is calculated residually. In effect, it is the consequence of all the programming assumptions taken together. Evaluation of its feasibility therefore amounts to evaluation of the feasibility of all the programming assumptions taken together. Since internal borrowing is for shorter terms and have higher interest rates than external debt, it would be even more inappropriate to use domestic loans specifically to fund priority expenditure. Nevertheless, any fiscal-space financing gap would be covered with internal borrowing flows.

3.2.4 Risks to fiscal space and their impact

Although this report focuses on means by which fiscal space could potentially be expanded, in the context of Lesotho, it would not be complete without also illustrating fiscal space effects of weaker economic growth and underperforming SACU transfers.

Weak economic growth

Lesotho's vulnerability to South Africa's economic performance have already been discussed. Over the medium term, South Africa's economy, although recovering slightly, is not expected to perform very well. Slow recovery in world commodity prices, increased political uncertainty, increased fiscal pressure due to sovereign debt rating downgrades and persistently high inflation and unemployment all contribute to South Africa's expected poor economic performance. Although Lesotho's economy has been resilient over the past five years, the cracks are beginning to show as real GDP growth has been trending downwards.

In the base scenario, real GDP growth is assumed to average 3% between FY16-17 and FY 20-21. In this scenario, **scenario 8**, we assume real GDP grows two-thirds slower than this; averaging 1% per year over the period. Even though revenue and priority expenditure as a percentage of GDP remain approximately the same between the base and alternative scenarios, in absolute terms, there is a significant drop in priority expenditure. Average priority expenditure per child is nearly 10% lower in the alternative scenario.

Box G: Weaker economic growth

Results	Scenario 0	Scenario	Variation
	7		
Average tax revenue/GDP, FY2016-2020	25.4%	25.4%	0%
Average priority expenditure/GDP, FY2016-2020	14.6%	14.8%	0.2%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2016-2020	\$335.10	\$301.50	-\$33.60
Net internal debt flow/GDP, FY2016-2020	4.0%	3.1%	-1.0%
Total government debt/GDP, FY2021	67.7%	67.2%	-0.5%

Source: Estimates and calculations from the projection workbook LSFS.xlsm

Decrease in SACU transfer

Lesotho is highly dependent on SACU transfers as a revenue sources. Over the past five years, the SACU transfer revenue item has constituted approximately 44% of Lesotho's total revenue. Besides the fact that this means that 44% of Lesotho's revenue is largely outside of the ambit of its own policy, this revenue is also extremely volatile and consequently difficult to predict.

In the base scenario, we have assumed that Lesotho's SACU revenue grows at the rate predicted by the SACU secretariat; approximately 0.3% per annum in nominal terms. Admittedly, this is not significant growth and will lead to decreases in the contribution of SACU revenue as a percentage of total government revenue in Lesotho. Nevertheless, given Lesotho's reliance on this revenue and its historical volatility, we thought it important to illustrate the effects of slower than expected growth in SACU revenue over the period on Lesotho's borrowing requirement. **Scenario 9** is similar to the base scenario in all of its assumptions, except that it assumes that the SACU transfer's nominal growth rate averages -0.3% over the period instead of 0.3%.

Box H: Decrease in SACU transfers

Results	Scenario 0	Scenario	Variation
	8		
Average tax revenue/GDP, FY2016-2020	25.4%	25.4%	0%
SACU transfer/GDP, FY2016-2021	19.5%	19.1%	-0.4%
Average priority expenditure/GDP, FY2016-2020	14.6%	14.6%	0.0%
Average priority expenditure per child (USD at 2016 prices and exchange rate), FY2016-2020	\$335.10	\$335.10	\$0.00

Results	Scenario 0	Scenario 8	Variation
Net internal debt flow/GDP, FY2016-2020	4.0%	4.3%	-1.0%
Total government debt/GDP, FY2021	67.7%	69.4%	1.7%

Source: Estimates and calculations from the projection workbook LSFS.xlsm

4 Conclusions

This chapter's *fundamental* recommendation is that, in support of its advocacy on behalf of expenditure beneficial for children, UNICEF should continually formulate quantitative projections, and make use of these in its dialogue with the Lesotho government and other stakeholders. These projections should not only cover future expenditure needs in education, health, social development and other sectors relevant for children, but should also encompass the main components of the "fiscal space" that provides the funding for such expenditure. Quantitative projections of this kind should assist UNICEF to engage in more effective dialogue.

