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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Acknowledgement

The Institute for Social Accountability (TISA) acknowledges the invaluable research and work that has been done by Dr Stephen Githae Njaramba – Applied Economist who was the lead researcher, his team consisting of Dr. Peter Silas Mwiathi – Economics Theorist and Dr. George Kariuki – Econometrics and Statistics Expert all from the Kenyatta University in informing the development of the research on unpacking Kenya's Public Debt Crisis: Unpacking Fiscal Consolidation 2021.

TISA also wishes to acknowledge the valuable insights given by Kwame Owino of the Institute of Economic Affairs (IEA), Dr. Simon Githuku of the Kenya Association of Manufacturers, Linda Muthoni – Tax and Public Policy Researcher, Geoffrey Koech of the National Taxpayers Association, Dr. Jacob Nato of KIPPRA and Evelyn Muendo of the East Africa Tax Justice and Governance Network in the validation process of the report.

TISA acknowledges and appreciates the technical support of the institutions under the *Okoa Uchumi Campaign* that contributed resources and knowledge to this research and made possible its successful validation.

TISA also acknowledges and appreciates, the presence of the IMF-Kenya office represented by Mr Tobias Rasmussen, institutions in the private sector, religious institutions, our partners in academia, our partners in the Media, community leaders and activists, as well as the Kenyan citizens for their invaluable input in the preparation, development, and validation of the research findings.

TISA wishes to also acknowledge and appreciate the funding and technical support received from the Hewlett Foundation, the Ford Foundation and Oxfam in Kenya. The research and dissemination activities were made possible with the consistent and valuable support of these Foundations.

In addition, appreciation is given to the TISA staff; the programmes team, the ICT, communications, and administrative staff who contributed to the research and made possible the various validation meetings. Last but not least,, TISA acknowledges the edit, design and layout team that has made possible the dissemination of this final report.

Abbreviations and Acronyms

CBK	Central Bank of Kenya
CI	Composite Indicator
DSSI	Debt Service Suspension Initiative
ECF	Extended Credit Facility
EFF	Extended Fund Facility
FDI	Foreign Direct Investments
FX	Foreign Exchange
G20	Group of Twenty Countries
GDP	Gross Domestic Product
GOK	Government of Kenya
IMF	International Monetary Fund
ISI	Import Substitution Industrialization
M1	Money Held by the Public
MPCC	Monetary Policy Consultation Clause
PAYE	Pay-As-You-Earn
PFMA	Public Finance Management Act
REER	Real Effective Exchange Rate
SAP	Structural Adjustment Programmes
SME	Small and Micro Enterprises
SOE	State Own Enterprise
SSA	Sub-Saharan Africa
TMP	Tax Modernization Programme
USD	United State Dollar
VAT	Value Added Tax
WB	World Bank

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Executive Summary

Kenya's public debt situation is at high risk due to consistent fiscal deficits. The stock of public debt stood at US$ 65.6 billion (Kshs 7,281.6 billion) as at the end of December 2020, equivalent to 69 percent of Nominal GDP. External debt accounts for 51.2 percent of the total public debt stock must be paid back in the currency in which it is borrowed. These foreign currencies are majorly earned through exports, remittances and foreign direct investment. However, despite the dire need for Kenya to boost her foreign earnings to cover up for the perpetual rising debt, data shows that Kenya has been losing international market share since 2013, while the other non-resource intensive Sub-Saharan Africa (SSA) countries are on average gaining market share. Equally, FDI net inflows have been on a decline. It is on the basis of an overvalued currency that Kenya's competitiveness ranking has consistently declined.

The Central Bank of Kenya (CBK) engages in periodic foreign exchange interventions to, purportedly, smooth volatility in the Kenyan shilling. It has maintained a heavily managed exchange rate that is not flexible enough to absorb external price shocks. This is evident in the real effective exchange rate which has been on an appreciating trend in recent years despite economic fundamentals showing otherwise. In addition, public expenditure has been rising higher than the rise in revenue, thus the debt problem. Between 2013/14 and 2019/20, public expenditure has grown by 112.4 percent, yet the ordinary revenue increased by 94.4 percent over the same period.

Due to the public debt crisis in the country, the Government of Kenya entered into an IMF supported fiscal consolidation and Structural Adjustment Program. In April 2021, the IMF officially approved the Kenya program, anchored in the Extended Fund Facility (EFF)/ Extended Credit Facility (ECF) to stabilize the economy and set a basis for growth and shared prosperity. In addition, Kenya signed a Memorandum of Understanding with the Paris Club group of lenders under the framework of the G20 Debt Service Suspension Initiative (DSSI) in December 2020.

It is against this background that *Okoa Uchumi Debt Campaign*, a civil society platform, commissioned this study to review Kenya's debt situation, the tax policy and the International Monetary Fund (IMF) fiscal consolidation program.

The study considered the following objectives:

1. Evaluation of Kenya's debt composition, cost and sustainability
2. An assessment of public expenditure trends and their role on debt crisis in Kenya
3. Analysis and review of monetary policy and its role on debt crisis in Kenya
4. A review and analysis of IMF proposals

In delivering these objectives, the study considered how Kenya's national debt mix policy has contributed to the present crisis; the IMF proposals and the extent to which they address the debt and fiscal distress; the use of monetary policy and its role on the debt crisis in Kenya and the public expenditure trends and their role on the debt crisis. The study is based on a descriptive research design that involved use of quantitative and qualitative approaches in collecting and analysing data. The data collection method involved a desk review of the following documents: policy documents, Economic Surveys, Annual Public Debt Reports, Medium Term Debt Management Strategy, Kenya Revenue Authority Reports on Revenue Administration Reforms in Kenya, Joint World Bank-IMF Debt Sustainability Analysis for Kenya and World Bank Reports. The documents were analyzed to provide a view of the external debts composition and the trend from 2013 to 2020, public expenditure trends, reviewed uses of monetary policy in an economy and the IMF Country Report No. 21/27 on Kenya's fiscal consolidation program. According to the study, Kenya is increasingly getting into a debt crisis due to persistent fiscal deficits largely driven by growth in foreign borrowing and expanding imports. With constraints in accessing concessional loans, Kenya is using commercial debt to support government budget and finance infrastructural projects. The country is equally running a current account deficit that is largely financed by capital inflows from borrowings.

The study proposes the following:

1. **More borrowing needs to in domestic denominated currency.** The National Treasury, together with IMF, should review the domestic-foreign debt mix policy so that more public debt is denominated in domestic currency that promotes domestic productivity. The study has shown that foreign borrowing is required due to need for more imports. The government needs to promote domestic production by using more domestically borrowed resources.

2. **Revise monetary policy:** 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 to match domestic and foreign demand.

3. **Where foreign debt is a must, the government should move away from the 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. It 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 maintaining public debt at a sustainable level.

4. **National Treasury should provide a justification beyond reasonable doubt 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, to take place in the middle or end of a financial year.** This will reverse the regular overshooting of actual expenditure. The budgetary overshooting is a sign that the National Treasury does not: set a realistic budget, have clear procedures for release of appropriations, strictly observance budget execution rules, have clear and transparent borrowing procedures and rules.

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

7. **Parliament should set the national indebtedness limits, pegged on real economic performance as provided for in Section 15 (2) (d) of PFMA.** This will make public debt sustainable.

8. **National Treasury data should be authenticated by an independent body regularly as provided for in the law.** Government should be more consistent in the way it reports the public finance data and make it easier to track the planned versus actual data.

9. **Commitment to loans should only happen once the programs and projects are ready for implementation.** This will 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.** The purpose and principles of good taxation ought to be applied for effectiveness of tax measures.

SECTION 1

Background

1.1 Introduction

Public debt has far reaching effects on economic development and wellbeing of the people. Prudent utilization of public borrowings enhances economic growth and development. However, the debt portfolio in a country contains a complex and risky financial structure that can generate an unstable balance of payments, currency risks and general financial instability. Public debt also makes economies vulnerable to external shocks. Many countries seek to support their structures by establishing, where possible, portfolio guidance related to the desired currency composition, duration and maturity structure of the debt to control these risks.

Maturity structure, interest rates and currency composition of a country's public debt portfolio, along with significant commitments in respect to contingent liabilities, has contributed to the known crisis. Therefore, concern about debt situation and practices has recently gained prominence with the emergence of several crises in the global scene. Over the last eight years, Kenya has seen an increment in acquisition of expensive commercial and project financing debts .

This study, therefore, focuses on debt sustainability in Kenya. It is divided into three parts; part one captures the background information, study purpose, objectives and the methodology used. The second part discusses the findings while the third section outlines the conclusion and recommendations.

1.2 Public Debt Situation and Macroeconomic Environment in Kenya

Kenya's public debt situation is at high risk owing to consistent fiscal deficits. The stock of public debt stood at US$ 65.6 billion (Kshs 7,281.6 billion) as at the end of December 2020, equivalent to 69 percent of Gross Domestic Product (GDP). This is an increment from Ksh 1.894 trillion in June 2013 and reflects a 253.4 percent growth in the overall public debt over the 2013- 2020 period. This is double the growth in the nominal GDP in the same period. In addition, external debt increased from Kshs. 843,562 million to Kshs. 3,515,812 million while the domestic debt increased from Kshs 1,050,555 to Kshs 3,177,526 million. World Bank (WB) and International Monetary Fund (IMF) composite indicator (CI) for economic and institutional performance have hence classified Kenya's public debt situation as risky.

The more Kenya's public debt is in foreign currency, the more it exerts pressure on the exchange rate , making imported goods expensive and out of reach for most Kenyans. Kenya's external debt accounts for 51.2 percent of the total public debt. Currency composition of external debt comprise of 64.9 percent in U.S. dollar, 20.0 percent in Euro, 6.7 percent in Japanese Yen, 5.6 percent in Chinese Yuan, 2.5 percent in Great Britain Pound with other currencies accounting for 0.3 percent. To pay its external debts, Kenya needs to earn foreign currency through exports, Foreign Direct Investments (FDI) or further borrowing.

Illustration 1.1: ***Kenya's public debt situation***

US$65.6bn

(Ksh 7,281.6 billion) Kenya's public debt situation as at the end of December 2020, equivalent to 69 percent of Gross Domestic Product (GDP)

Kenya's public debt situation is at high risk owing to consistent fiscal deficits.

