Okoa Uchumi Campaign

KENYA DEBT CRISIS: UNPACKING FISCAL CONSOLIDATION

2021

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The *Okoa Uchumi campaign* is a civil society platform committed towards working with citizens to resolve Kenya's public debt crisis. The campaign advocates for balanced and equitable budgets as a means of achieving debt sustainability and economic inclusion. The campaign seeks to bolster constitutional safeguards in public debt management and to push for the accountability of political leaders in public debt management.

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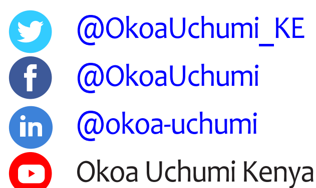

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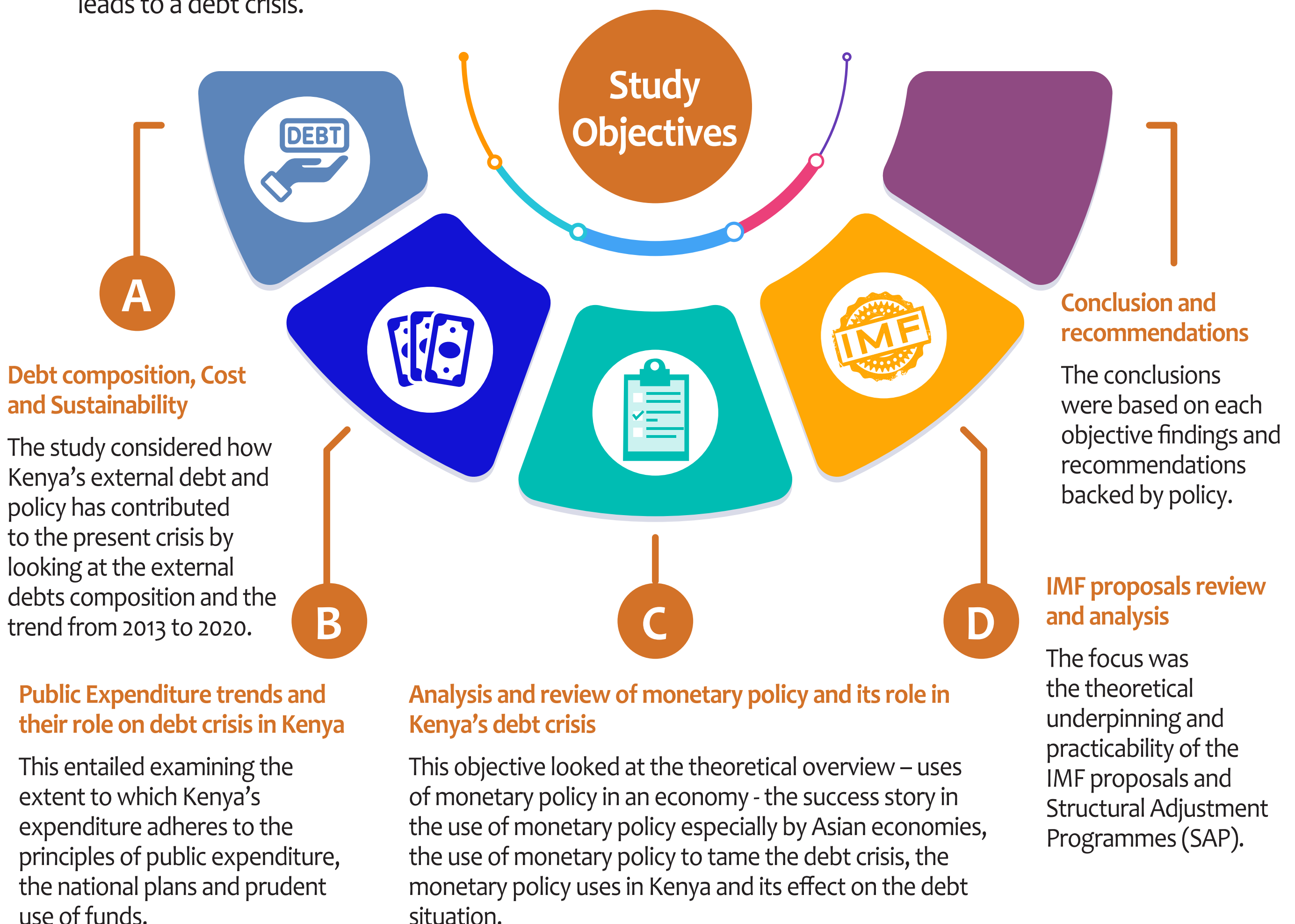
About this study

This study commissioned by *Okoa Uchumi Debt Campaign*, a civil society platform, reviewed the debt situation in the country, the tax policy and the International Monetary Fund's fiscal consolidation. Through its recommendations, the campaign seeks to push for political accountability and bolster constitutional safeguards in public debt management to achieve debt sustainability through a balanced and equitable budget.

