INTERNATIONAL MONETARY FUND

Addressing Fiscal Pressures

Kingdom of Lesotho

Yibin Mu

SIP/2022/002

IMF Selected Issues Papers **are prepared by IMF staff as background documentation for periodic consultations with member countries.** It is based on the information available at the time it was completed on [June 15, 2022]. This paper is also published separately as IMF Country Report No 22/162.

2022
December

SELECTED ISSUES PAPER

 SIP/2022/002

IMF Selected Issues Paper
African Department

Addressing Fiscal Pressures, Kingdom of Lesotho
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Authorized for distribution by Aqib Aslam
December 2022

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ABSTRACT: Lesotho's fiscal situation is challenging. This paper assesses the pressure points of main components of revenues, current spending, and capital spending, and then proposes a growth-friendly consolidation plan while protecting the vulnerable.

RECOMMENDED CITATION: Yibin Mu, Addressing Fiscal Pressures in Kingdom of Lesotho

JEL Classification Numbers:	E60 E61 H61 O23
Keywords:	Fiscal Policy, Macroeconomic analysis, Expenditure, Capital Spending, Wage bills, Social Spending
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SELECTED ISSUES PAPERS

Addressing Fiscal Pressures

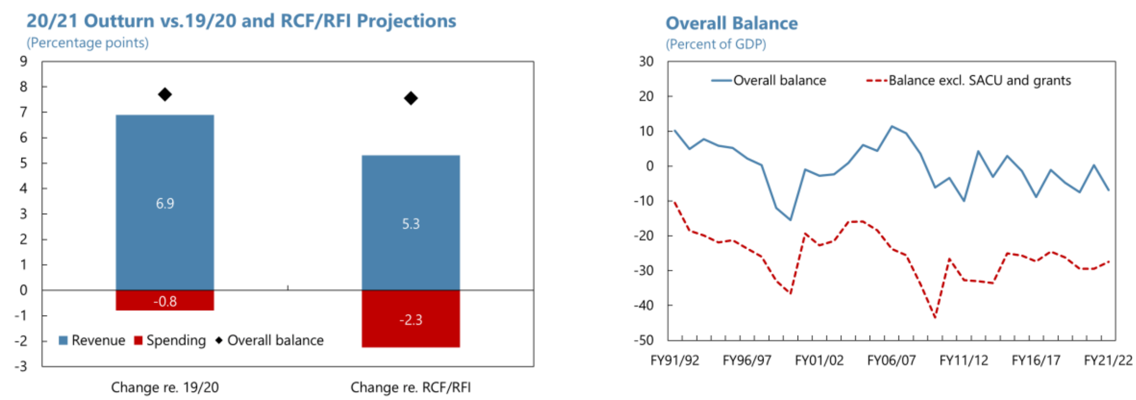
Kingdom of Lesotho

Introduction

1. **The fiscal outlook remains challenging and absent upfront consolidation the external position will continue to deteriorate.** SACU transfers shrunk by a third in FY21/22 and though they are projected to rebound in the short run, the outlook remains subdued and characterized by uncertainty. With the upward drift in spending over time, COVID-induced spending trade-offs are likely to persist if the pandemic lingers. In the absence of consolidation, the government would be forced to either (i) cut spending abruptly or (ii) accumulate sizeable arrears.

2. **While fiscal performance in FY20/21 was better than expected, the hard-won savings were not capitalized on in FY21/22.** Revenue performance in FY20/21 was 5.3 percentage points of GDP higher than projected under the 2020 RCF/RFI, from direct taxes and royalties and lower nominal GDP effects. Current expenditure fell by 3.6 percentage points of GDP relative to RCF/RFI projections—by limiting spending on goods and services and wage increases—and was redirected to measures to mitigate the pandemic (Figure 1). The result was a small overall balance surplus for FY20/21. However, the FY21/22 budget did not build on these gains, setting out double-digit deficits over the medium term with no concrete adjustment measures. While the March 2022 Budget Speech has provisionally tempered the fiscal outlook, it remains sensitive to revenue collection and the ability to control spending.

Figure 1. Recent Fiscal Development



3. **Efforts to restrain expenditure throughout 2020 and 2021 were undermined by growing domestic payments arrears.** Even though the FY21/22 Mid-Term Budget Review revised down spending, Ministries, Departments, and Agencies (MDAs) continued to spend according to previous budget allocations. As a result, the stock of arrears has increased to LSL1.25 billion (3.4 percent of GDP) as of end-November 2021 from LSL720 million (2.1 percent of GDP) at end-March 2021.