Ksh 3,515,812m

increase of external debt from Kshs. 843,562 million over the period 2013- 2020

Ksh 3,177,526m

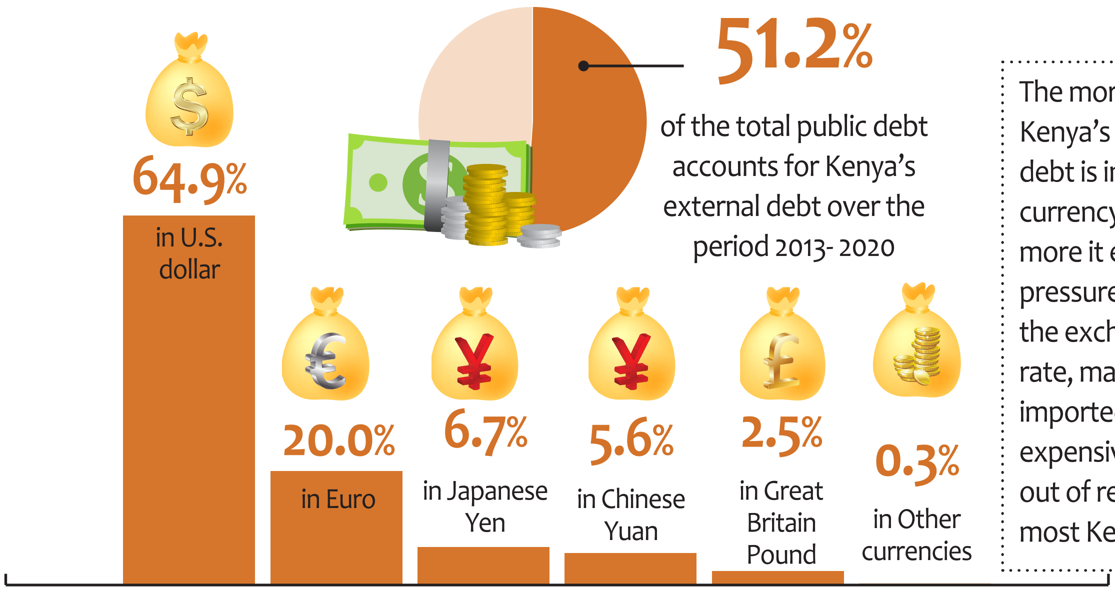
increase of domestic debt from Ksh 1,050,555 million over the period 2013- 2020

Kenya needs to earn foreign currency through exports, Foreign Direct Investments (FDI) or further borrowing

Illustration 1.2: ***Currency composition of Kenya's external debt (2013- 2020)***

51.2%

of the total public debt accounts for Kenya's external debt over the period 2013- 2020

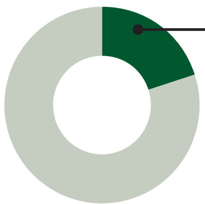


The more Kenya's public debt is in foreign currency, the more it exerts pressure on the exchange rate, making imported goods expensive and out of reach for most Kenyans.

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

The foreign earnings equally go to paying for import of goods and services. Historically, export of goods and services in Kenya remained above 20 percent of GDP from 2001 to 2012 and averaged 19 percent during 1998-2020 period. In recent years Kenya has suffered weak export performance. More recent data shows that Kenya has been losing market share since 2013, while the other non-resource intensive Sub-Saharan Africa (SSA) countries are gaining. This means that the country is running a current account deficit which has largely been financed by capital inflows from borrowings. In 2020, the net inflows amounted to 4.7 percent of GDP, reflecting government borrowing, including IMF emergency support and borrowing by other financial corporations (non-banks) to manage the deficit. FDI net inflows reached only 0.2 percentage points of GDP —one percentage point lower than in 2019. This indicates a reduced portfolio flows into Kenya and is worsened by the government's appetite for external commercial borrowing.

Illustration 1.3: Export of goods and services



Export of goods and services in Kenya remained above

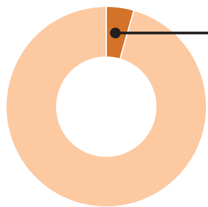
20%

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 1.4: 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.

Maintaining exchange rate flexibility would help the economy absorb potential economic shocks. This is by allowing the exchange rate to respond to increased demand for foreign currency. Theoretically, this will constitute the concept of Purchasing Power Parity (PPP). If the demand for foreign goods go up in relation to similar domestically produced goods, the domestic currency depreciates, making the foreign goods expensive. This will lead to Purchasing Power Parity. Fixed or managed currency does not allow this flexibility and the market fails to achieve PPP. The Central Bank of Kenya (CBK) engages in periodic Foreign Exchange (FX) interventions to smooth volatility in the Kenyan shilling. Kenya has maintained a heavily managed exchange rate that is not flexible enough to absorb external shocks.

If the demand for a foreign good goes up in relation to similar domestically produced good, the domestic currency depreciates, making the foreign good expensive.

The Real Effective Exchange Rate (REER) has been appreciating in recent years despite economic fundamentals showing otherwise. The fundamentals include declining net exports and reduced FDI. In 2020, the appreciating trend reversed and the annual average REER depreciated slightly by 1.5 percent compared to 2019. Since March 2020, the REER has gradually depreciated as the exchange rate absorbed some of the impact of the COVID-19 shock, which has reduced sources of foreign exchange for Kenya. By December 2020, the REER had depreciated by about eight percent compared to December 2019. However, according to IMF and World Bank, the Kenyan currency is overvalued and this requires maintenance of the reserve coverage. At end of 2020, reserves stood at USD 8.4 billion, compared to USD 9.1 billion at the end of 2019, which is an equivalent of 8.4 percent of GDP or 4.6 months of 2021 imports. Holding foreign currency reserves reduces probability and severity of an economic crisis.

Illustration 1.5: ***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.

It is important to note that there is a negative implication when the Kenyan shilling depreciates as this implies a higher imports financing cost. However, there is also a positive side to a weak shilling - it means lower foreign prices for the country's exports which improves the country's competitiveness and the balance of trade position in the world market. Further, a weak shilling promotes domestic investments, creates employment and discourages consumption of luxury imports. All these are necessary to improve the current account balance and support economic growth. For instance, in 2011, there was a large current account deficit of about 11 percent of the GDP. The exchange rate had to depreciate significantly to correct this imbalance in the economy. However, with Kenya having a huge oil import bill, depreciation of domestic currency will cause inflationary pressures. This can be avoided by removing tax from essential imports. It is on the basis of overvalued currency that Kenya's competitiveness ranking has consistently declined. The decline is documented by the World Economic Forum's Global Competitiveness Index.

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 discourages domestic investment and impacts negatively on economic growth and employment as it 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 could collect less tax revenue thus undermining Government activities.

Usually, risky debt structures are the result of inadequate economic policies - fiscal, monetary and exchange rate. States, from a macroeconomic point of view, should endeavor for a sustainable public debt. The 2020 credit rating by major sovereign rating agencies Standard and Poor and Fitch Ratings placed Kenya at B+ with a negative outlook. The mitigating measures to the rising debt levels lie in active debt management and fiscal consolidation programme supported by a sound macroeconomic environment.

The Government of Kenya outlined several measures to address the country's public debt crisis. It entered in an IMF supported fiscal consolidation and structural adjustment program. In April 2021, the IMF officially approved the Kenya program, anchored in the Extended Fund Facility (EFF)/ Extended Credit Facility (ECF) which aims to stabilize the economy and set a basis for resurgence of growth and shared prosperity. In addition, Kenya signed a Memorandum of Understanding with the Paris Club group of lenders under the framework of the G20 Debt Service Suspension Initiative (DSSI) in December 2020. However, Kenya cannot negotiate for suspension of debt servicing payment beyond the temporary suspension granted under DSSI as it lowers the credit rating under the Eurobond terms, which would be considered a default and can trigger a recall of the entire loan and interest.

Public borrowing arises due to either a revenue shortfall or higher public expenditure. To contain public debt, alignment of public expenditure to revenue is important. In most of the cases, especially in Kenya, this is attempted through increment of tax rate and recently the attempt to make the tax system more efficient by streamlining exemptions and strengthening revenue administration. About 70 percent of government revenue in Kenya comes from taxation.

Illustration 1.6: Kenya's government revenue

70%

of government revenue in Kenya comes from taxation.

Kenyans are overtaxed.
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 and even if it is effected, it will have no effect on tax revenue and will most likely lead to adverse effects on the economy. There is need to focus on tax compliance and collection, taming tax evasion and corruption rather than increasing taxes for the already strained households and businesses. The tax administration measures have been unproductive in enhancing tax revenue in the recent past. This is a clear indication of overburdened Kenyans. Kenya's fiscal space is diminishing hence the tax reliefs offered to cushion Kenyans and businesses against the economic shocks of the Covid-19 pandemic were hastily reversed. This has made experts question whether Kenya has surpassed its tax optimal position.

There is need to focus on taming tax evasion and corruption rather than increasing taxes for already strained households and businesses.

It is noted that, between 2013/14 and 2019/20, public expenditure increased by 112.4 percent, yet the ordinary revenue increased by 94.4 percent.

To understand the purpose of taxation in an economy, one needs to distinguish among the three objectives of allocation, redistribution and stabilization of any government (Musgrave, 1959). The first objective, allocation, is recommended if the tax policy does not interfere with market determined allocation. Under this objective, tax is used to correct market failure and improve market efficiency in the economy. The second objective, income redistribution, is meant to ensure fairness, equity and lessen inequalities in the distribution of income and wealth. The third objective of stabilization is meant for full employment and price stability in an economy. The functions of redistribution and stabilization are implemented through tax policy, public expenditure policy, monetary policy and public debt management policy. Thus, the key purpose of any tax policy should be redistribution, stabilization or both.

Okoa Uchumi Debt Campaign

The foregoing prompted *Okoa Uchumi Debt Campaign*, a civil society platform, to redress Kenya's public debt crisis. Specific concern is whether the growing public debt has been directed towards the development of unproductive projects; whether the government has imprudently accepted large, costly, and risky investments (unnecessary project financing), without transparency in decision-making and as a result, Kenya is drowning in debt and in risk of a debt distress. The campaign seeks to push for political accountability and bolster constitutional safeguards in public debt management as a means to debt sustainability through a balanced and equitable budget. The platform, therefore, commissioned a study that reviewed the debt situation in the country, the tax policy and the IMF fiscal consolidation program.

The study considered the following issues:

1. What are the theoretical underpinnings and orientation of public debt and are they aligned with Kenya's development policy and needs?

2. Specific public debt related issues:

A Debt composition and sustainability

- How has Kenya's debt mix policy contributed to the present crisis?
- Critically review the IMF/DSMP proposed debt mix and make recommendations on the right ratio.
- Identify information gaps in Kenya's public debt policy.

B Examine the extent to which Kenya's Expenditure Framework over the past eight years is founded on the principles of sustainable development, and whether it has contributed to the debt crisis in the country.