Why Kenya is facing a debt crisis

The study found out that Kenya is increasingly getting into a debt trap due to persistent fiscal deficits driven by growth in foreign borrowing and expanding imports. With constrained access to concessional loans, commercial debt is being used to support government budget and finance infrastructural projects. The country is equally running a current account deficit that is mainly financed by capital inflows from borrowings.

To avoid a debt trap, Kenya must earn enough foreign income from exports, remittances and other sources if it is to manage its import bill, debt repayments and interest payments. In the absence of this, as it is currently, the country gets into the debt trap, that is to borrow even more as the only avenue to increase access to foreign resources. The borrowing spree does not only magnify the external debt problem but also leads to a debt crisis.



A — Debt composition, Cost and Sustainability

The study considered how Kenya's external debt and policy has contributed to the present crisis by looking at the external debts composition and the trend from 2013 to 2020.

B — Public Expenditure trends and their role on debt crisis in Kenya

This entailed examining the extent to which Kenya's expenditure adheres to the principles of public expenditure, the national plans and prudent use of funds.

C — Analysis and review of monetary policy and its role in Kenya's debt crisis

This objective looked at the theoretical overview – uses of monetary policy in an economy - the success story in the use of monetary policy especially by Asian economies, the use of monetary policy to tame the debt crisis, the monetary policy uses in Kenya and its effect on the debt situation.

D — IMF proposals review and analysis

The focus was the theoretical underpinning and practicability of the IMF proposals and Structural Adjustment Programmes (SAP).

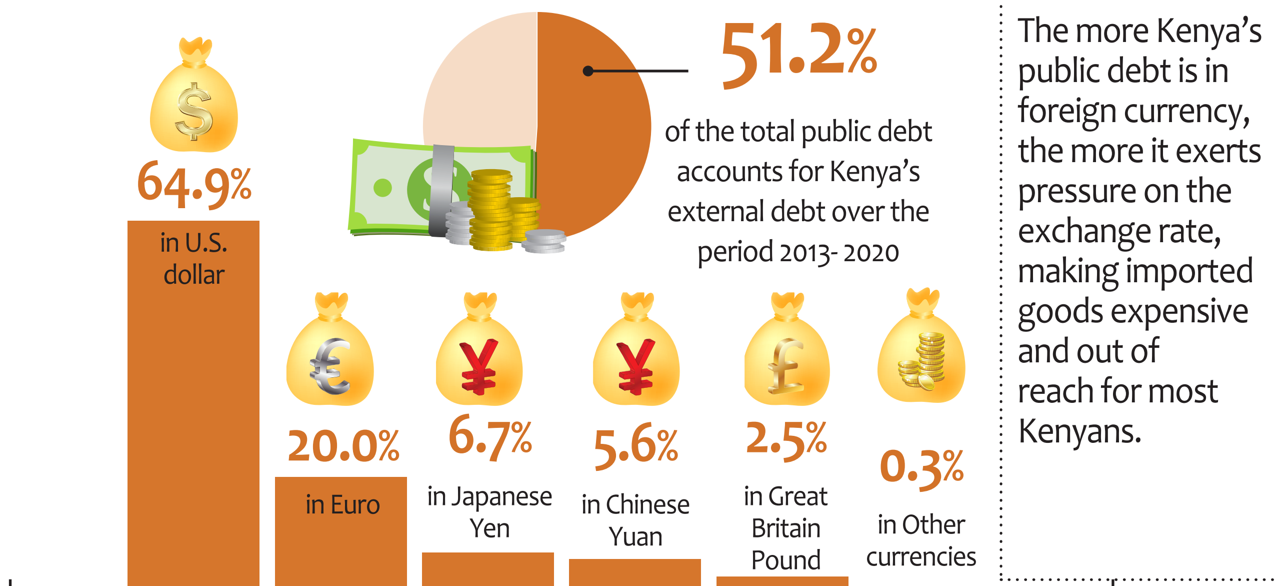
Conclusion and recommendations

The conclusions were based on each objective findings and recommendations backed by policy.