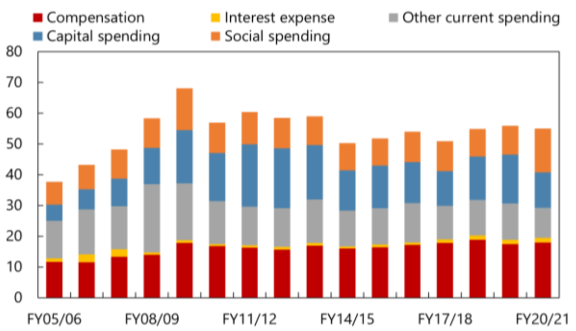
4. **The traditional approach of containing spending through nonwage cuts to limit nominal spending growth may improve the deficit temporally but will likely have negative effects on growth and equality.** The emphasis on preserving wages over efficient capital spending risks growth in the medium term. At the same time, the use of cash-based warrants can restrict spending but can also lead to arrears in the absence of robust PFM mechanisms and a well-planned depoliticized budget. A shift from a wage-preserving approach to a strategic, growth-friendly, poverty-reducing, and efficiency-oriented spending program—backed by broad-based domestic revenue mobilization efforts that weans the economy of external SACU transfers—would increase the chance of success and the sustainability of fiscal consolidation. By nature, this requires an

assessment of not only fiscal costs but also intended results/outcomes, such as the achievement of social and economic objectives, and the provision of high-quality public goods and services.

Analyzing Spending

5. Public spending in Lesotho has been outpacing GDP growth (Figure 2). As a result, public spending in percent of GDP increased from below 40 percent to beyond 50 percent over the last 15. The share of compensation of public employees and social spending has been increasing, squeezing capital spending and other nonwage current spending. Since some current spending is incorrectly recorded under the capital budget, the true size and growth of current spending is likely even larger.[1]

Figure 2. The Evolution of Public Spending
(Percent)



Sources: IMF staff calculations.

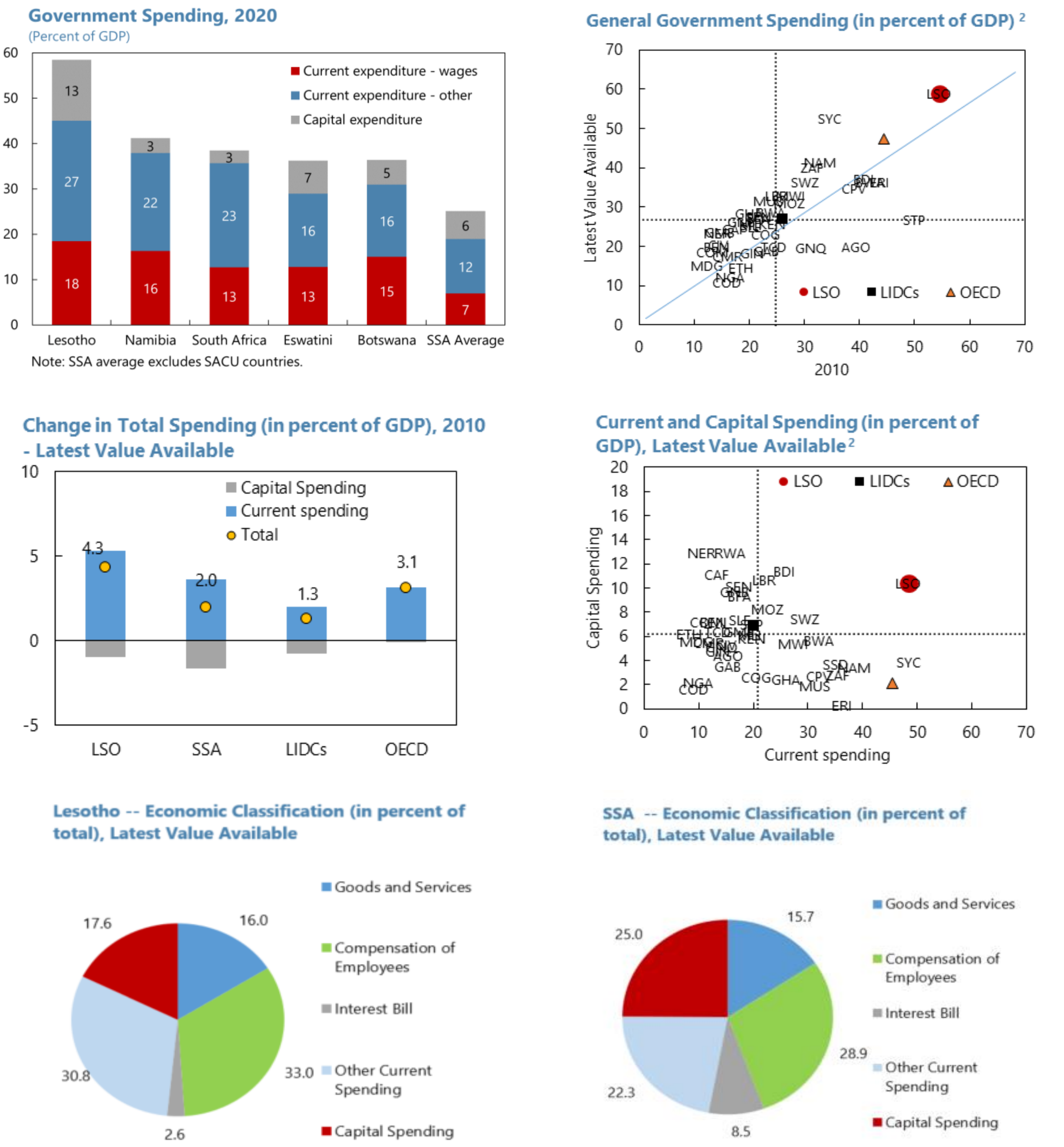
6. Lesotho's public expenditure stands out among peers and is tilted much more towards consumption than investment (Figure 3). Lesotho's public expenditure stands out across the region, across all categories: capital spending, wage spending, and nonwage current spending. Over the past decade, the jump of expenditure in percent of GDP has increased by 4.3 percent on average, compared to 2 percent for sub-Saharan Africa (SSA), and 1.3 percent for LIDCs. Compensation in Lesotho accounts on average for a larger share of total spending in Lesotho compared to SSA, while capital spending for almost 18 percent of total spending, compared to a quarter for SSA.