C Soundness of the monetary policy proposals

- What is the role of monetary policy in the present debt crisis?
- Does the IMF proposals address gaps in Kenya's monetary policy?

The study, broadly reviewed the public debt situation in Kenya and IMF fiscal recommendations by considering the following objectives:

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 trends from 2013 to 2020.

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.

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

This objective looked at the uses of a monetary policy in an economy, citing success stories from the Asian economies. It also looked at the use of monetary policy in taming the debt crisis.

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.

1.4 Study Approach and Methodology

The study considered how Kenya's public debt mix policy has contributed to the present crisis, the IMF proposals and the extent to which they address Kenya's debt and fiscal distress.

The study also reviewed role of the monetary policy in Kenya's debt crisis and the public expenditure trends. The study was based on a descriptive research design that involved the use of quantitative and qualitative approaches in collecting and analysing data. The data collection method involved a desk review of policy documents, Economic Surveys, Annual Public Debt Reports, Medium Term Debt Management Strategy, Kenya Revenue Authority, Reports on Revenue Administration Reforms in Kenya, Joint World Bank-IMF Debt Sustainability Analysis for Kenya and World Bank Reports. The documents were analysed to provide a view of the external debts composition and the trend from 2013 to 2020, public expenditure trends, uses of monetary policy in an economy and the IMF Country Report No. 21/27 on Kenya Fiscal Consolidation program.

SECTION 2

Findings and Discussions

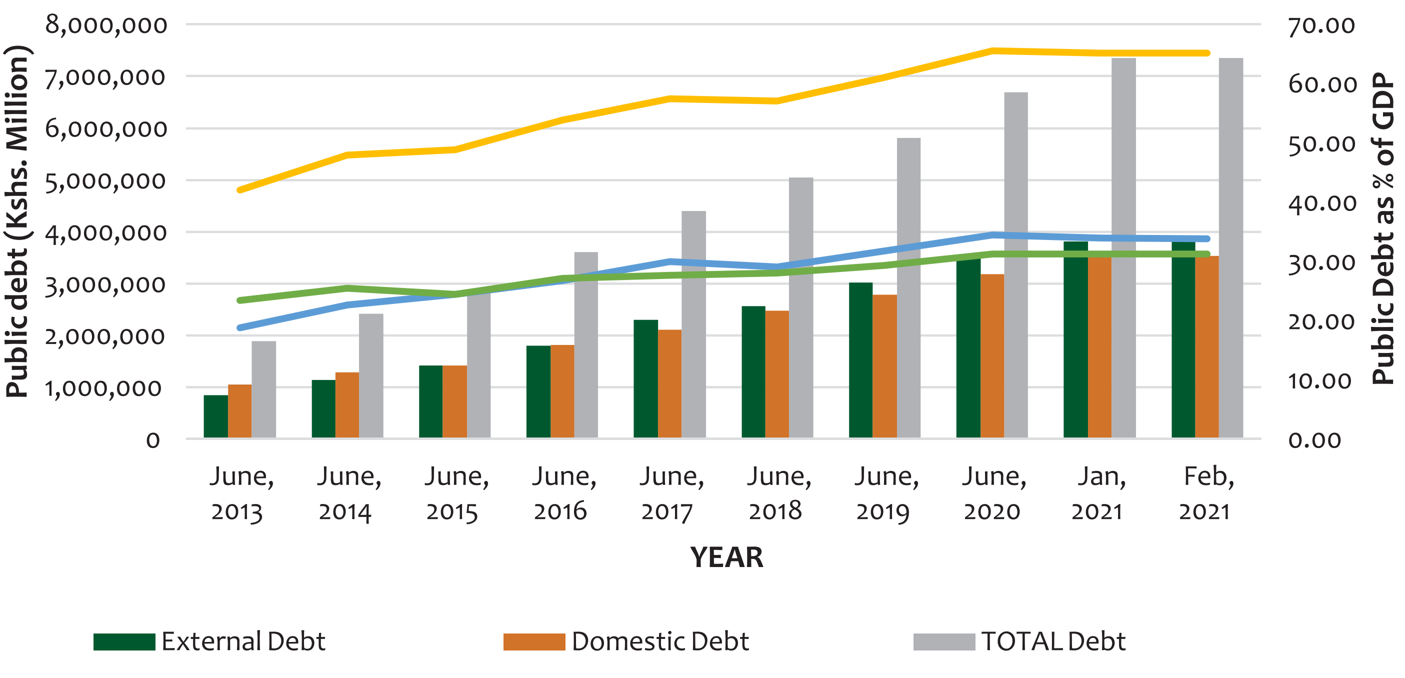
2.1 Introduction

This section builds evidence by analysing data, generating trends on Kenya's debt position. The section considers how Kenya's external debt and policy have contributed to the present debt; the IMF proposals and how they address Kenya's debt and fiscal distress; uses of monetary policy in an economy and the extent to which Kenya's expenditure adhere to the principles of public expenditure. It also focuses on the national plans and prudent use of resources.

2.2 Debt Composition, Cost and Sustainability

Kenya's overall public debt has increased in recent years. Gross public debt increased from 48.6 percent of GDP at the end of 2015 to an estimated 69 percent of GDP at the end of 2020, reflecting high deficits, partly driven by past spending on large infrastructure projects and, in 2020, by the COVID-19 global shock. About half of Kenya's public debt is owed to external creditors. Kenya's public debt situation is at high risk owing to consistent fiscal deficits. The stock of public debt stands at US$ 65.6 billion (Kshs 7,281.6 billion). The debt trends and composition are shown in Figure 2.1

Figure 2.1: *Trends in Kenya's public debt for the period 2013 – 2021*



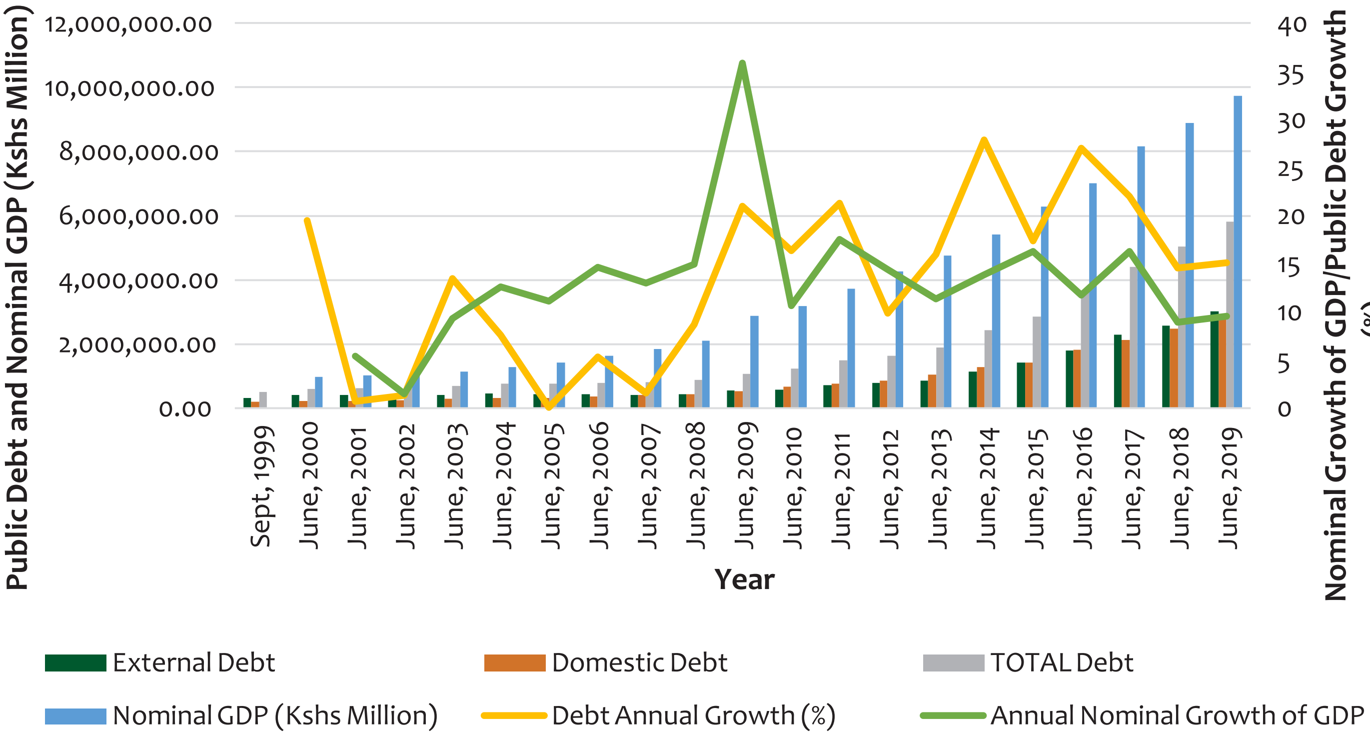
Source: *Annual public debt reports 2019/20; 2018/19 and 2017/18*

Kenya's public debt stock increased from Ksh 1.894 trillion in June 2013 to Ksh 6.693 trillion in June 2020, a reflection of a 253.4 percent growth in the overall public debt over the period June 2013- June 2020. This is double the growth in the nominal GDP over the same period. In the same period, external debt increased from Kshs. 843,562 million to Kshs. 3,515,812 million while the domestic debt increased from Kshs 1,050,555 to Kshs 3,177,526 million. This reflects domestic and foreign growth rate of 202.5 and 316.8 percent respectively. As shown in Figure 2.1, the foreign debt from 2016 increased more than domestic debt, accounting for 51.2 percent of the total public debt. This means the country requires foreign currency for expanding imports.

Debt in foreign currency has major risks and excessive leverage on it can distress the exchange rate and the monetary policy.

Another important relationship to consider is that of economic growth and public debt growth rates. Economic growth is important for three main reasons: improve welfare, cater for the new population and debt payments. In a situation where the rate of debt growth is higher than economy growth, it only points to a looming default. The growth rate of public debt and that of nominal GDP, 2000 -2020, is presented in figure 2.2.