Summary of key findings

Why public debt denominated in foreign currency is bad for Kenya

Illustration 1.1: ***Currency composition of Kenya's external debt (2013- 2020)***



Source: *Annual public debt Reports 2019/20; 2018/19 and 2017/18*

Public debt denominated in foreign currency has major risks and excessive leverage on it can lead to pressure on the exchange rate and monetary policy distress that give rise to financial crisis.

From 2013 to 2020, external debt in Kenya increased from Kshs. 843,562 million to Kshs. 3,515,812 million. This reflects foreign debt growth rate of 316.8 percent.

This means the country increasingly requires foreign currency for expanding to meet its external liabilities. The liabilities to the rest of the world are growing at an average rate of 20 percent per annum. This is not good for debt sustainability.

The increase in commercial loans has pushed up the cost and risk of public debt in Kenya.

This is against the acknowledgement given in the government's debt and borrowing policy, 2020, which envisage concessional and semi-concessional borrowing to minimize cost, risk and reduce the public debt to a sustainable level.

Why a strong Kenyan shilling is Killing domestic industries

A strong Kenyan shilling reduces the competitiveness of exports which could dampen economic growth. Kenyan exports become expensive abroad and imports become cheaper thereby discouraging domestic industries as the share of foreign goods in the domestic market increases.

Furthermore, a high interest rate which discourages domestic investment and hurts economic growth and employment, is generally associated with short-term inflows of foreign exchange which strengthens the shilling. Strengthening the shilling by short-term foreign inflows increases the risk of exchange rate instability.

An appreciating currency is like a tax hike; it increases the burden on manufacturers of domestic goods while making imports cheaper domestically. This can lead to a recession as excess capacity can trigger layoffs. As the economy goes into a recession, there would be weak effective demand and the National Treasury would collect less tax revenue which would undermine the activities of the Government.

Debt trap: Why Kenya is likely to keep borrowing

Kenya is not earning enough foreign income from exports and remittances hence it cannot manage its import bill, debt repayments and interest payments. With inadequate foreign income, the country is likely to borrow even more as the only avenue to increase access to foreign resources, leading to a debt trap. The borrowing spree does not only magnify the external debt problem but also leads to a debt crisis.

Looming debt crisis as Kenya goes for expensive commercial loans

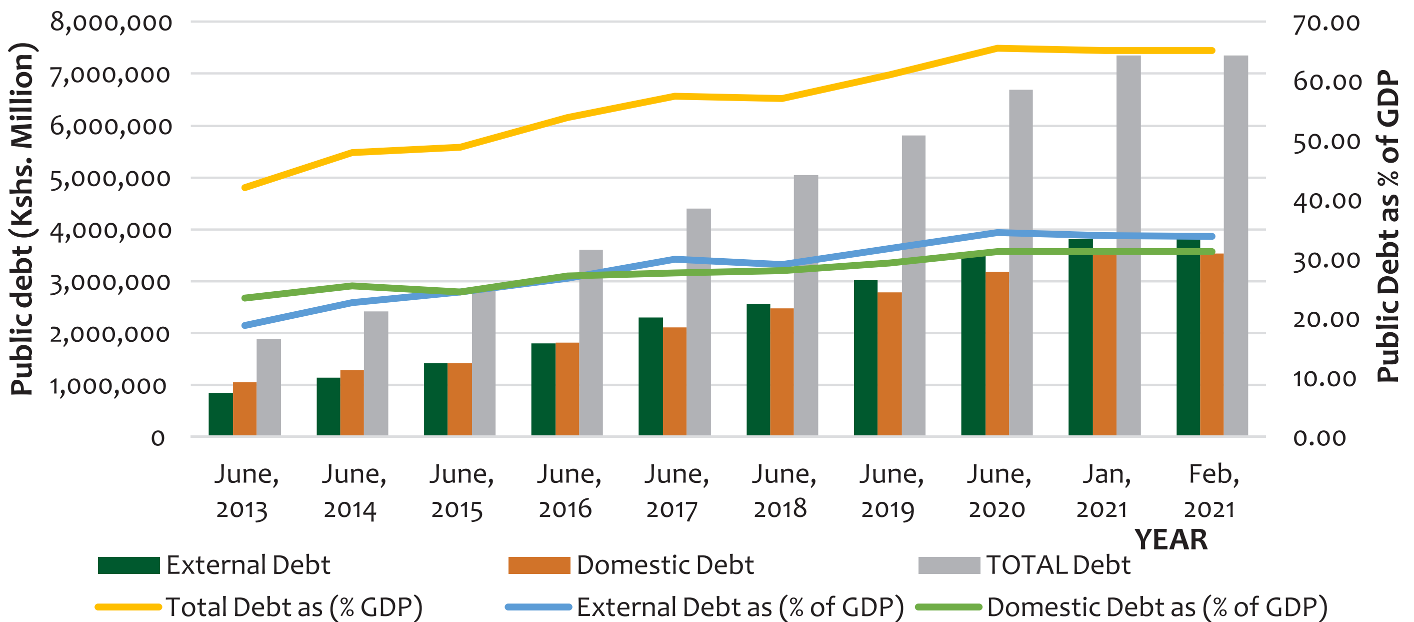
Kenya's public debt path is riskier as the government has demonstrated preference for more expensive commercial loans which raises the cost of debt that may eventually lead to a debt crisis. It is complicated when the rapid growth in external debt is not matched with growth in foreign exchange earning. Persistent increase in budget deficit has made debt rise more rapidly than the GDP growth rate. A