The analysis this report describes is intended to be essentially illustrative, to show how the methodology it recommends can be used to address the relevant policy issues. But certain tentative conclusions regarding the substantive issues do emerge, including the following:

1. The Lesotho Revenue Authority has articulated commitment to enhancing the tax base, by way of introducing the Integrated Revenue Management System³⁹. Although the rate of improvement is unlikely to be enough to significantly impact fiscal space in the medium term, continuous effort in this regard is essential. The projection exercise suggests that even with only marginal improvements in PIT and CIT administration, substantial fiscal space expansion could be achieved. Furthermore, such improvements would also contribute immensely to decreasing Lesotho's reliance on SACU revenue.
2. Over the past five years, the SACU transfer revenue item has constituted approximately 44% of Lesotho's total revenue. Besides the fact that this means that 44% of Lesotho's revenue is largely outside of the ambit of its own policy, this revenue is also extremely volatile and consequently difficult to predict. The projection exercise shows the significant deteriorating effect of lower SACU revenue transfers on expenditure ceilings, budget deficits and the trajectory of debt.
3. Lesotho currently has a proposal on the table to increase its tax revenue through an increase in the VAT rate of alcohol and tobacco products. The added benefit of such a tax is the expected health benefit for the consumer from decreased consumption and the subsequent decreased burden on the health system. Even though the VAT revenue from these products is relatively small, the large increase in the VAT rate, as proposed, could potentially contribute substantially to fiscal space.
4. Lesotho's poor public financial management practices not only affects government revenue by contributing to the hesitance of potential donors, but also has a severe impact on the efficiency of expenditure. Besides general underspending on capital projects, overspending on operational costs is also a major concern. Improving the budgeting and procurement system could potentially unlock large amounts of funding that could be redirected to priority sector.
5. Fiscal space for priority expenditure can also be created through decreases in non-priority expenditure. In Lesotho there are two policies currently under discussion that could be utilised in this regard. Firstly, a reduction or elimination of the fuel subsidy could be reallocated to priority expenditure. The regressive nature of this expenditure item makes its reduction or elimination especially palatable in the political sphere. Secondly, there is discussions around the redeployment of human resources from the defence sectors to the social sectors. The costs and benefits of such a decision would have to be scrutinised and compared to alternatives as the training required for such a fundamental shift could potentially necessitate significant additional resources.

³⁹ (Ministry of Finance: Budget background, 2013)

6. External grants are likely to decrease rather than increase over time. This will continue the trend experienced over the last five years. A global economic slowdown, Lesotho losing its status as a Low-Income-Country and the poor financial management systems are seen as the main contributors to this trend.
7. In general, non-concessional external debt should never be used to fund priority expenditure such as education and health. The basic reason is that the yields from education and health expenditure come only in the long term, beyond the terms typical of non-concessional external debt. For similar reasons, internal term debt should not be used to fund education and health expenditure. If the downward trend of the concessional debt to total external debt continues without direct intervention to decrease Lesotho's total debt levels, debt sustainability might become a significant issue for Lesotho in the future.
8. As is the case in most instances, Lesotho's economic growth will have a large impact on the country's ability to increase expenditure to priority areas. If, as was suggested during the country visit, economic growth is driven by improvements in the mining sector, the increase in total government revenue in general as well as specific increases in CIT revenue and mining royalty revenue will expand fiscal space dramatically. Furthermore, an improvement in the tourism industry could also drive GDP growth and government revenue. However, according to the 2012/13 – 2016/17 National Strategic Development Plan, the tourism sector has generally grown slower than the rest of the Lesotho economy and contributes less than 2% to total GDP. The impact of an improvement in the industry will therefore be marginal. Nevertheless, the relationship between tax revenue and GDP growth implies that any improvement will be welcomed. Given Lesotho's comparative advantage in this sector, it should be an easy win which should be capitalised upon.
9. On the other side of the argument, just as economic growth can drive fiscal space expansion, a decrease in GDP will drive a contraction. In addition to domestic issues, Lesotho is very vulnerable to South Africa's economic performance. With the current economic and political uncertainty in the country, lower GDP growth remains a legitimate concern in Lesotho.