Figure 2.2: *Growth of public debt and growth of nominal GDP, 2000 -2020*



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

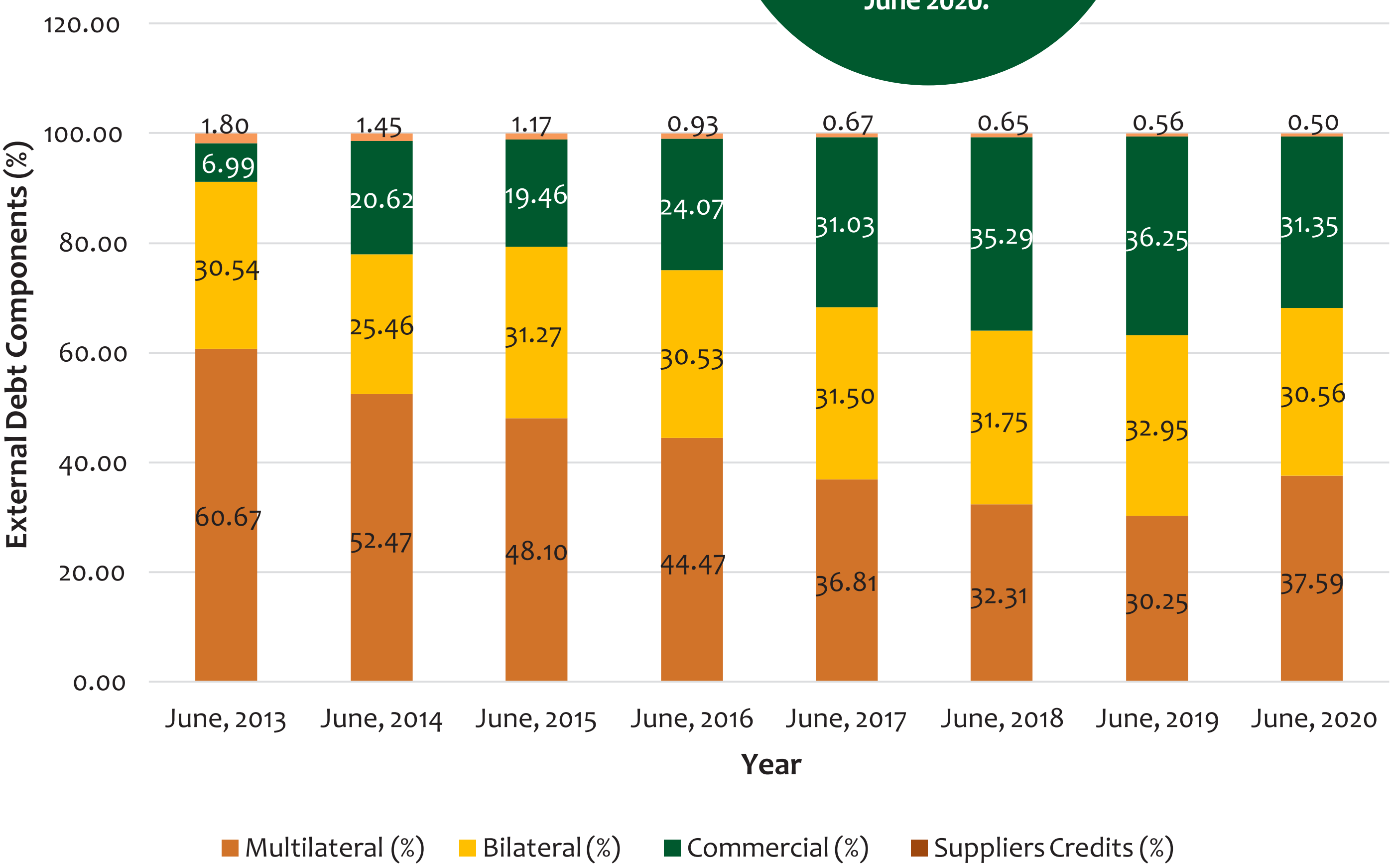
Figure 2.2 shows that the GDP growth rate has, since 2013, been less than the public debt growth rate. From 2003 to 2010, the growth rate in nominal GDP was higher than that of public debt. However, from 2013, the growth rate in public debt has been consistently higher than that of GDP. This is not good for debt sustainability. This growth is largely driven by growth in foreign borrowing. The growth in public debt should remain less than that of growth of nominal GDP in order for public debt to be sustainable.

In addition, the composition of external public debt poses cost and risk to the country. Trends of external debt composition in Kenya for June 2013 to June, 2020 is presented in figure 2.3.

The growth in public debt should remain less than that of nominal GDP in order for public debt to be sustainable.

The share of commercial debt increased from 6.99 percent in June 2013 to 36.25 percent in June 2019 before slightly dropping to 31.35 percent in June 2020.

Figure 2.3: External debt composition 2013 - 2020



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

Figure 2.3 shows commercial debt acquisition in Kenya from June 2013. Commercial borrowings refer to the international syndicated loans and the Export Credit Financing contracted at a reference rate plus a margin. This is the most costly and risky component of external public debt. Increasing commercial loans is an indication of the increasing cost and risk of public debt. This is acknowledged in government's debt and borrowing policy, 2020 which envisage concessional and semi-concessional borrowing to minimize cost, risk and ensure public debt is sustainable. This is because multilateral and bilateral debts have low interest rate, long average maturity time and a grace period.

The share of commercial debt increased from 6.99 percent in June 2013 to 36.25 percent in June 2019 before slightly dropping to 31.35 percent in June 2020. The increase in commercial debt is due to issuance of sovereign bonds and commercial syndicated loans. The proportion of multilateral and bilateral public debt in the total external public debt was 60.67 and 30.54 percent respectively in June 2013. However, in June 2020, multilateral and bilateral debt stood at 37.59 and 30.56 percent, respectively. This indicates that the share of multilateral debt in external debt reduced by nearly 50 percentage points since 2013. The cost of these loans is also on the rise as shown on Table 2.1

Table 2.1: ***Composition of external debts, June 2013 - June 2020 (Kshs million)***

Composition/ Cost	2012	2013	2014	2015	2016	2017	2018	2019	2020
Multilateral	455,077	511,790	597,340	684,631	798,842	844,389	829,846	914,394	1,321,629
Rates	2	2	2	2	2	2	2	2	2
Bilateral	243,543	257,537	289,914	445,057	548,351	722,569	815,388	996,058	1,074,258
Rates	1	1	1	1	1	1	1	1	1
Commercial	50,540	58,928	234,799	276,937	432,377	711,893	906,440	1,095,754	1,102,294
Rates	7	7	7	7	7	7	7	7	7
Supplier Credits	14,811	15,207	16,452	16,628	16,628	15,303	16,725	16,932	17,631
Rates	2	2	2	2	2	2	2	2	2
Foreign Debt (% of GDP)	19	19	23	24	27	30	29	32	34
Foreign Debt (% of Total Debt)	47	45	47	50	50	52	51	52	53
Real GDP		3,444,339	3,646,821	3,842,186	4,061,901	4,300,699	4,507,377	4,792,174	5,049,686
Total debt		2,422,832	2,843,696	3,611,331	4,406,863	5,047,234	5,808,591	6,693,338	7,281,826
Total Debt minus Interest payable (% real GDP)		70.3	78.0	94.0	108.5	117.4	128.9	139.7	144.2

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

The share of commercial loans in total external debt has been increasing in the last seven years. This is despite it being the most costly and risky component of public debt as per rates payable. The growth can be attributed to issuance of Eurobonds to support government budget and finance infrastructural projects. However, it is not clear why the government is increasingly preferring expensive and risky commercial loans over the multilateral/bilateral loans. It is worth noting that the real GDP is far less than the nominal GDP. This was realised after Kenya re-based its data. Re-basing was simply the withdrawal of price effects from the data and considering the country's purchasing power. With this, the public debt stood at 144.2 percent of the real GDP.

The increasing foreign currency denominated commercial loans, mainly in the Dollar and the Euro, exposes Kenya to currency risk. Unhedged foreign currency borrowing makes the borrower sensitive to exchange rate fluctuations. If a government borrows in foreign currency, while generating revenue exclusively in domestic currency, it will be susceptible to a possible depreciation of the domestic currency. Such cases increase debt to GDP ratio and the interest payment thus negatively affecting the budget balance.

This is dampened if state corporations, private firms and households are also indebted in foreign currency since the entire economy will be heavily exposed to currency risk. This situation has made Kenya to be oversensitive to the shilling appreciation. An extreme example of such a scenario was the financial crisis in Iceland in 2008 and in Zimbabwe when Zimbabweans refused their own currency between 2009-2019.

Eichengreen and Hausmann (1999) argued that most emerging countries are unable to issue external debt in domestic currency, hence have no other choice other than to issue debt securities denominated in one of the main global currencies such as the Dollar or the Euro. Kenya is not an exception as evidenced in its 2014 and 2018 Eurobonds. The inability of a country to borrow abroad in domestic currency is referred to as "the original sin", since it engenders currency incompatibility at the aggregate level, which represents a major constraint for policy makers. Depreciation of the domestic currency leads to an increase in the stock of public debt indexed to foreign currency. In addition, annual interest expenses will increase due to the greater debt stock, even if the average interest rate is unaffected. This would also make new government borrowing costlier, producing second round effects since a higher average interest rate would entail even higher interest expenses. This would have adverse effects on the government budget balance and the debt trajectory leading to a vicious circle of deficit and debt. This makes the county's monetary policy ineffective.

Foreign currency borrowing is also associated with higher refinancing/ rollover risk. The two risks i.e. currency risk and refinancing risk are mutually reinforcing. The currency risk tends to exacerbate the refinancing risk since its widespread presence may trigger the materialization of refinancing risk. This is sbecause depreciation of the domestic currency may reduce the government's ability to meet its foreign currency debt obligation. If creditors suspect that the borrower's currency might lose ground, they would no longer be interested in financing the borrower and in most extreme cases recall their loans leading to debt and currency crises.

In such a case the only option for the government that wants to avoid defaulting on its foreign debt would be to seek international financial assistance. This is the position Kenya is in, that it cannot negotiate for suspension of debt servicing payment beyond the temporary suspension granted under DSSI as it lowers the credit rating under the Eurobond terms and would be considered a default hence trigger a recall of the entire Eurobond loan and interest.

Historical debt crises are caused by excessive foreign currency borrowing. Financial crises in emerging market economies are usually preceded by periods of abundant inflow of foreign currency funding. Favorable global financial condition creates incentives for emerging market economies to import capital from abroad to finance domestic consumption and investment at low cost . In the short run this reflects positively on consumer and investor confidence leading to higher propensity to borrow and spend. If left unaddressed, this excessive external borrowing can result to an unsustainable expansion of domestic demand and leave the economy open to external shocks. A good example is the crisis of Latin America in the 1980s and 1990s which was a consequence of the borrowing spree that took place during the previous decade. This is exactly what is happening in Kenya and needs to be reversed to avoid a debt crisis.

Kenya's rapid accumulation of foreign currency debt is not sustainable thus external adjustment is necessary. Despite the worsening situation, commercial foreign banks have continued to increase their lending to the government through syndicated credits. The government has realized the risk and has reverted to IMF for credits and restructuring.