rising public debt that grows at a higher rate than the economy is a pointer that government has not invested to stimulate economic growth and increase ordinary revenue.

Kenya's preference for expensive commercial loans., point to a debt crisis

The debt crisis has been building over time

Figure 2.1: ***Public Expenditure trends and their role on debt crisis in Kenya (2013 – 2021)***



Kenya is currently going through a twin risk reflected in the public budget deficits and public debts caused by chronic macroeconomic imbalances, which were not resolved when conditions were still favourable. For public debt to be sustainable, its growth should remain below that of nominal GDP.

Public deficit and debt problem are intertwined with the external deficit, highlighting the adverse effects that poor taming of growth in public debt brings.

To increase revenue, Kenya should tame corruption and tax evasion

Illustration 1.3: ***Kenya's government revenue***

70%

of government revenue in Kenya comes from taxation.

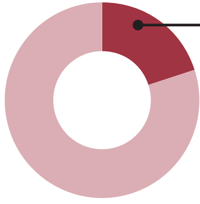
There is need to tame tax evasion and corruption rather than increasing taxes from already strained households and businesses.

Source: *Annual public debt Reports 2019/20; 2018/19 and 2017/18*

Kenyans are overtaxed and any fiscal measure leading to increasing taxes will be unpopular.If such a move is effected, it will have no effect on tax revenue thus leading to adverse effects on the economy. Kenya's tax administration measures have been unproductive in enhancing tax revenue over the recent past.

How Kenya can tame the borrowing spree

***Illustration 1.4:** Export of goods and services*



Exports of goods and services in Kenya remained above

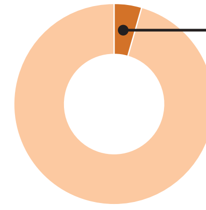
20%

of GDP from 2001 to 2012 and averaged **19 per cent** during 1998-2020.

Kenya must earn enough foreign income from exports, remittances and other sources if it is to manage its import bill, debt repayments and interest payments.

With the debt trap, the country is likely to borrow even more as the only avenue to increase access to foreign resources. This, not only magnifies the external debt problem in the long run but also raises vulnerabilities leading to a debt crisis.

***Illustration 1.5:** Kenya's net inflows*



Net inflows amounted to

4.7%

of GDP in 2020, reflecting government borrowing, including IMF emergency support, borrowing by other financial corporations (non-banks) to manage the deficit.

This showcases government's appetite for external commercial borrowing.

Where foreign debt is a must, the Government should move away from the expensive commercial loans. The ultimate goal should be the reduction of borrowing by taming corruption and misuse of revenue.

***Illustration 1.6:** Kenya's reserve coverage*

US$8.4bn

Kenya's reserve as at the end of 2020, compared to **USD 9.1 billion** as at the end of 2019

Reserve coverage was equivalent to 8.4 percent of GDP as at the end of 2020

Holding a foreign currency reserve lowers the probability and severity of an economic crisis.