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Appendix 1: Fiscal space projections

This Appendix describes the details of the base-scenario projection exercise discussed in Section 1.6 above, and then describes the results of a sensitivity analysis.

The base-scenario programming assumptions are intended to be relatively simplified, to make the calculation relatively easy to carry out and to understand. The following general explanatory points are noted:

1. The assumptions are “programming” assumptions. They are not intended, and should not be understood, as *forecasts*, but rather as plausible possibilities for planning purposes. In particular, the growth rates of government expenditure are intended as plausible policy settings;
2. In general, the aim for the base scenario is to set programming assumptions that are “neutral.” For example, Lesotho’s merchandise export volumes are assumed to grow at the same rates as the world trade volume, so Lesotho exports maintain the same share of the world trade volume. The volume of Lesotho’s merchandise imports is assumed to grow at the same rates as real GDP, so merchandise imports would tend to maintain the percentage of GDP. For recurrent expenditure, the assumption that staff sizes will grow at the same rate as the population would be neutral in a similar sense. So is the assumption that government wage rates would grow at the same rate as per-capita nominal GDP;
3. The elasticities that help determine the government’s revenue performance are taken to be somewhat higher than one in the initial projection year, and then to decline gradually toward one over the projection period. In general, it is inadvisable to apply econometric point estimates based on historical data for these values, for at least two reasons. The first is that future elasticities are likely to differ from historical elasticities. The second is that, say, if the elasticity of a given revenue line with respect to nominal GDP is assumed always to exceed (be less than) one, the projected revenue flow would rise (diminish) indefinitely as a percentage of GDP;
4. It is straightforward to set programming assumptions that adjust gradually over the projection period, using (“geometric”) adjustment formulas. This is useful for several different assumption lines. For example, a large proportion of the assumptions are set as growth rates. These can be assumed to rise or diminish gradually from their initial projection values toward their final projection values. Another way to use a gradual adjustment would be for the elasticity of a given revenue line with respect to nominal GDP to take on an initial value somewhat different from one, but then gradually adjust toward a long-term value of one.

For the base scenario, the programming assumptions are as follows:

(A) World economic conditions (1-3):

- (1) The growth rate of the world trade volume rises gradually from its estimated FY15-16 value of 4.3 per cent to a FY20-21 value of 6 per cent.
- (2) The growth rate of the U.S.-dollar world price level rises gradually from its estimated FY15-16 value of 1 per cent to a FY20-21 value of 2 per cent.
- (3) The London Interbank Offer Rate rises gradually from its FY14-15 value of 0.8 per cent to a FY19-20 value of 1.5 per cent.

(B) Basic South African macroeconomic variables (4-10):

- (4) The growth rate of real GDP remains at a value of 3 per cent over the projection years.
- (5) The GDP deflator grows at the same rate as the year-average consumer price index.
- (6) The December-December growth rate of the consumer price index (CPI) declines gradually from 5 per cent in FY15-16 to 4.5 per cent in FY20-21.
- (7) The December-December growth rate of the U.S. dollar exchange rate grows at a rate (approximately) equal to the differential of the South African and the world U.S.-dollar inflation rates.
- (8) The overall population growth rate remains constant at 0.4 per cent.
- (9) The growth rate of the population under 19 years of age remains constant at 0.7 per cent.
- (10) The headcount poverty incidence remains unchanged from 59.7% in FY2011/12

Exports and imports of goods and non-factor services (11-17):

- (11) Export prices grow at the same rate as the world U.S.-dollar price level.
- (12) The export volume grows at the same rate as the world trade volume.
- (13) Import prices grow at the same rate as the world U.S.-dollar price level.
- (14) The import volume grows at the same rate as real GDP.
- (15) Non-factor service exports grow at a rate equal to the combined growth rates of world trade volume and the world US\$ price level.
- (16) Non-factor service imports excluding insurance and freight charges for merchandise imports grow at a rate equal to the combined growth rates of world trade volume and the world US\$ price level.
- (17) Insurance and freight charges remains at 11.8 per cent from FY16/17 through to FY20/21.