Previous occurrences of debt crises, specifically in Latin America, show how excessive foreign currency borrowing can make countries vulnerable. Though domestic currency borrowing does not entirely eradicate the risk of a debt crisis , it indirectly enables a country to cope with the crisis if it happens. This is because the central bank will be less concerned about the exchange rate fluctuations particularly when the government and the private sector borrow mainly in the domestic currency.

As a lender of last resort, the central bank lends freely to commercial banks to contain liquidity disruptions. This not only helps to cure liquidity problems but also enables the government to refinance its debt with commercial banks at favorable terms. Liquidity disruptions are common with sovereign debt crisis. The ability of the central bank to support government debt in foreign currency is restricted by the size of its foreign exchange reserves. On the other hand, the capability to intervene in domestic currency debt financing is not directly determined by the level of foreign exchange reserves.

Kenya's rapid accumulation of foreign currency debt poses currency and debt crisis and is not sustainable.

During the COVID-19 crisis, many emerging countries' central banks pursued unconventional monetary policies aimed at supporting their economies, including the purchase of government debt securities denominated in domestic currency (IMF, 2020). However, adequately backed foreign exchange reserves assure financial markets that the newly created money does not lead to a currency devaluation. This path could be misleading for the developing economies.

The European sovereign debt crisis of 2010-2012 revealed the important role of central bank emergency lending in containing the fallout from the crisis. It is for this reason that dependence on foreign currency borrowing is considered a "curse" as it makes the country susceptible to a financial crisis and less capable of managing its internal affairs.

In order to pay foreign debt, Kenya should earn foreign currency through exports, investments, remittances or further borrowing. Table 2.2 shows the country's foreign reserves, the trade balance and the stock of external debts.

Table 2.2: *Kenya's liability to the rest of the world in Kenya shillings (million), 2013-2020*

	2013	2014	2015	2016	2017	2018	2019	2020
Foreign Reserves (A)	361,225	529,426	435,524	560,885	642,558	756,908	939,903	885,952
Trade balance (B)	(75,176)	(90,605)	(83,278)	(71,209)	(94,291)	(95,608)	(100,465)	(92,285)
External Debt (C)	843,562	1,138,505	1,423,253	1,796,198	2,294,154	2,568,399	3,023,138	3,515,812
A - C	**-482,337**	**-609,079**	**-987,729**	**-1,235,313**	**-1,651,596**	**-1,811,491**	**-2,083,235**	**-2,629,860**

Source of Data: *Various Economic Surveys*

Table 2.2 indicates the country's liability to the rest of the world is growing at an average rate of 20 percent because reserves are increasing at a lower rate compared to external obligations. The country would be paying the external liabilities through running a surplus current account (trade balance) or accumulating more reserves mainly through Foreign Direct Investments (FDI) and remittances. The reserve earnings also go towards paying for import of goods, services and debts. Failure to achieve these, the country would be accumulating external debts as shown in the last row of Table 2.2

Foreign debts can only be paid in a stable environment when a country is accumulating equal or higher foreign reserves than foreign debts and its GDP growing at a higher rate than public debt.

2.3 Public Expenditure trends and their role on debt crisis in Kenya

This part examines the extent to which Kenya's budget adheres to the principles of public expenditure, the national plans and prudent use of funds. It also discusses the contribution of fiscal deficits to the increasing public debt in Kenya. Budget deficit has been on the rise. Table 2.3 shows that the actual budget deficit increased from 558.6 billion in 2013/2014 to 1.36 trillion in 2019/2020 financial year. This is 143.9 percent increase in seven years and an average annual increase of 17 per cent.

***Table 2.3:* Public fiscal budget - 2013/2014 to 2019/2020 (Ksh. million)**

		2013/2014	2014/2015	2015/2016	2016/2017	2017/2018	2018/2019	2019/2020
Recurrent Expenditure	Budgeted	1,043,902	1,411,159	1,583,823	1,734,403	2,107,177	1,947,932	2,398,753
	Actual	1,021,923	1,381,045	1,564,286	1,657,215	2,083,678	2,375,053	2,447,192
Development Expenditure	Budgeted	635,178	684,360	682,983	761,705	670,621	607,199	652,348
	Actual	511,070	572,465	483,066	625,780	492,387	569,745	808,889
Total Public Expenditure	Budgeted	1,679,080	2,095,519	2,266,806	2,496,108	2,777,799	2,555,132	3,051,100
	Actual	1,532,993	1,953,509	2,047,352	2,282,996	2,576,065	2,944,798	3,256,081
Ordinary Revenue	Budgeted	1,006,862	1,170,529	1,299,912	1,514,989	1,650,989	1,794,522	2,115,902
	Actual	974,418	1,113,038	1,236,453	1,403,939	1,522,455	1,698,817	1,893,902
Recurrent Balance	Budgeted	(37,040)	(240,630)	(283,911)	(219,414)	(456,188)	(153,410)	(282,851)
	Actual	(47,505)	(268,007)	(327,832)	(253,277)	(561,223)	(676,236)	(553,289)
Domestic debt Rqt	Budgeted	487,269	323,723	481,911	503,356	736,483	280,768	565,100
	Actual	357,487	333,073	476,316	467,408	659,667	877,034	966,914
External financing	Budgeted	477,763	368,316	484,983	477,763	390,327	479,841	370,098
	Actual	411,649	507,399	334,582	411,649	382,577	368,947	395,264
Budget Deficit**	Budgeted	672,218	924,990	966,894	981,119	1,126,809	760,609	935,198
	Actual	558,575	840,472	810,899	879,057	1,053,610	1,245,981	1,362,178
Actual Budget Deficit Growth Rate		-	50.5	-3.5	8.4	19.9	18.3	9.3
Nominal GDP		4,745,090	5,402,647	6,284,185	7,022,963	8,165,842	8,892,111	9,740,360
Real GDP prices		3,646,821	3,842,186	4,061,901	4,300,699	4,507,377	4,792,174	5,049,686
Budget Deficit as a % of GDP		11.8	15.5	12.9	12.5	12.9	14.0	13.9

*** Only considers ordinary revenue.*

Source of Data: *Economic Surveys*

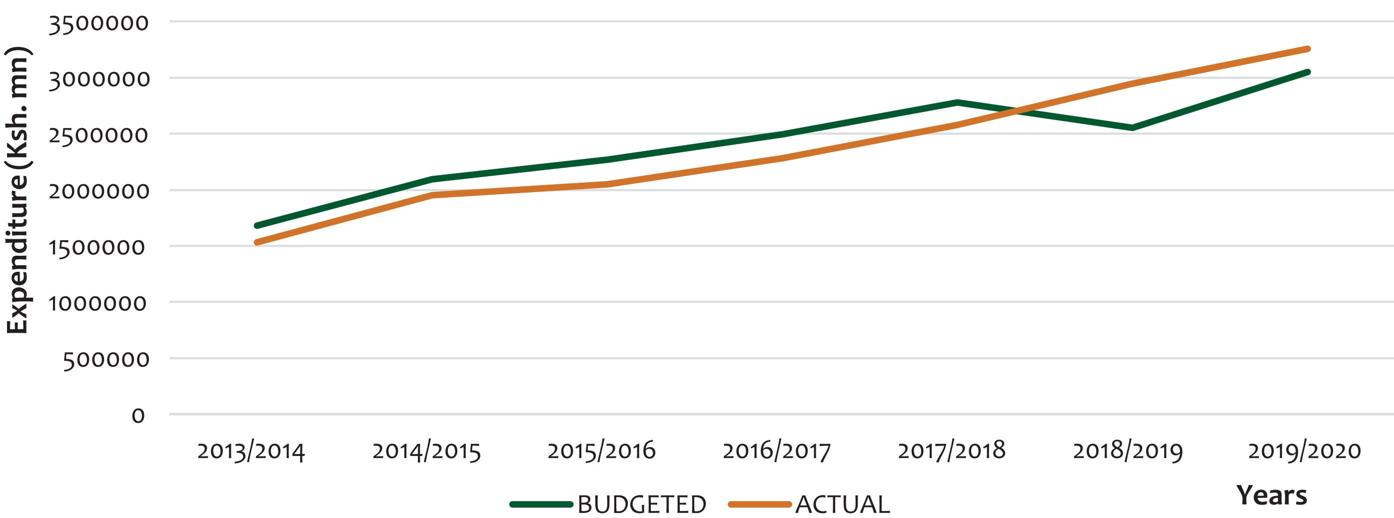
Table 2.3 shows that the budgeted recurrent expenditure increased from 1.04 trillion to 2.4 trillion between 2013/2014 and 2019/2020 financial years - a 131 percent increment over the period and an average of 19 percent annual growth in seven years. The increase is against an average of 5.5 percent annual growth in inflation. On the other hand, the actual recurrent expenditure increased from 1.02 trillion to 2.45 trillion in the same period of 7 years. This represents an average annual growth rate of 20 percent. The drivers to this growth is not clear.

Budgeted development expenditure increased marginally from 0.63 trillion to 0.65 trillion between 2013/2014 and 2019/2020 financial years. This represents an average annual growth rate of 0.5 per cent while that of actual development expenditure has an average annual growth rate of 8.3 per cent. The analysis depicts a big mismatch between the budgeted and actual development expenditures. It, therefore, points to lack of adherence to the planned programmes and activities in the country.

The upward trajectory of recurrent expenditure and the high proportion of recurrent expenditure in the budget is highly unsustainable and a ticking time bomb. From the financial year 2014/2015, the recurrent expenditure accounts for over 70 percent of the budget. This is contrary to the Public Finance Management Act 2012 which stipulates that over the medium term a minimum of 30 percent of the national and county government's budget shall be allocated to the development expenditure. This has not been the case with development expenditure falling below 20 percent in 2017/2018 and 2018/2019 financial years. There is an urgent need to enforce the threshold and ensure recurrent expenditure has a ceiling of 70 percent as provided for in the PFM Act, 2015. Since the 2014/2015 financial year, there has been a violation of this requirement. Realignment of expenditure from recurrent to development would release resources to development programs that would yield significant economic returns, beyond job creation.