Kenya should reverse penchant for more taxes

Illustration 1.7: ***Kenya's revenue - increasing measures introduced in 2020***

Tax Law Amendment Act (April 2020)

30%
of electricity cost incurred in addition to the normal electricity expense disallowed

Exemption of interest earned on contribution paid to Deposit Protection Fund from tax discontinued

100%
Reduced investment deduction rate from **150%**

15%
Increased rate on non-resident dividends from 10%

Value Added Tax (VAT)

Expanded the VAT base by removing the exclusion of excise duty and levies from taxable value of petroleum*

Removed plant and machinery from VAT exemptions

Removed supplies for construction of power generating plant from VAT exemptions

Changes introduced through Finance Act 2020

1%
Introduction of a minimum income tax payable by all companies of the gross turnover*

1.5%
Introduction of tax on digital services of the gross transaction value

14%
Reversal of VAT reduction of standard rate from **16%**

Ksh28,800pm
Retained the increase of personal relief from **Ksh 16,896**

Pay-as-you-earn (PAYE) exemption removals

25%
Reversal of reduction of standard PAYE rate from **30%** *

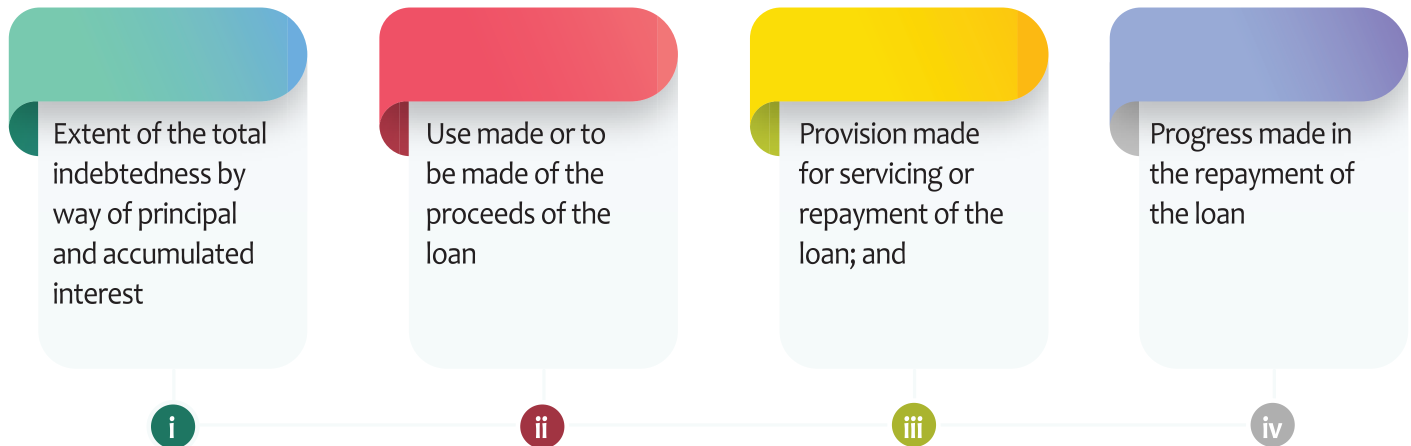
Justice Odunga declared minimum tax introduced by the Finance Act (June 2020) unconstitutional on grounds that the levy exposed businesses, and especially those recovering from losses, to double taxation.

* ***Counterproductive measure given the economic situation in the country***

Source: *Annual public debt Reports 2019/20; 2018/19 and 2017/18*

On borrowing by national government, Article 211(2) of the Constitution provides that when Parliament passes a resolution for borrowing, the Cabinet Secretary for the National Treasury shall present the information in illustration 1.8 concerning any particular loan or guarantee:

Illustration 1.8: ***What National Treasury should reveal about loans, guarantees***



Conclusion: Kenya's public debt is not sustainable

Reducing fiscal deficit remains key to stemming public debt accumulation and maintaining it at sustainable levels. The objective is to reduce the fiscal deficits and public debt vulnerabilities and lower Kenya's risk of debt distress from high to moderate in the medium term.