National-expenditure accounts (18-20):

- (18) Consumption expenditure by provincial governments remains at 30.3 per cent of GDP over the projection period.
- (19) Gross fixed capital formation remains at 33.2 per cent of GDP.
- (20) The net increase in inventory stocks remains at 2.3 per cent over the projection period.

(C) Tax and non-tax revenue (21-33):

- (21) The elasticity of personal income tax with respect to nominal GDP remains at 1.0 per cent over the projection period.
- (22) The elasticity of company-tax revenue with respect to nominal GDP remains at 1.0 percent over the projection period.
- (23) The elasticity of other income-tax revenue with respect to nominal GDP declines from 1.16 in FY16-17 to 1 in FY20-21.

- (24) The elasticity of government administration fee revenue with respect to GDP remains at 1 over the projection period.
- (25) The elasticity of customs revenue with respect to merchandise-imports value declines from 1.16 in FY15-16 to 1 in FY20-21.
- (26) The elasticity of excise revenue with respect to nominal GDP declines from 1.16 in FY15-16 to 1 in FY20-21.
- (27) The elasticity of export-duty revenue with respect to export value decreases from 1.2 in FY14-15 to 1 in FY19-20.
- (28) The internal value-added tax rate remains unchanged at 15 per cent.
- (29) The elasticity of central-government non-tax revenue with respect to nominal GDP remains at 1 between FY15-16 and FY20-21.

(D) External grants to the government (34-37):

- (30) As the external grants are remain at 3.7 percent over the projection period.

(E) Government expenditure in the priority and non-priority categories (50-76):

(E.1) For non-interest recurrent expenditure,

(E.1.a) In the education sector,

- (31) The staff size grows at the same rate as the number of children.
- (32) Staff salaries grow at a rate equal to the growth rate of per-capita nominal GDP.
- (33) Expenditure on current goods and services grows at a rate equal to the combined growth rates of the year-average CPI and the sectoral staff size.
- (34) Expenditure on non-staff recurrent expenditure excluding current goods and services grows at a rate equal to the combined growth rates of the year-average CPI and the number of children.

(E.1.b) In the health sector,

- (35) The staff size grows at the same rate as the population.
- (36) Staff salaries grow at a rate equal to the growth rate of per-capita nominal GDP.
- (37) Expenditure on current goods and services grows at a rate equal to the combined growth rates of the year-average CPI and the sectoral staff size.
- (38) Expenditure on non-staff recurrent expenditure excluding current goods and services grows at a rate equal to the combined growth rates of the year-average CPI and the population growth rate.

(E.1.c) In the social development sector

- (39) The elasticity of social assistance spending (grants for children) with respect to the child population remain at 1 between FY15-16 and FY19-20.
- (40) The elasticity of child welfare spending with respect to the child population remain at 1 between FY15-16 and FY20

(E.2) For non-recurrent expenditure, over the projection years,

- (41) Education non-recurrent expenditure remains at 0.1% of GDP between FY15-16 and FY20-21
- (42) Health non-recurrent expenditure remains at 0.2% of GDP between FY15-16 and FY20-21
- (43) Social welfare non-recurrent central-government expenditure remains at 0.01% of GDP between FY15-16 and FY20-21

(E.3) Non-priority expenditure

- (44) The elasticity of non-priority expenditure with respect to nominal GDP remains at 1 between FY15-16 and FY19-20.

(F) For external and internal debt:

- (45) Average interest rates on the previous year's year-end external debt stock increase (decrease) with LIBOR.B106.
- (46) Average interest rates on the previous year's year-end internal debt stock remains at 6.5 per cent between FY15/16 and FY20/21.
- (47) External-debt repayments increase increased over the projected period.
- (48) External-debt disbursements in each projection year amount to 52.0 per cent of total non-recurrent expenditure.

Table A1.1 immediately following lists these assumptions, and Table A1.2 shows the base-scenario projection results. (Table A1.1 shows only the assumption values. Consult the listing above to understand the reasoning underlying any specific assumption.).