Another concern is the widening gap between the budgeted and actual expenditures over time. Budget and actual total public expenditure in Table 2.2 shows a worrying trend. This is also shown in Figure 2.4

Figure 2.4: *Trends in Kenya's public debt for the period 2013 – 2021*



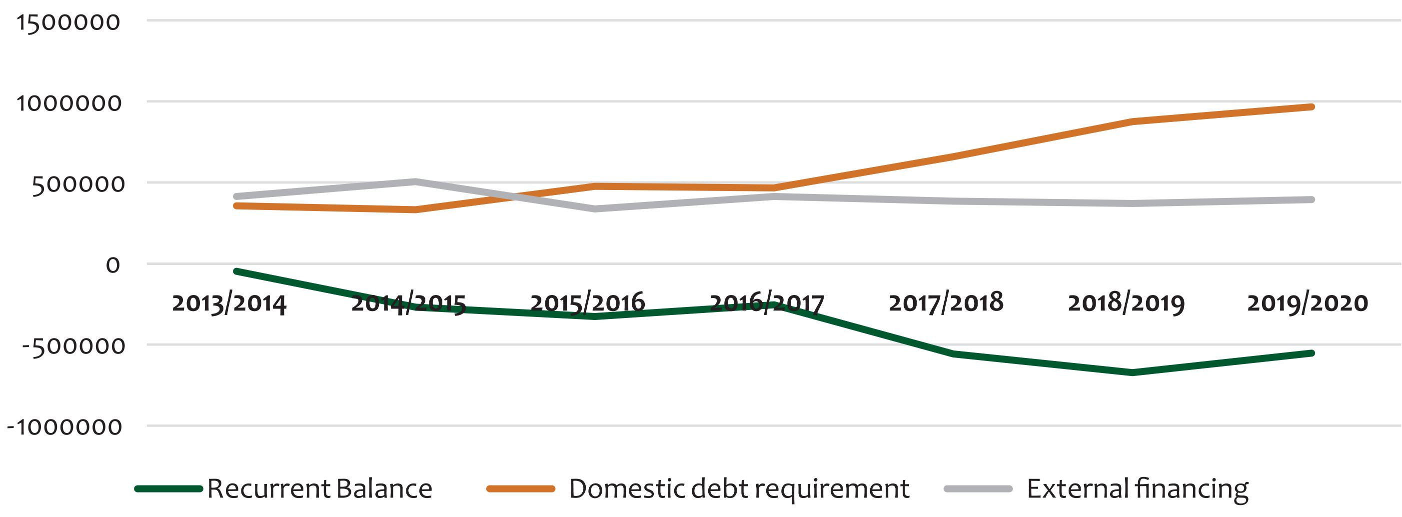
Source: *Annual public debt Reports 2019/20; 2018/19 and 2017/18*

Figure 2.4 shows a widening gap between budgeted and actual expenditures over the financial years. Before 2017/2018 financial year, the budgeted expenditure was higher than the actual expenditure. After 2017/2018 financial year, the actual expenditure was higher than the budgeted, meaning the budget was surpassed. This fails to meet the basic principles of public finance that requires the budget be as close as possible to the actual situation. The error in planning has equally widened over the years. The overshoot in the actual expenditure shows overcommitment. The overshooting of the actual expenditure raises queries on whether Kenya's National Treasury observes the prerequisites of financial resources management 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. The mismatch between budgeted and actual expenditures originates from numerous budget reviews through supplementary budgets.

A critical look at public expenditure financing in Kenya using data in Table 2.3 and Figure 2.5 further shows a growing recurrent balance (the difference between the ordinary revenue and recurrent expenditure). This is a clear indication that the ordinary revenue is below the recurrent expenditure for the period 2013/2014-2019/2020 meaning part of recurrent expenditure and the entire development expenditure is being financed through borrowing.

The phenomenon of borrowing externally to pay debt interest is an explosive debt path since what is being borrowed to pay interest attracts interest as well.

Figure 2.5: ***Total recurrent balance and finance requirements***



Source of Data: *Economic Surveys*

Financing of the recurrent expenditure, part of which is interest on existing debt, requires external borrowing. The phenomenon of borrowing externally to pay debt interest is an explosive debt path since what is being borrowed to pay interest attracts interest as well. The

Kenyan path is riskier as the government has demonstrated preference for more expensive commercial loans as opposed to multilateral borrowing which was preferred in the previous years. The expensive debt not only raises the cost of debt but also leads to a debt crisis. This is further complicated when the rapid growth in external debt is not matched with growth in foreign exchange earning as shown in Table 2.1.

The continuous use of both domestic and foreign debts to meet Kenya's recurrent expenditures as shown in Figure 2.5 is not sustainable and is at the expense of funding investment that would potentially stimulate economic growth. The use of debt to finance recurrent expenditure is also contrary to the provisions of PFM Act 2012 that stipulates that over the medium term, the national government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure. The conformity to the provisions of the Act is key in managing the fiscal deficits risks.

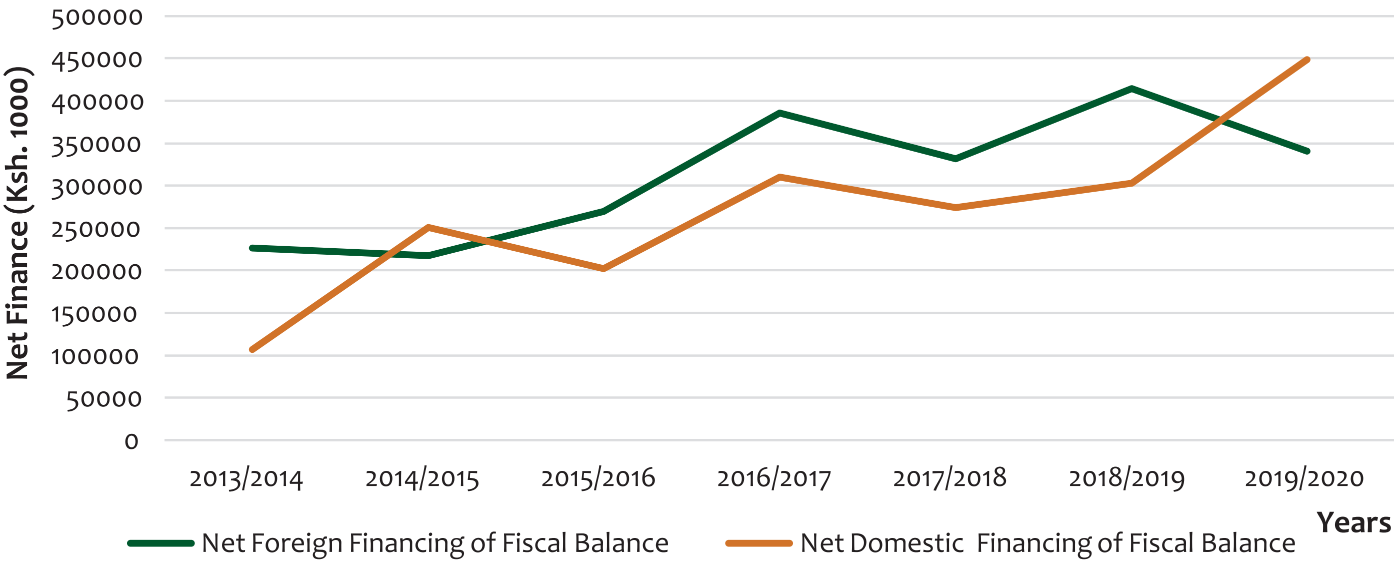
Over the years, the public deficit financing has heavily relied on the external borrowing. This is shown by Table 2.4 and the trend in Figure 2.6

***Table 2.4:* Fiscal deficit financing FY 2012/13 -2020/21 (Kshs. million)**

		2013/2014	2014/2015	2015/2016	2016/2017	2017/2018	2018/19	2019/2020
Domestic Financing	Estimate	99,100	323,700	245,035	236,100	248,700	310,100	593,900
	Actual	106,700	251,102	202,300	309,760	273,710	303,658	448,331
Foreign Financing	Estimate	290,900	301,900	419,010	462,267	374,600	321.500	324,000
	Actual	226,700	217,479	269,924	385,745	331,641	414,518	340,805

Source of Data: *Economic Surveys*

***Figure 2.6:* Net foreign and domestic financing**



Source of Data: *Economic Surveys*

Between 2014/2015 and 2019/2020, there was over-reliance on foreign deficit financing compared to domestic financing. This means the country is over relying on imported goods and services in order to run fiscal activities against the public spirit of buy Kenya to build Kenya. This is necessitated by the capital intensive infrastructure. The externally supported infrastructure denies the country utilization of domestic resources. The inability to grow ordinary revenue increases the need to borrow in the face of growing public expenditure. Thus, the expansion of government expenditure amidst minimal growth in foreign exchange earnings and stagnating tax paying domestic economy feeds into growth of public debt by raising both the domestic and foreign debts.

Table 2.4 also shows increasing mismatch between budgeted and actual expenditure for domestic and foreign borrowed resources. Higher budgeted than actual expenditure on foreign debt alludes to cost in terms of commitment fee. The signed agreement between the government and foreign actors amount to commitment fees whether resources are utilized or not. This is with regard to loan commitment for resources yet to be drawn. The loan drawing may delay due to disputes like land ownership and protracted procurement procedures.

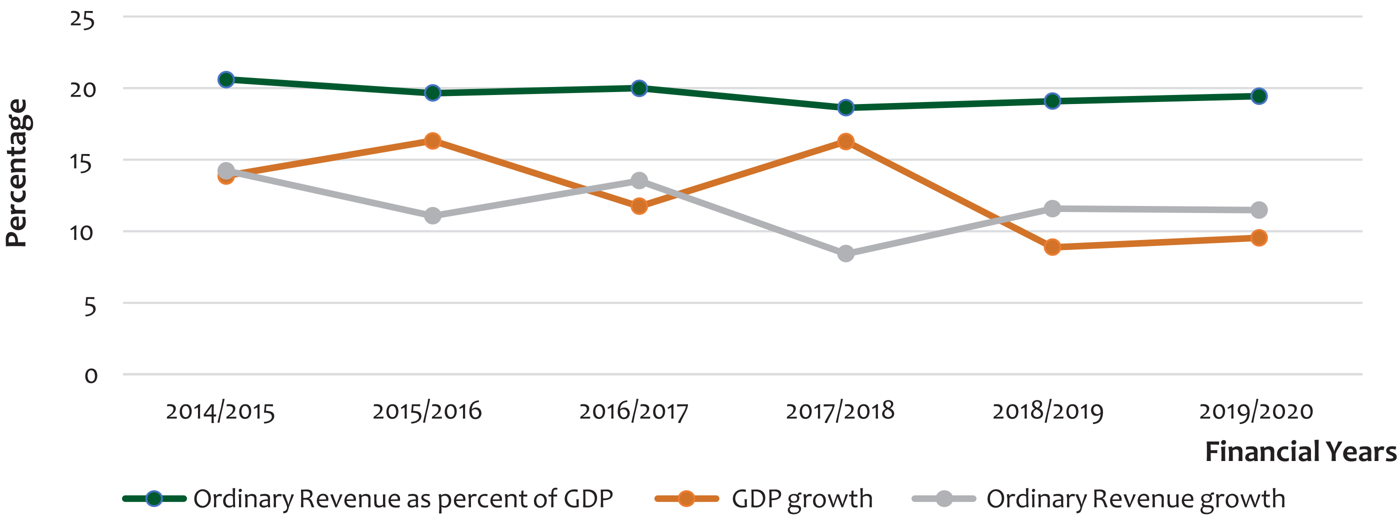
2.3.1 Tax Reforms and Tax Revenue

In Kenya, various tax reforms have been initiated over the years to address inequality and generate sufficient revenue to finance public expenditure. The tax reforms aim at making the tax system mitigate the ever-recurring fiscal imbalances through tax policies that intend to: make tax yield responsive to national income changes (tax buoyancy); lessen the complexity and heighten transparency of the tax system (Muriithi & Moyi, 2003). Major tax reforms in Kenya started in 1986 under the Tax Modernization Programme (TMP). The TMP aimed at achieving a sustainable tax system amid changing domestic and international conditions. Tax policy shifted towards reliance on indirect taxes over direct ones, sales tax was replaced by VAT which was favored for investment and growth while trade taxes were used to create a competitive export sector by fostering export led growth. Reforms targeting custom duty involved gradual reduction in tariff from a high of 170 to 25, duty exemption restrictions, tariff structure reforms and firming up administration of customs duties. Additional reforms included the establishment of Kenya Revenue Authority (KRA) (Muriithi & Moyi, 2003; Ouma 2019).