To achieve this, the government should reduce the fiscal deficit to levels consistent with the GDP growth rate. The tenets of public debt management in Kenya are enshrined in the Constitution and the Public Finance Management (PFM) Act 2012 and the Public Finance Management Regulations, 2016.

The legal framework is meant to promote prudent and sound debt management practices for both national and county governments with the aim of enhancing public finance effectiveness and transparency in management of public resources.

Study Recommendations

1. **More borrowing should be in domestic denominated currency.** The National Treasury and IMF should review the domestic-foreign debt mix policy such that more public debt is denominated in domestic currency that promotes domestic productivity. The government needs to promote and consume domestic production and use more of domestic borrowed resources.

2. **The country's monetary policy should be revised:** The study calls for a move of the country's exchange rate closer to its equilibrium. With this, the country can reduce taxes on imported inputs and upgrade its productive capacity.

3. **Where foreign debt is a must, the government should move away from commercial loans to avoid exposing the country to risk.** The guiding principle of borrowing as espoused in section 50(1) of the PFMA should be observed. This stipulates that in guaranteeing and borrowing money, the national government shall ensure that its financing needs and payment obligations are met at the lowest possible cost in the market, which is consistent with a prudent degree of risk, while ensuring that level of public debt is sustainable.

4. **The National Treasury should provide a justification on why recurrent balance is financed through external debt.** This should only be allowed if the financing is critical in maintaining or protecting valuable aspects of life. The government should adhere to the Public Finance management Act 2012 which stipulates that over the medium term a minimum of 30 percent of the national and county governments' budget shall be allocated to the development expenditure. This needs to be enforced by Parliament.

5. **Parliament should cap the number of supplementary budgets to a maximum of one, at mid or end of the financial year.** This will reverse the regular overshooting of actual expenditure above the budgeted. The budgetary overshooting is a sign that the National Treasury does not observe the prerequisites for management of financial resources that include having a realistic budget, clear procedures for the release of appropriations, strict observance of the budget execution rules, experienced and skilled personnel to prepare and monitor the cash plans and clear and transparent borrowing procedures and rules.

6. **Government borrowing should only be used for the purpose of financing development expenditure** and not for recurrent expenditure, (See section 15(2)(c)) of the PFMA. This law needs to be enforced by Parliament.

7. **A resolution be duly moved and passed by Parliament** as provided for in Section 15(2)(d) of PFMA that sets the national indebtedness limits and be pegged to real economic performance. This is to ensure that the public debt limits are maintained at sustainable levels at any given time.

8. **Authentication of National Treasury data by independent body should be carried out regularly.** This is provided for in the law. Government equally needs to be more consistent in the way it reports the public finance data and should make it easier to track the planned versus actual data. In addition, there is need to ensure consistency of data across various government documents/ sources. There is need to improve forecasting and planning.

9. **Commitment to loans should only happen once the programs and projects are ready for implementation.** This will reduce wastages incurred through commitment fees thus, eliminate the gap between budgeted and actual public debt.

10. **Government should stop using taxation merely to fund public spending whereas, in principle, this can be realized through prudent fiscal management.** This is through spearheading prudent spending and cutting on wasteful and nonpriority expenditures. The purpose and principles of good taxation need to be reassessed in Kenya to address their productivity.

Way forward

- Kenya must earn enough foreign income from exports and remittances and other sources if it is to manage its import bill, debt repayments and interest payments.
- In absence of this, as it is currently, the country risks getting into a debt trap even more as the only avenue to increase access to foreign resources.
- This trend does not only magnify the external debt problem in the long run but also raises vulnerabilities leading to a debt crisis.
- Reducing fiscal deficit remains key to stemming debt accumulation and maintaining debt at sustainable levels.
- Reduce the fiscal deficits and public debt vulnerabilities and lower Kenya's risk of debt distress from high to moderate in the medium term.
- The government should reduce the fiscal deficit to levels consistent with the GDP growth rate.

For the full report, visit our website: www.tisa.co.ke

The Okoa Uchumi Campaign is a civil society platform that seeks to build citizen voice and demand into critical national monetary and fiscal prioritization areas where citizen voice is presently missing. The campaign aims to link public debt/ national revenue decisions to every-day lives of citizens as a basis for building citizen demand. The campaign will bolster civil society campaigns for political accountability in debt management, towards the sustainable resolution of Kenya's debt crisis, and the attainment of balanced budgets which support socio economic inclusion.

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