7. The compensation of public employees in Lesotho has been on an increasing trend.[2] The wage bill as a percent of GDP has increased from around 11.7 percent in FY05/06 to 18.4 percent in FY20/21, increasing from around 60 percent to 70 percent as a share of domestic revenue. Lesotho's compensation of public employees also stands out among sub-Saharan Africa in percent of GDP in SSA, with the highest public wage premium among SACU countries. Lesotho has the highest wage bill as a percent of GDP while the number of public servants per thousand of population are the smallest among SACU countries (Figure 4). This implies the average wage for Basotho public servants would be very high relative to other SACU countries.

1 This reclassification of current spending under the capital budget has begun in the FY22/23 budget.

2 SACU transfers windfall in FY20/21 led to the exceptional low compensation-to-total-revenue ratio.

Figure 3. Benchmarking Government Spending[1]

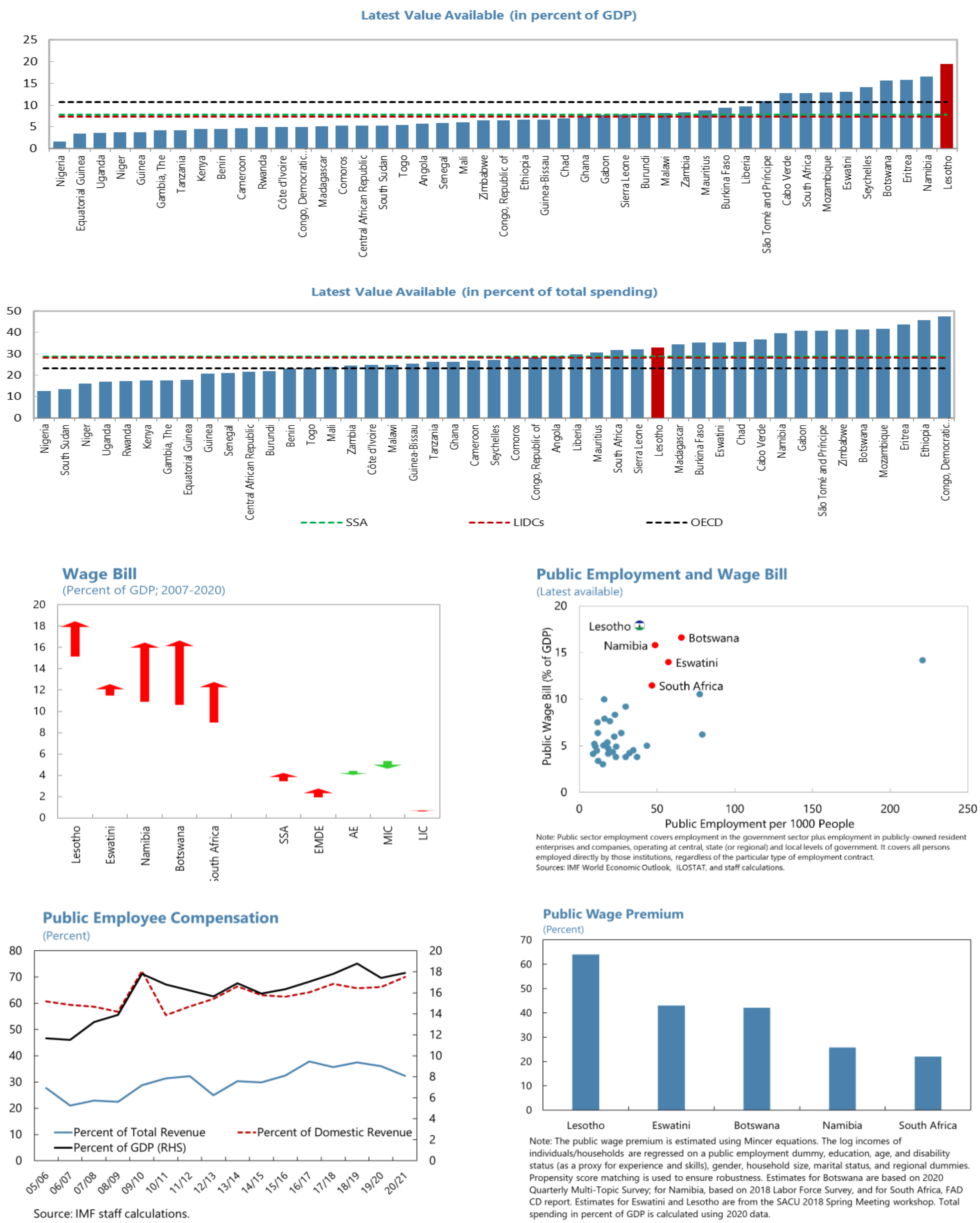


Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook.