A1. 1: Programming assumptions for fiscal space projection exercise (base scenario)

		Average:	
Initial projection year: FY16/17	FY15-16	FY16-17-FY20-21	FY20-21
(A) EXTERNAL 'STATE-OF-THE-WORLD' VARIABLES:			
Growth rates:			
World trade volume	4.3%	6.0%	6.0%
World U.S.-dollar price level	1.0%	2.0%	2.0%
Interest rates:	0.0%	0.0%	0.0%
London Interbank Offer Rate (LIBOR)	0.8%	1.5%	1.5%
<i>Source: IMF World Economic Report</i>			
<i>U.S. GDP deflator.</i>			
(B) BASIC MACROECONOMIC VARIABLES:			
Growth rates:			
Gross domestic product (national currency - 2015/16 prices)	-2.2%	3.0%	3.0%
Gross domestic product (national currency)	5.9%	8.2%	7.7%
Gross domestic product at 2015/16 prices and exchange rate (US\$)	-21.1%	-11.8%	17.8%
GDP deflator	-2.2%	5.0%	4.6%
Consumer prices (year-average)	4.3%	5.0%	4.6%
Consumer prices (December)	5.1%	4.8%	4.5%
Exchange rate (year-average)	23.9%	1.5%	2.5%
Exchange rate (December)	0.0%	2.7%	2.5%
Population (millions)	0.4%	0.4%	0.4%
Population 5 - 19 (millions)	1.0%	1.0%	1.0%
Population under 19 (Millions)	0.7%	0.7%	0.7%
Headcount poverty incidence	n/a	59.7%	59.7%

		Average:	
	FY15-16	FY16-17-FY20-21	FY20-21
Initial projection year: FY16/17			
Growth rates (US\$ million):			
Merchandise exports:		8.1%	8.1%
Unit value		2.0%	2.0%
Volume		6.0%	6.0%
Merchandise imports:		-6.8%	12.4%
Unit value		2.0%	2.0%
Volume		3.0%	3.0%
		0.000	0.000
Growth rates:			
Non-factor services receipts		8.1%	8.1%
Non-factor services payments, excluding merchandise-imports insurance and freight		-10.3%	17.8%
Ratios:		0.000	0.000
Ratio, insurance and freight costs/merchandise imports value		0.110	0.110
Incremental capital-output ratio		4.082	4.306
		0.000	0.000
Per cent of GDP:			
Consumption expenditure by governments excl. central government	30.3%	30.3%	30.3%
Gross fixed capital formation	33.2%	33.2%	33.2%
Net increase in inventory stocks	-2.3%	-2.3%	-2.3%
(C) GENERAL-GOVERNMENT FINANCIAL ACCOUNTS:			
Tax and non-tax revenue (excl. external grants) (+):			
(C) TAX REVENUE:			
Central government:			
Elasticities of...			
personal income tax with respect to nominal GDP		1.0	1.0
company-tax revenue with respect to nominal GDP		1.0	1.0
other income-tax revenue with respect to nominal GDP		1.0	1.0
administrative fees revenue with respect to nominal GDP		1.0	1.0
customs revenue with respect to merchandise-imports value		1.1	1.0
excise revenue with respect to nominal GDP		1.0	1.0

		Average:	
	FY15-16	FY16-17-FY20-21	FY20-21
Initial projection year: FY16/17			
GDP growth		1.0	1.0
Value-added tax:			
Elasticity of VAT revenue with respect to nominal GDP		1.0	1.0
VAT rate on alcohol and Tobacco Products	15.0%	15.0%	15.0%
NON-TAX REVENUE:		0.000	0.000
Elasticities of...		0.000	0.000
Government non-tax revenue		1.000	1.000
SACU income growth rate		0.3%	0.3%
(D)External grants (+):	3.7%	3.7%	3.7%
(E) CENTRAL-GOVERNMENT EXPENDITURE:			
Growth rates:			
Recurrent education expenditure:			
Education staff		1.0%	1.0%
Education remuneration rates		7.7%	7.3%
Non-staff recurrent education expenditure:		6.1%	5.6%
Recurrent education expenditure on goods and services		6.1%	5.6%
Other non-staff recurrent education expenditure		6.1%	5.6%
Recurrent health expenditure:			
Health staff		0.4%	0.4%
Health remuneration rates		7.7%	7.3%
Non-staff recurrent health expenditure:		5.4%	5.0%
Recurrent health expenditure on goods and services		5.4%	5.0%
Other non-staff recurrent health expenditure		5.4%	5.0%
Elasticities of...			
Recurrent Social Development expenditure with respect to nominal GDP growth		1.000	1.000
Child welfare spending with respect to the child population		1.000	1.000
Per cent of GDP:			
Non-recurrent education expenditure:	0.1%	0.1%	0.1%
Non-recurrent health expenditure:	0.2%	0.2%	0.2%
Non-recurrent social development	0.0%	0.0%	0.0%