Over the years, various tax policy reforms have been implemented to meet government revenue requirements. The reforms include: Revenue Administration Reform and Modernization Program (RARMP) that began in 2004-05 aimed at improving efficiency in tax administration; digitization of tax administration and the Public Finance Management Reforms (PFMRs) launched in 2006. PFMRs were aimed at enhancing the responsiveness of the Kenyan government to fiscal policy priorities as well as enhancing accountability and transparency.

In line with the reforms and fiscal needs, the government in every financial year makes tax proposals touching on income tax, excise duty, VAT, and customs. For instance between 2013/2014 and 2019/2020 the government of Kenya introduced various proposals that included: imposing a withholding tax on winnings from gaming and betting; capital gain tax which has since been raised from 5 to 12.5 percent; rental income tax at 10 percent of gross rental income; increase in import duties for welding electrodes, millstones , grind stones and introduction of a 1.5 per cent railway development levy on all imported goods. The reforms also entailed transfer of pricing audits, zero-rating various items and lowering VAT withholding from 6 percent to 2 percent among others. One of the notable digital reforms include the web enabled iTax system launched in 2013 and the KRA mobile phone application M-service platform launched in 2014 (KRA 2010; Ndung'u 2017; Wawire,2020). However, the growth in revenue, as shown by the ordinary revenue as a percentage of GDP is a non-buoyancy tax as shown in Figure 2.7

***Figure 2.7:* GDP and ordinary revenue growth**



***Source:** Kenya Economic Surveys (Various issues)*

Measured with reference to GDP growth, the growth in revenue performed below 20 percentage points. This is despite the outlined reforms aimed at increasing revenue. In addition, Figure 2.5 shows that, an increase in tax revenue impacts negatively on GDP. This is a clear indication that the country's tax system is not at its optimum. To increase tax revenue, the government may need to reduce the tax rate hence stimulate production and consumption in the country. This will in turn stimulate the economy and increase tax revenue.

2.4 Analysis and review of monetary policy and its role on the debt crisis in Kenya

This part looks at the monetary policy and the shilling appreciation against the advantages of depreciation. It also draws attention to the trade-off between increased net exports and the impact induced by depreciation.

The central bank will often use a monetary policy to stimulate the economy during a recession or in anticipation of a recession. Expanding money supply results in lower interest rates and domestic market borrowing costs,leading to increased consumption and investment. This affects the county's currency value in terms of the other countries' currencies. Decline in competitiveness , the root course of the high current account deficit, is mainly connected with changes in the county's currency value.

The balance-of-payment models explains the role of monetary policy in the determination of exchange rates. Theories show that exchange rate enters the macroeconomic framework of monetary policy through interest and output determination because changes in exchange rates affect competitiveness. Depreciation acts much in the same way as fiscal policy by affecting the level of demand for domestic goods associated with each level of output and interest rate. It shifts world demand towards domestic goods and thus, acts in an expansionary manner.

The greatest formulation of exchange-rate theory is the monetary approach by Chicago's quantity theory of the open economy and Purchasing Power Parity (PPP). It shows that exchange rate is moved by changes in money supply.

A country that experiences hyperinflation (because of excess money supply), will experience a corresponding external depreciation of its currency. This, if not tamed, will maintain PPP. Goods produced domestically and by foreign competitors behave as if they are perfect substitutes if there are no tariff and non-tariff barriers to trade (including exchange rate management). Simple imports and exports by market participants will establish uniformity of price (PPP) in closely integrated markets for raw materials, commodities and food. When domestic goods prices become more competitive, demand is expected to shift towards domestic goods if market is not interfered with through fiscal or monetary policy. This will stimulate production in an emerging economy like in Kenya, thus promoting domestic income, consumption as well as export of goods and services.

Use of monetary policy affects exchange rate and thereby countries' competitiveness. If the exchange rate decreases (currency appreciates), it attracts more imports and less exports in the substitutable industries. This will be depicted by the decline in net export of the domestic market. Monetary policy has also been used to achieve external balance - through its effect on exchange rate and market interest rate.

Thus, monetary policy can affect the accumulation of external debt stock, cost of servicing external debt and risk of the external public debt. Depreciation of the domestic currency leads to increase in external debt stock and increased cost of servicing external debt.

If a country operates under flexible exchange rate (allowed to respond to market forces), and if there are no barriers to trade, then the exchange rates misalignment is immediately corrected through arbitration (demand for foreign and domestic currency). When domestic demand for goods and services increases more than domestic production, the exchange rate depreciates due to increased demand for foreign goods (and therefore, demand for foreign currency). This maintains the domestic demand for goods and services but at higher prices – which increases employment. This flexible regime of exchange rate leaves the monetary policy fully independent to ensure maximum employment, stable prices and moderate long-term interest rates. However, to avoid high fluctuation in the rates, the monetary authority may, moderately, intervene to calm the wave.

On the other hand, under fixed exchange rate or a heavily managed exchange rate, the monetary policy is fully dependent on the pressure on the exchange rate. The monetary policy here is used purely to maintain the authority in determining exchange rate. When the exchange appreciates, the monetary policy is used to draw foreign currency from the domestic market resulting in expansionary monetary policy (increased domestic currency – selling securities for short-term, lowering reserve requirements and lowering discount window). When the pressure is on the domestic currency to depreciate, the monetary authority draws from its reserves the foreign currency and suppllies it to the domestic market by buying off the domestic currency. This amounts to contractionary monetary policy (reduced supply of domestic currency in the market).

Under fixed or managed exchange rate, the monetary authority must maintain foreign currency reserves to facilitate these interventions. Besides the fact that this amounts to holding idle resources, a country that is not able to export or attract foreign investments to match its imports must borrow and incur debts to maintain these foreign reserves. A country, therefore, can borrow to manage its exchange rate.

Role of monetary policy in debt crisis: Lessons from abroad

The debt crisis of the 1980s is an example of how an uncoordinated monetary policy in dealing with exchange rate can lead to a debt crisis. The crisis began in August 1982 when Mexican government announced that its central bank had run out of foreign reserves and it could no longer meet its foreign debt obligation of USD 80 billion and stopped exchange rate defense. Creditors, mostly private lenders to Latin America, scrambled to reduce their risks by cutting off new credits and demanding repayment on earlier loans. These countries did not have enough foreign reserves to meet the demand. The result was a widespread inability of developing countries to meet prior debt obligations, leading to default.

The United States effected expansionary monetary policy in the late 2000s during the Great Recession that began in 2007. The US federal funds target of discount window was reduced from 5.25 percent to a range of 0 percent to 0.25 percent in December 2008, which economists call the zero-lower bound. By historical standards, rates were kept unusually low for a long time to mitigate the effects of the 2007-2009 financial crisis and its aftermath. Starting in December 2015, the Fed began raising interest rates when recovery was assured. In total, the Fed raised rates nine times between 2015 and 2018 by 0.25 percentage points each time. In light of increased economic uncertainty, the Fed then reduced interest rates by 0.25 percentage points in a series of steps beginning in July 2019. This is termed as use of monetary policy to support the economy.

Monetary policy is an important tool in managing domestic debt. The CBK Act provides for CBK to act as fiscal agent and banker to the Government in addition to its core functions. In addition, Section 45 of the Central Bank of Kenya Act provides a legal framework for the bank to manage public domestic debt on behalf of the government. This includes contracting domestic debt through sale of Treasury Bills and Bonds, extending overdraft facilities to the government, maintaining domestic debt register and making payments of domestic debt. As a banker to the government, CBK effects payments to external creditors on specific instructions from the National Treasury. Kenya uses monetary policy to manage its exchange rate. When the pressure is on currency ,it depreciates, CBK mops excess liquidity to curtail aggregate demand. Though this safeguards Kenya against the risk of the exchange volatility, it also denies Kenya gain from depreciation of the Kenya Shilling. The gain would emanate from increased costs of imports and reduced prices on exports. This is so because the managed exchange rate is hardly allowed to depreciate. This is depicted by Table 2.5 .