1 Coverage refers to general government as per World Economic Outlook metadata.

2 Sashines are the average of SSA.

Figure 4. Public Wages



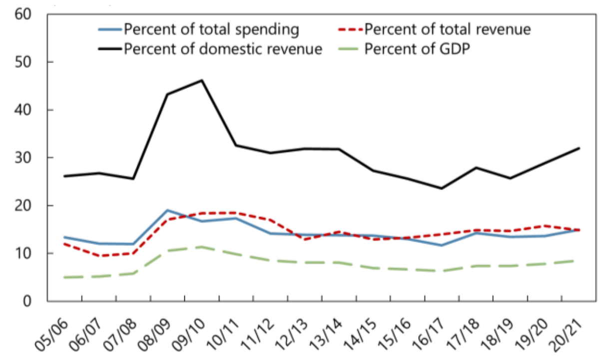
Sources: IMF FAD Expenditure Assessment Tool (EAT), IMF FAD Government Wage Bill and Employment Dataset, IMF FAD Public-Private Wage Premium Dataset, World Bank.

Note: Dash lines are the average for countries in the regional benchmark group.

8. Social spending has been increasing over the past five years, from 6.4 percent of GDP in FY16/17 to around 8.2 percent of GDP in FY20/21, or around 15 percent of total spending. Budget transfers to Tertiary Bursary Program and Old Age Pension (OAP) account for the largest, 2.64 and 2.39 percent of GDP, respectively, or 4.81 and 4.35 percent of total spending, respectively. (Figure 5, Table 1).

Figure 5. Social Spending in Lesotho

(Percent)



Source: IMF staff calculations.

Table 1. Lesotho: Social Protection Spending in Lesotho (FY20/21)

	Amount	Percent of GDP	Percent of Total Spending	Percent of Total Social Spending	Coverage
CGP	57.6	0.17	0.31	2.08	22
School feeding	187.2	0.56	1.01	6.75	100
Cash-for-work assistance	98.22	0.29	0.53	3.54	20
Public assistance	28.8	0.09	0.16	1.04	6
OVC bursary	73.5	0.22	0.40	2.65	11
Tertiary bursary	891.4	2.64	4.81	32.12	4
OAP	806.9	2.39	4.35	29.08	>100
Other social spending*	631.4	1.87	3.40	22.75	
Total social spending	2775.0	8.23	14.96	100.00	

Units: LSL Million

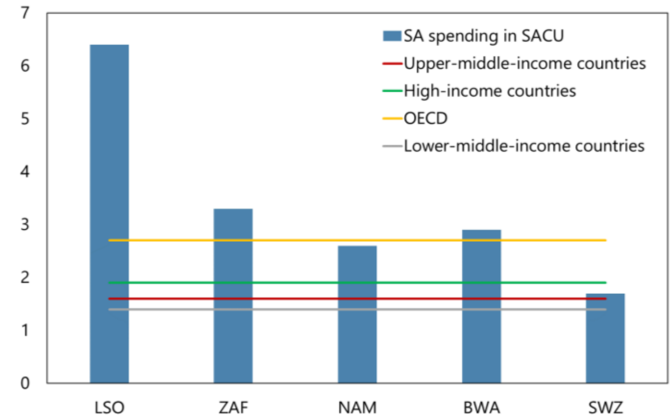
Note: *Mainly employer social benefits.

Sources: Author's calculation based on the data from the authorities.

9. Lesotho social spending ranks among the highest within the region. Social spending is also twice that of its neighbors on social protection spending as a share of GDP (World Bank 2021, Figure 6).

10. Capital expenditure has been on a declining path for much of the past decade—both as a share of GDP and as a share of total expenditure. From a recent peak in FY11/12 of 20.2 percent of GDP and around a third of expenditure, by FY20/21 it had fallen to12.0 percent of GDP and around a fifth of expenditure. Capital expenditure has been squeezed as overall revenues have declined in the context of rigid current expenditures. There are also capacity issues in line ministries that slow the development of 'bankable' projects consistent with national priorities and that result in uneven quality of project appraisal. Concerns were also raised about the legacy of current expenditure costs associated with some donor-financed capital projects.

Figure 6. Social Protection Spending Comparison
(Percent of GDP)

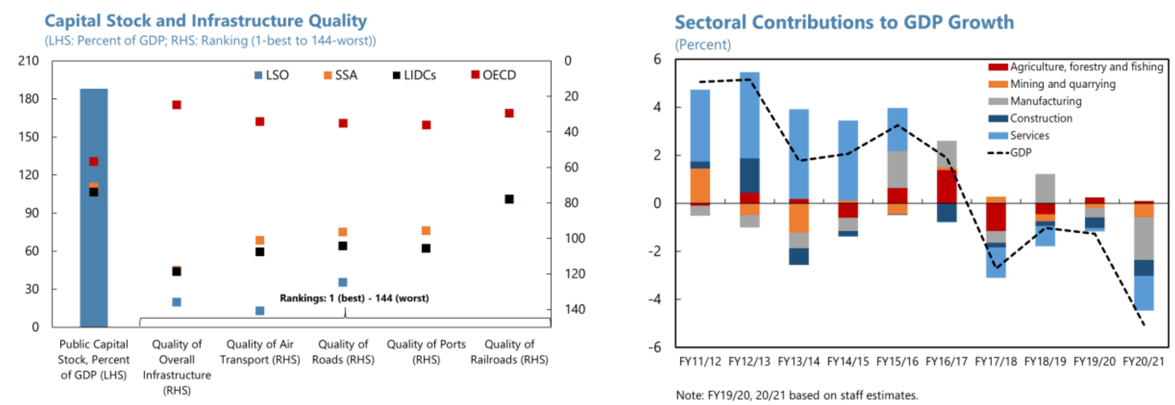


Sources: World Bank ASPIRE database and IMF staff calculations.