		Average:	
	FY15-16	FY16-17-FY20-21	FY20-21
Initial projection year: FY16/17			
(F) EXTERNAL AND INTERNAL DEBT:			
Average interest rates (applied to preceding year-end debt stock):			
Average interest rates on external debt	-1.8%	-1.9%	-2.0%
Average interest rates on internal debt	-6.5%	-6.5%	-6.5%
Per cent of preceding year-end debt stock:	0.0%	0.0%	0.0%
External-debt repayments (-)	-1.8%	-2.6%	-3.2%
Per cent of GDP:	0.0%	0.0%	0.0%
External-debt disbursements (+):	5.6%	3.6%	2.2%
External-debt disbursements/total non-recurrent expenditure	52.0%	52.0%	52.0%
External-debt repayments (-)	-1.4%	-1.2%	-1.4%
Net internal-debt flow (+):	0.6%	2.8%	7.1% ⁴⁰

Source: Estimates and calculations from the projection workbook LSFS.xlsm.

A1. 2: Projection results for the fiscal-space projection exercise (base scenario)

	FY15/16	Average: FY16/17-FY20/21	FY20/21
GENERAL-GOVERNMENT FINANCIAL ACCOUNTS:			
Percent of GDP Initial projection year: FY16/17			
(A) Total priority non-interest expenditure:	14.6	14.6	14.6
Total education expenditure	7.9	7.9	7.9
Total health expenditure	6.1	6.1	6.1
Total social assistance expenditure	0.6	0.6	0.6
Priority recurrent expenditure:	14.3	14.3	14.4
Recurrent education expenditure:	7.8	7.8	7.9
Expenditure on education staff	6.3	6.4	6.5
Non-staff recurrent education expenditure:	1.5	1.4	1.4
Recurrent education expenditure on goods and services	0.1	0.1	0.1
Other non-staff recurrent education expenditure	1.4	1.3	1.3
Recurrent health and social development expenditure:	5.9	5.9	5.9
Expenditure on health staff	5.8	5.8	5.8
Non-staff recurrent health expenditure:	0.2	0.1	0.1
Recurrent health expenditure on goods and services	0.1	0.1	0.1
Other non-staff recurrent health expenditure	0.1	0.1	0.1
Recurrent social development expenditure	0.6	0.6	0.6
Expenditure on social development staff	0.2	0.2	0.2
Non-staff recurrent social development expenditure:	0.4	0.4	0.4
Recurrent social development expenditure on goods and services	0.1	0.1	0.1
Other non-staff recurrent social development expenditure	0.4	0.4	0.4