Notes: Spending data are from the latest available years in the ASPIRE database (based on administrative data): 2014-16 for Botswana, 2010–11 for Eswatini, 2014–17 for Lesotho, and 2015 for South Africa. Spending for Namibia are based on the SP note for the year 2018. Regional averages come from the State of SSN, WB 2018. Data for OECD countries refer to 2013 and are based on the Social Expenditure Database. Economies are divided among income groups according to 2016 GNI per capita, calculated using the World Bank Atlas method. The groups are as follows: low-income, US$1,005, or less; lower-middle-income, US$1,006-3,955; upper-middle-income, $3,956-12,235; and high-income, $12,236 or more.

11. Public investment should finance areas where it will have the maximum growth impact, crowding in private sector investment, and reducing poverty. The capital budget has so far produced a capital stock that is relatively high as a share of GDP but of lower quality compared to peers (Figure 7). Streamlining the budget by identifying and minimizing stalled projects and misclassified current spending—as well as improving investment appraisal and execution—will help ensure that capital spending is more efficient and better targeted to achieve development priorities and maximize growth.

Figure 7. Capital Spending in Lesotho



Sources: IMF FADExpenditure Assessment Tool (EAT), World Economic Outlook, World Development Indicators, IMF Investment and Capital Stock Dataset, and World Economic Forum.

Sources: Ministry of Finance and IMF Staff calculations.

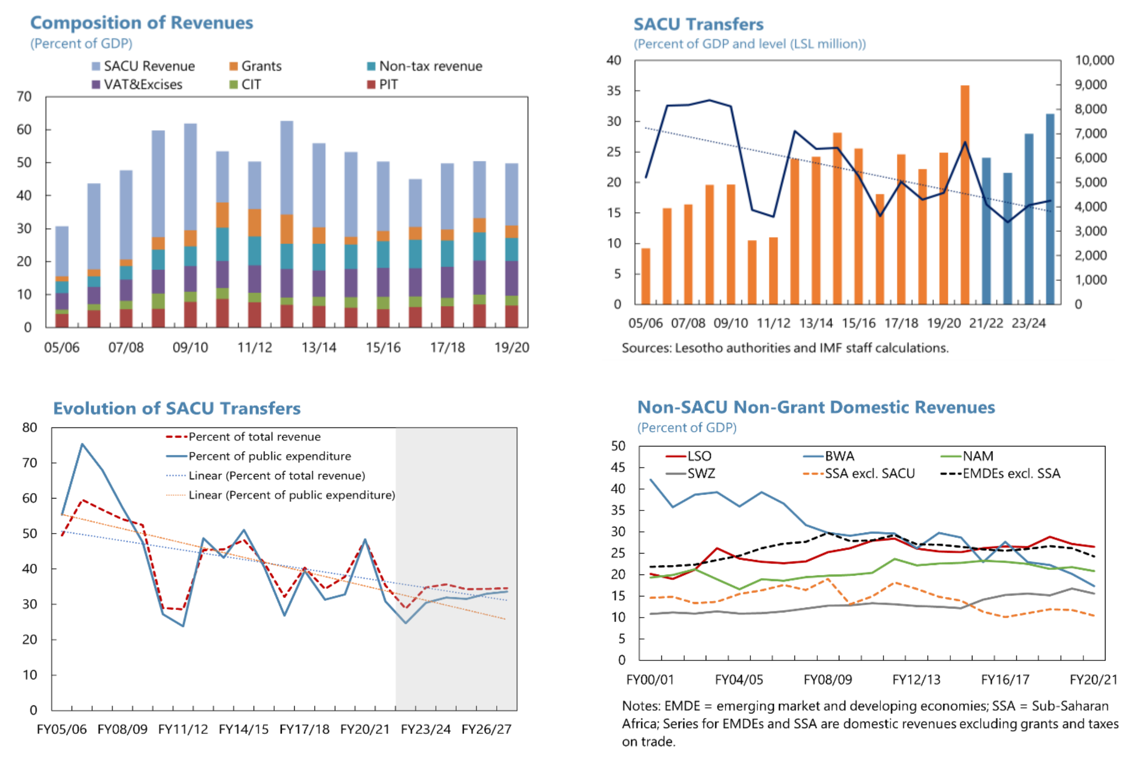
Analyzing Revenues

12. Lesotho has become reliant on external SACU transfers. Total revenue comprises external transfers (grants and SACU transfers) and domestic revenues. The latter includes tax revenues—including personal income tax (PIT), corporate income tax (CIT), VAT and excises—and non-tax revenues, for example, water and mining royalties. Overall, the share of external transfers has been declined from 60 percent in late 2010s to around 50 percent in recent years (Figure 8).

- SACU transfers have been volatile over time and appear to be declining over time. SACU transfers to Lesotho has been on declining trend in percent of GDP, total revenue, or total expenditures. The outlook of SACU transfers is also very challenging. SACU transfers are forecasted to shrink by a third in FY21/22 and remain subdued thereafter.

- Lesotho's domestic revenue mobilization has performed well over time.[3] Lesotho's domestic revenue in percent of GDP is among the highest in the region.

Figure 8. Evolvement of Revenue Compositions



Sources: National Authorities and IMF staff calculations.

Analyzing the Overall Fiscal Balance

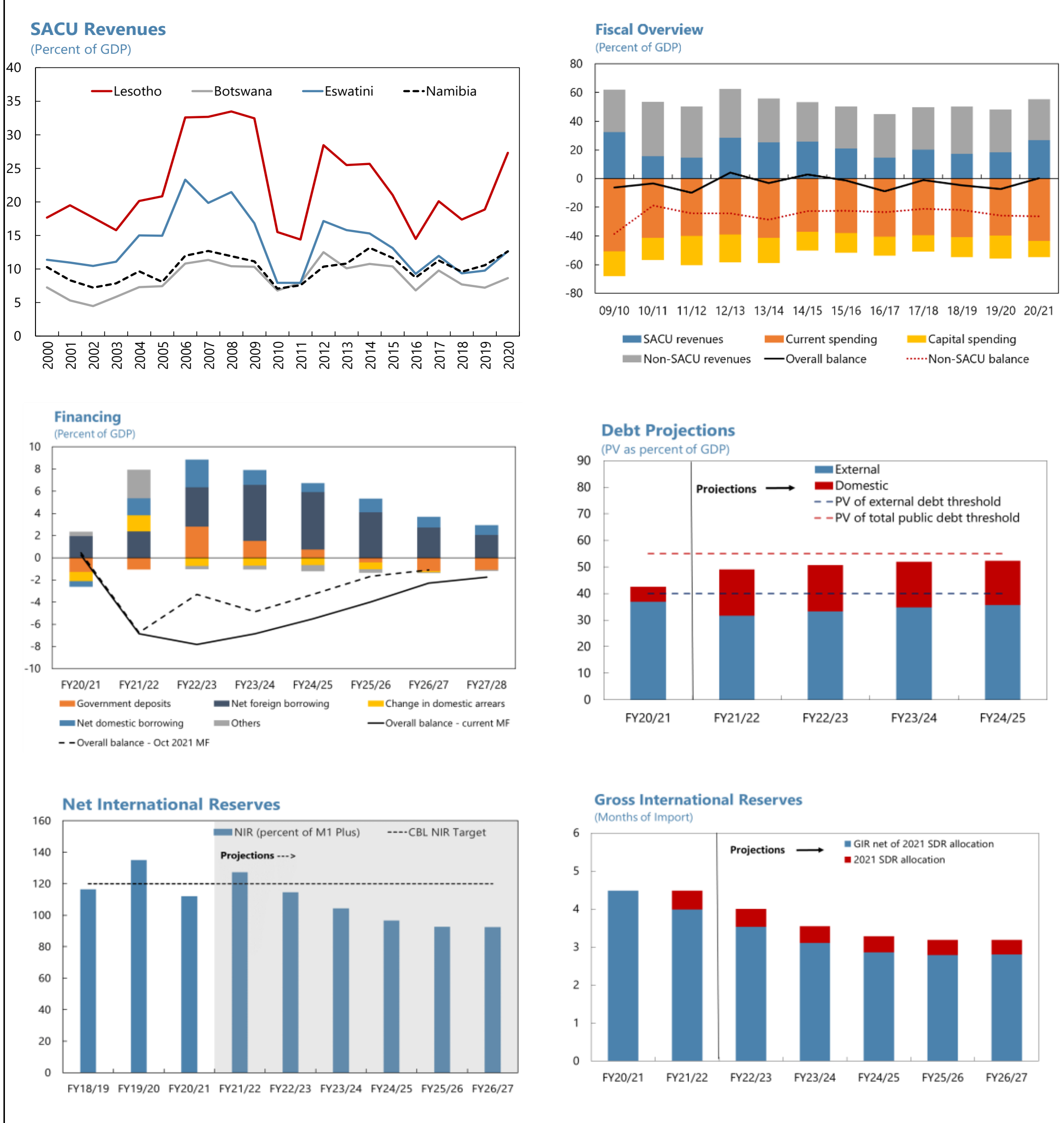
13. Lesotho faces increasing fiscal challenges. Benefited from generous SACU transfers, Lesotho has maintained very high expenditure levels. However, SACU transfers are very volatile while the spending

[3] See SIP: *An Overview of Taxation in Lesotho*.

seems much rigid in downward adjustment, as a result, the total spending in percent of GDP has been increasing and the deficit (excluding SACU transfers) has been deteriorating.