	FY15/ 16	Average: FY16/17- FY20/21	FY20/ 21
GENERAL-GOVERNMENT FINANCIAL ACCOUNTS:			
Priority non-recurrent expenditure:	0.3	0.3	0.3
Non-recurrent education expenditure:	0.1	0.1	0.1
Non-recurrent health expenditure:	0.2	0.2	0.2
Non-recurrent social development:	0.0	0.0	0.0
(B) Tax and non-tax revenue (excl. external grants) (+):	54.3	49.8	47.1
Tax revenue	25.0	25.4	25.3
Income tax:	13.8	13.8	13.8
Personal income tax	6.4	6.4	6.4
Company tax:	4.2	4.2	4.2
Other income	3.1	3.1	3.1
Taxes on property			
Taxes on goods and services	10.2	10.2	10.2
Value-added tax	8.4	8.4	8.4
Alcohol and tobacco products	0.6	0.6	0.6
Other goods and services	7.8	7.8	7.8
Excise taxes	1.8	1.8	1.8
Taxes on specific services	0.0	0.0	0.0
Taxes on the use of goods and on permission to use or perform activities	0.1	0.1	0.1
Taxes on international trade and transactions	0.9	0.9	0.9
Other taxes	0.0	0.0	0.0
Non-tax revenue (excl. external grants) (+):	29.4	24.4	21.7
SACU	24.2	19.3	16.6
Other Revenue	5.1	5.1	5.1
Property income	1.6	1.6	1.6
Interest			
Dividends			
Rent	0.1	0.1	0.1
Rent (Land)	0.1	0.1	0.1
Royalties	0.0	0.0	0.0
Sales of goods and services	3.5	3.5	3.5
Sales by market establishments	3.0	3.0	3.0
Administrative fees	0.2	0.2	0.2
Incidental sales by nonmarket establishments	0.3	0.3	0.3
Fines and forfeits	0.0	0.0	0.0
Miscellaneous and unidentified revenue	0.0	0.0	0.0
	0.0	0.0	0.0
(C) External grants (+):	3.7	3.7	3.7
(D) Total non-priority non-interest expenditure (-):	-44.5	-44.5	-44.5
Non-priority recurrent expenditure:	27.6	27.6	27.6
Non-priority non-recurrent expenditure:	16.9	16.9	16.9
(E) External-debt disbursements (+):	5.6	3.6	2.2
(G) External debt service (-):	-1.6	-2.1	-2.2
External interest expenditure	-0.8	-0.9	-0.8
External interest expenditure (-) (US\$ million)	-0.1	-0.1	-0.1
External debt repayments (-)	-0.7	-1.2	-1.4
External debt repayments (-) (US\$ millions)	0.0	-0.1	-0.1

GENERAL-GOVERNMENT FINANCIAL ACCOUNTS:	FY15/ 16	Average: FY16/17- FY20/21	FY20/ 21
Net internal financial flows (incl. internal interest) (+):	-2.9	4.1	8.4
Net internal financial flows (excl. internal interest) (+):	0.1	4.6	9.4
Internal-debt disbursements (+)	4.1	0.0	0.0
Internal debt repayments (-)	-4.0	0.0	0.0
Internal interest expenditure (-)	-0.3	-0.5	-1.0
Discrepancy (+)	-2.7	0.0	0.0
External and internal debt:	56.1	60.0	68.1

Source: Estimates and calculations from the projection workbook LSFS.xlsm.

**A1. 3: Projected priority expenditure (U.S. dollars per child and prices and exchange rate of FY15/16),
FY16/17 -FY20/21 (base scenario)**

GENERAL-GOVERNMENT FINANCIAL ACCOUNTS:	FY15/ 16	Average: FY16/17- FY20/21	FY20/ 21
U.S. dollars per child and prices and exchange rate of FY2016 Initial projection year: 2016			
(A) Total priority non-interest expenditure:	312.7	335.1	350.8
Total education expenditure	168.9	181.5	190.2
Total health expenditure	130.5	139.4	145.6
Total social assistance expenditure	13.3	14.3	14.9
Priority recurrent expenditure:	307.0	329.0	344.4
Recurrent education expenditure:	167.2	179.6	188.3
Expenditure on education staff	134.5	146.7	155.2
Non-staff recurrent education expenditure:	32.6	32.9	33.1
Recurrent education expenditure on goods and services	2.2	2.2	2.3
Other non-staff recurrent education expenditure	30.4	30.7	30.9
Recurrent health and social development expenditure:	126.7	135.4	141.5
Expenditure on health staff	123.5	132.2	138.2
Non-staff recurrent health expenditure:	3.3	3.2	3.2
Recurrent health expenditure on goods and services	1.6	1.6	1.6
Other non-staff recurrent health expenditure	1.6	1.6	1.6
Recurrent social development expenditure	13.0	14.0	14.6
Expenditure on social development staff	3.8	4.0	4.2
Non-staff recurrent social development expenditure:	9.3	9.9	10.4
Recurrent social development expenditure on goods and services	1.5	1.7	1.7
Other non-staff recurrent social development expenditure	7.7	8.3	8.6
Priority non-recurrent expenditure:	5.7	6.1	6.4
Non-recurrent education expenditure:	1.7	1.8	1.9
Non-recurrent health expenditure:	3.7	4.0	4.2
Non-recurrent social development:	0.3	0.3	0.3

Source: Estimates and calculations from the projection workbook LSFS.xlsm.