14. Fiscal pressures under the current policy scenario are causing financing constraints to bind, risking debt sustainability and the peg (Figure 9). Lesotho experienced chronically large fiscal deficit and a growing debt burden, beyond 60 percent of GDP. The high levels of government spending and debt are limiting room for maneuver. Under current policies, the IMF, and World Bank Joint Debt Sustainability Analysis (DSA) showed that the present value of public debt would rapidly approach threshold after which the country is at high risk of debt stress. Net international reserves would decline to below 100 percent, and gross international reserves will go below 3.5 months of imports coverage.

Figure 9. Fiscal Pressures Drive Financing Needs and Debt



Source: IMF staff calculations.

Policy Recommendations

15. Fiscal consolidation is crucial to reduce imbalances and rebuild much-needed fiscal space to protect the vulnerable, finance the recovery, and mitigate external shocks. Given the already high revenue ratio, the highest among SACU countries, expenditure must bear the brunt of adjustment. The authorities must find ways to contain current spending, scale back unproductive capital spending, and improve efficiency to ensure fiscal sustainability and preserve macroeconomic stability. The risk of overly ambitious revenue projections and high expenditure jeopardize not only fiscal sustainability, but also resources needed to sustain the exchange rate peg.

16. Lesotho's public expenditure in percent of GDP is among the highest in the world, which poses significant challenges to fiscal and debt sustainability; instead of cross-board cutting, it is advisable to take targeted cutting on specific items to support growth, specifically:

- *Contain the wage bill.* Spending of public employee compensation accounts for around 20 percent of GDP or over 70 percent of domestic revenues. If the country can freeze the public wage and size the of public employee for 2–3 years, this can reduce wage bills by 3–5 percentage points of GDP or to below 60 percent of domestic revenues (See Para. 18).

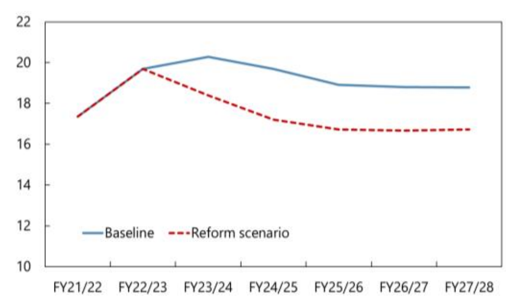
- *Rationalize the social spending.* Eliminating the ghost OAG beneficiaries, significantly cutting the budget transfers to tertiary bursary program while enhancing poverty-reducing social programs could reduce social spending in percent of GDP by about 2–3 percentage points while increasing poverty-reducing by 0.5–1 percentage point of GDP (See Para 19).

- *Improve capital spending efficiency.* Lesotho's capital spending accounts for 12–15 percent of GDP, much higher than neighboring countries. However, the outcome is poor. It is advisable to enhance the selection of capital projects while there is some room for cutting in capital spending (See Para. 20).

In nutshell, the above measures could save spending by 5–8 percentage points of GDP, which should improve Lesotho's fiscal situation dramatically and get on sustainable path.

17. Compensation of public employees is surely an area for savings. It is advisable to adopt the following structural reforms to contain wages. Over 4 to 5 years, public wage bill in percent of GDP could be lowered by 3–5 percentage points (Figure 10) and from 70 percent to below 60 percent of domestic revenues.

Figure 10. Public Compensation Scenarios
(Percent of GDP)



Note: Red line assumes wage freezing at FY22/23 level until FY24/25 and half COLA and half Notch afterwards.

a. *Implement a wage freeze* with no cost-of-living-adjustments ("COLA") and no structural wage increases ("notches") for 2 to 3 years and then half "notch" and half "COLA" for 1 to 2 years;

b. *Freeze the number of public services.* Close established positions that have been vacant for 12 months or more and freeze the hiring of non-essential public servants, and fill existing posts by re-deploying the existing work force as needed. The definition of essential

positions will be determined by the Establishment Committee. This definition and the requirement to close long-vacant positions will be recorded in the Civil Service Establishment Policy and published online. If the Establishment Committee deems that those temporarily hired under the Apprentice Program are nonessential, the Apprenticeship Program should be wound up. While apprenticeships have provided valuable training and transferable skills to those looking to enter the job market, it should be noted that absorption of young people into the public sector has undermined the recruitment in the private sector.

c. After two to three years of freezing period, *add steps within job grades and reduce associated pay increases to slow remuneration growth.* Explore the introduction of performance-based compensation.

d. Alongside measures to curb the high wage-to-GDP ratio, efforts should *review and adopt a new Civil Service Employment Policy* that aims to maintain a sufficiently lean, professional, and highly efficient civil service.

18. Prioritizing poverty-reducing social spending is essential to protect the vulnerable. However, the size of Lesotho's social spending stands out within the region as being relatively high as a share of GDP and so it is advisable to eliminate/minimize inefficient spending and better re-allocate across existing social programs. In addition, it is advisable to use new technologies to help reduce both leakage and the cost of operations.

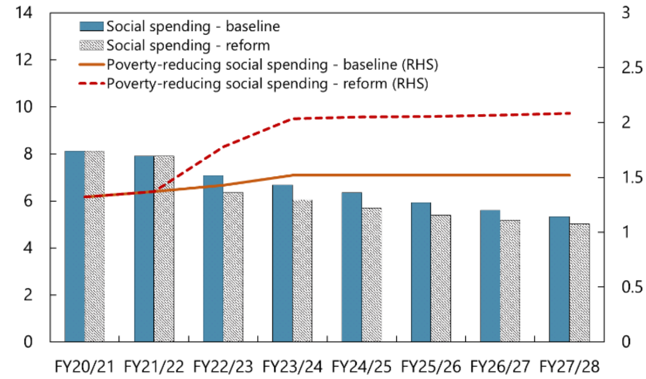
- *Continue to eliminate false payments to "ghost" pensioners under the Old Age Pension Program (OAP)*. According to the same World Bank study (World Bank 2021), there are around 38 percent of ineligible OAP beneficiaries. Assume cleaning up these ineligible beneficiaries (removing 34 percent with 4 percent as cushion) during year T=1and then 6 percent of natural growth of the program to capture the natural increasing of beneficiaries. To do so, it is necessary to link the new OAP management information system—Government of Lesotho Social Assistance Benefits System (GOLSABS)—with the National Identity and Civil Registry (NICR) via a secure exchange of data to ensure program integrity and help eliminate "ghost" pensioners.

- *Reduce the cost of the tertiary bursary scheme over time*, which is currently financing many students who do not need support. These cuts will start in T+1 (e.g., FY22/23) by reducing the intake of new students and further reducing costs by enhancing collection of outstanding student loans and improving the targeting of the scheme through means-testing approach.

- *Increase spending on key poverty-reducing social assistance programs.* Specifically, spending on the cash-for-assistance, child grants, orphans and vulnerable children, public assistance, and school feeding programs will be increased to expand coverage and adequacy of benefit levels and help alleviate poverty and inequality. Increased social spending on these specific programs can also help offset the regressive impact of any tax policy changes. Specifically, double school feeding program and jump public assistance, OVC bursary and cash-for-work programs by fifty percent.

Figure 11 and Table 2 show the combined considerable results of these reforms. Total social spending could be reduced by 2–3 percentages of GDP over three to four years while poverty-reducing spending could be improved from 1.4 to 1.6 percent of GDP.

Figure 11. Social Spending
(Percent of GDP)



Source: IMF staff calculations.

Table 2. Lesotho: Simulation of Social Program Reforms

	Base*	growth rate	T+1	T+2	T+3
Poverty-related social programs to be enhanced					
CGP	0.16	0.3	0.19	0.23	0.28
School feeding	0.51	0.3	0.61	0.74	0.91
Cash-for-work assistance	0.27	0.15	0.28	0.31	0.33
Public assistance	0.08	0.15	0.08	0.09	0.10
OVC bursaries	0.20	0.15	0.21	0.23	0.25
Total (floor)	1.21		1.38	1.60	1.86
Programs to be contained					
Tertiary bursary	2.71		1.75	1.15	0.75
OAP	2.19	0.08	1.34	1.36	1.37
Programs to be maintained					
Other social spending	1.72		1.66	1.65	1.64
Total social spending	7.84		6.13	5.76	5.62

Note: in LSL milllions
* data are from the authorities.
** Cleaning up inellible beneficareis druing t+1, and then assuming natrual growth of 8 percent.

19. Alongside current spending, the capital budget needs urgent attention to strip out misallocated and unproductive capital spending. The capital budget will be rationalized by identifying and eliminating unproductive projects and temporarily halting stalled projects. Improving investment planning and execution—including project appraisal and prioritization—will also help ensure that capital spending will be better targeted to achieving both the objectives under the NSDP-II and the SDGs. The capital budget can be streamlined further by eliminating inefficiencies, including items of current expenditure misallocated as capital spending. Potential savings can also be deployed to build climate-resilient infrastructure. Particularly, the government funded capital investment projects should be cleaned up and then enhanced to support growth.

20. Cost-cutting measures will also benefit from the compilation of a registry of government assets. This registry will help with the identification and disposal of unnecessary public nonfinancial assets, which can help raise funds and reduce costs. Such savings, for example, would include the reduction of the government vehicle fleet.

21. **Fiscal consolidation along the above lines would be growth friendly.** Rising expenditure in recent years has not led to higher growth, perhaps owing to inefficiencies. Fiscal consolidation through scaling back less-productive expenditure while focusing on more efficient, well-targeted spending, growth-friendly investment, and revenue administration could, therefore, mitigate risks to growth (Figure 12). Nonetheless, strong social safety nets remain important to protect the vulnerable.

22. **Domestic revenue mobilization can still help support the adjustment**. While (non-SACU non-grants) domestic revenue performance—driven by stable personal income tax revenues, VAT, and water royalties—stands out relative to peers, the authorities are encouraged to use all available opportunities to broaden the tax base, improve tax administration, and increase compliance so as to help maximize resources as external transfers decline. These include (i) introducing excises on alcohol and tobacco; (ii) improving the efficiency of tax administration by introducing cashless tax collection systems, and (iii) improving compliance by enhancing transparency and audit. It is also vital to maintain the integrity of existing taxes, notably the VAT.

Figure 12. Growth and Recurrent Public Spending

Source: IMF staff calculations.

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