A1. 4: Additional sensitivity analysis for the fiscal-space projection exercise – enhanced expenditure on nutrition and child protection

Scenario:	0	1	2	3	4	5	6	7	8
Assumptions that vary with scenarios:									
Real GDP growth, FY16/17-FY20/21	Growth rate remains unchanged at 3% over the projection period.	Growth rate remains unchanged at 3% over the projection period.	Growth rate remains unchanged at 3% over the projection period.	Growth rate remains unchanged at 3% over the projection period.	Growth rate gradually rises over the projection period; from 5 % in FY2016/17 to 7 % in FY20/21	Growth rate gradually rises over the projection period; from 5 % in FY2016/17 to 7 % in FY20/21	Growth rate remains unchanged at 3% over the projection period.	Growth averages a rate of -1 % over the projection period	Growth averages a rate of -1 % over the projection period
Elasticity of company-tax revenue with respect to nominal GDP, FY16/17-FY20/21	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Remains at 1 over the projection period	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Remains at 1 over the projection period	Remains at 1 over the projection period.	Remains at 1 over the projection period.
Elasticity of personal income tax revenue with respect to nominal GDP, FY16/17-FY20/21	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Remains at 1 over the projection period	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 1.5 in FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.

Scenario:	0	1	2	3	4	5	6	7	8
VAT rate on alcohol and tobacco products, FY16/17-FY20/21	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period	Gradually increases over the projection period; from 15.0 % in FY15/16 to 19 % in FY20/21.	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period	Remains unchanged at 15 % over the projection period
Elasticity of administrative fee income to nominal GDP, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.
Elasticity of education staff size with respect to child population, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 4.0 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.4 in FY20/21.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.0 in FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.
Elasticity of health staff size with respect to total population, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 4.0 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.4 in FY20/21.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.0 in FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.

Scenario:	0	1	2	3	4	5	6	7	8
Elasticity of social protection expenditure to child population, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 4.0 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.4 in FY20/21.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 5.0 in FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.
Elasticity of non-priority recurrent expenditure to nominal GDP growth, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Gradually decreases over the projection period; from 1.0 in FY15/16 to 0.85 in FY20/21.	Remains at 1 over the projection period	Remains at 1 over the projection period.
SACU transfer growth rate, FY16/17-FY20/21	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at 0.3% over the projection period	Grows at (-0.3%) over the projection period
Elasticity of royalties with respect to GDP growth, FY16/17-FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Remains at 1 over the projection period.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.5 in FY20/21.	Gradually increases over the projection period; from 1.0 in FY15/16 to 2.5 in FY20/21	Remains at 1 over the projection period.	Remains at 1 over the projection period.
Results:									
Average tax revenue/GDP, FY2016-2021	25.40%	26.40%	25.90%	26.70%	26.10%	25.90%	25.40%	25.40%	25.40%

Scenario:	0	1	2	3	4	5	6	7	8
Average priority expenditure/GDP, FY2016-2021	14.60%	14.60%	15.10%	14.90%	14.50%	15.40%	14.80%	14.80%	14.60%
Average priority expenditure per child (U.S. dollars at FY2016 prices and exchange rate), FY2016-2021	\$335.10	\$335.10	\$347.70	\$341.30	\$356.60	\$379.40	\$339.60	\$301.50	\$335.10
Net internal debt flow/GDP, FY2016-2021	4.0%	3.4%	4.0%	4.0%	4.2%	5.10%	4.30%	2.1%	4.3%
Total government debt/GDP, FY2021	67.7%	65.0%	67.7%	67.7%	63.5%	67.7%	60.4%	67.2%	69.4%

Source: Estimates and calculations from the projection workbook LSFS.xlsm.



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