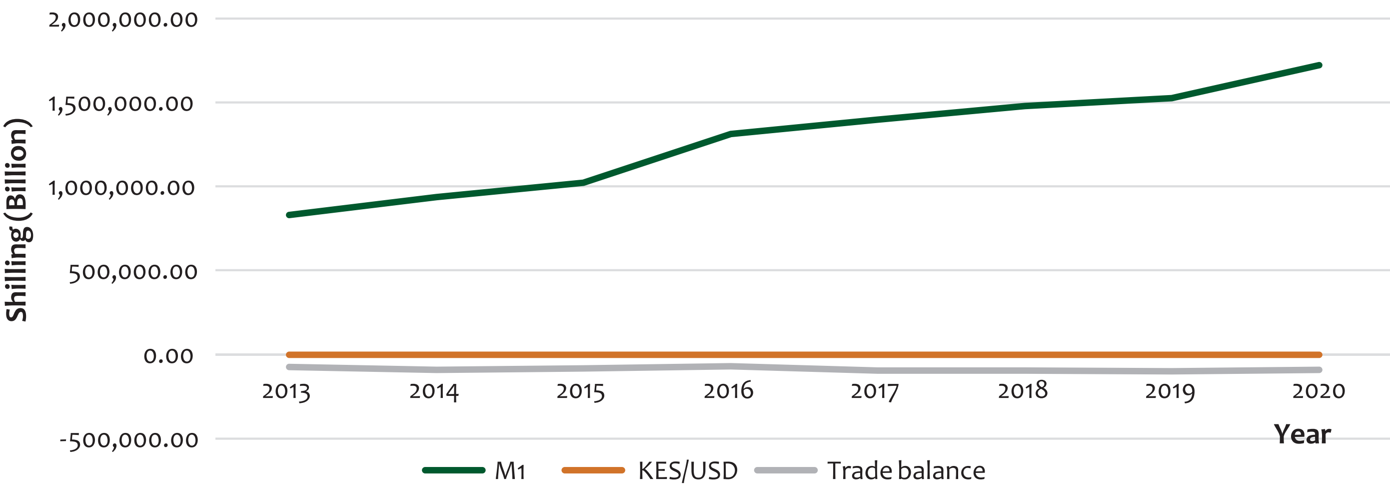
***Table 2.5:* Exchange rate, money supply and trade balance in Kenya -2013-2020**

Year	Money Supply (M1)	Exchange Rate (USD/KES)	GDP Growth Rate	M1 Growth Rate	Trade balance
2013	831,874	87	6	11	-75,176
2014	938,157	90	5	13	-90,605
2015	1,023,047	102	6	9	-83,278
2016	1,310,016	102	6	28	-71,209
2017	1,397,256	103	5	7	-94,291
2018	1,477,526	102	6	6	-95,608
2019	1,525,237	101	5	3	-100,465
2020	1,720,132	111	0	13	-92,285

Source of Data: *Central Bank of Kenya (Various Reports)*

Table 2.5 shows a reduction in trade balance with an increase in money held by the public (M1). As M1 increased between the year 2013 and 2016, the trade balanced reduced to its lowest at (71,209) billion. At the same time, the domestic currency depreciated against US dollar from 87 to 102. With the intervention of monetary authority due to importers outcry around 2016, moping up of currency from the public resulted to stagnation of M1 growth rate. This strengthened the Kenyan shilling leading to an increase in trade deficit. The shilling has also strengthened recently due to foreign inflows spurred by a $766 million infrastructure bond issuance in April. Figure 2.8 shows the long run stagnation of exchange rate in Kenya.

Figure 2.8: Exchange rate, money supply and trade balance trend in Kenya (2013-2020)



Source of Data: *Central Bank of Kenya (Various Reports)*

Money supply increases in Kenya is simply to maintain the exchange rate pegged. This is illustrated in Figure 2.6. The result is that exports are not stimulated and the imports keep rising. Trade balance, consequently, is in deficit. The deficit is often financed through borrowing. According to IMF (2021), Kenya's real effective exchange rate (REER) has been on an appreciating trend in recent years. Despite a stable nominal effective exchange rate (NEER), relatively lower inflation rate than in trading partners had in recent years contributed to medium-term real appreciation and Kenya's REER had appreciated more than its regional peers.

At the end of 2020, the country's reserves stood at USD 8.4 billion, compared to USD 9.1 billion at end of the year 2019. Reserve coverage target of CBK is 8.4 percent of GDP, about 4 months of imports and in line with the IMF's reserve adequacy condition.

Exports of goods and services to GDP remained above 20 percent from 2001 to 2012 and averaged 19 percent during 1998-2020. In recent years, however, Kenya has suffered weak export performance. More recent data shows that Kenya has been losing market share since 2015, while the other non-resource intensive SSA countries were, on average, gaining market share.

With loss in competitiveness and reducing foreign reserves, debt management policies that include an over reliance on foreign currency are very risky. Hence, Kenya's strategy of debt mixes of 60:40 (External to Domestic) is risky. While external debt may appear to be less expensive than domestic debt of the same maturity it could turn out to be costly in volatile capital markets or if the exchange rate depreciates. This could result if CBK is unable to defend the exchange rate due to lack of foreign reserves. Debt managers should, therefore, know that the choice of exchange rate regime can affect the links between debt management and monetary policy. For instance, external debt may appear to be cheaper in a fixed exchange rate regime because the regime caps exchange rate volatility. However, such debt can prove to be very risky if the exchange rate regime becomes untenable.

2.5 IMF proposals review and analysis

In April 2021, the IMF approved to Kenya , a 38-month credit under the Extended Credit Facility (ECF) and the Extended Fund Facility (EFF) for US$ 2.34 billion, aimed at supporting Kenya's program to address debt vulnerabilities, support the response to the COVID-19 crisis and enhance governance. The credit supported Kenya's response to the COVID-19 shock and the authorities' plan to reduce debt vulnerabilities while advancing the structural reform agenda.

The reform agenda entailed strengthening the anti-corruption framework, addressing financial weaknesses in state-owned enterprises (SOEs) and strengthening the monetary policy framework for financial stability.

The economic core of IMF proposal, which will be supported by the proposed EFF/ECF arrangements, is based on prudent macroeconomic management and structural reforms to anchor macroeconomic stability and stimulate investment. Fiscal consolidation can be achieved through raising revenue, reducing waste and inefficiencies in spending while protecting developmental spending. Table 2.6 presents the review of programme proposals by the Kenya government and the IMF conditions.

Table 2.6: Fiscal consolidation programmes and IMF conditions

Programmes	Policies	Objectives	Conditions
COVID-19 Response and Reducing Medium-Term Debt Vulnerabilities	Support to the response of COVID-19 9 shock	✓ Protect health and social expenditures. ✓ Unwind emergency expenditures in non-priority areas. ✓ Transfers to vulnerable groups ✓ Vaccination and immunization programs.	✓ Curtail non-critical spending in consultation with IMF staff
	Reduction of Public Debt Burden	✓ Keep the debt-to-GDP ratio on a firmly declining trend ✓ Bring the tax-to-GDP ratio to 15.6 percent in FY23/24 ✓ Reduce recurrent spending to 17.9 percent in FY23/24	✓ Reduce budget deficit to 4.3 percent of GDP by FY2023/24 ✓ Total expenditure to decline by 1.4 percent of GDP ✓ Bring Tax-to-GDP ratio to 15.6 percent in FY23/24
	Contain fiscal and debt vulnerabilities	✓ Repeal the bulk of the emergency tax cuts introduced in April 2020 ✓ Expedite judicial procedures to collect outstanding tax debts ✓ Anticipate payment of dividends from public sector. ✓ Limit recurrent spending ✓ Better prioritizes domestically financed projects. ✓ Provide limited support to SOEs	✓ Total revenue including grants to reach 16.8 percent of GDP
	Normalization of economic activity	✓ Tax mobilization – tax reversal ✓ Elevate Fiscal risks from SOEs	✓ Removal of tax exemptions – This can be read as removal of tax incentives
	Protect high-priority service delivery and investment programs	✓ Reduce remaining tax exemptions. ✓ Strengthen revenue administration. ✓ Restrain recurrent expenditure particularly through a gradual reduction in the wage bill and transfers to public sector entities. ✓ Improve efficiency and effectiveness of government spending. ✓ Strengthen PFM systems, budget control and execution processes, cash management, and public investment management—including related to PPPs and associated fiscal risks	✓ Reduced Public Expenditure but protecting social protection
	Reduction of external debt vulnerabilities.	✓ Prioritize concessional financing. ✓ Limit commercial borrowing.	✓ Reduced commercial borrowing and replacing with concessional borrowings. ✓ 40:60 in reference to domestic vs foreign borrowing

Programmes	Policies	Objectives	Conditions
Structural Reforms	Addressing SOEs' Financial Challenges	✓ A financial evaluation of SOEs with largest fiscal risks ✓ Strategy for addressing financial pressures in the SOE sector, including a framework for deciding on interventions and reforms ✓ Completing a draft blueprint that will identify necessary actions and legal reforms to enhance governance ✓ Developing an integrated monitoring and reporting system ✓ Initiating a review of institutional structures. ✓ Scale-up resources at the Treasury's Government Investment and Public Enterprises (GIPE) Department, while	✓ Start publication of an annual report on tax expenditures and their budget implications by September 2021 ✓ By end-September 2021, an expanded fiscal risk analysis that quantifies contingent liabilities from high-risk SOEs and PPPs will be included in the annual Budget Review and Outlook paper ✓ Express interest in continued IMF technical assistance in the areas of fiscal risk analysis and legal reforms. ✓ Removal of exemptions outside agriculture and limiting of zero-rating ✓ Taxation of capital income as well as excise taxes ✓ An evaluation of financial health and FY2020/21 fiscal needs of the SOEs that pose the highest fiscal risk to the FY2020/21 budget ✓ Completion of an in-depth analysis of the financial vulnerabilities of the largest and most exposed firms in the sector and ✓ Development of a strategy to address fiscal risks from SOEs, including a framework for deciding on interventions.
	Governance	✓ Priorities to enhance the anticorruption framework ✓ Promotion of fiscal transparency via publishing procurement information including beneficial ownership data of companies awarded contracts ✓ Operationalizing the Access to Information Act ✓ Review of the current legal framework for asset declarations of senior public officials and conflict of interest rules	✓ Increased by 30 percent the number of Level II audits of firms, using risk-based approaches to select taxpayers by end of 2021 ✓ Strengthening post-clearance audit by increasing assigned staffing from the current 21 to 45 before end-June 2021 ✓ By December 2021, enhance valuation methods in customs by using data analysis ✓ By December 2021, complete a comprehensive review of end-use of exempt products to rein in abuse. ✓ Complete audit of all exemptions over the past 5 years to detect misuse. ✓ By June 2021, achieving processing of all compliant customs entries within 24 hours. ✓ By June 2021, develop and implement risk-based compliance strategies for two to three non-compliant sectors

Programmes	Policies	Objectives	Conditions
Monetary Policy Framework and Financial Stability	The monetary policy stance	✓ Medium-term inflation target ✓ Foreign exchange interventions ✓ CBK publish a white paper by end-June 2021 ✓ Outlining planned reforms to improve the monetary policy framework ✓ Guarantee scheme in supporting credit to SMEs ✓ Management of foreign reserves ✓ Review of banks' earnings and capital buffers of restructured loans. ✓ Refining our macroeconomic modeling and forecasting frameworks.	✓ Medium-term inflation target of 5 percent +/- 2.5 percentage point band ✓ A monetary policy consultation clause (MPCC) with a 5 percent +/- 2.5 ppt band will help monitor inflation performance, providing for a consultation with the Executive Board to be triggered if inflation falls outside the band. ✓ Improving the operations of financial markets, including fully developing by December 2021 a Centralized Security Depository that will improve monetary policy transmission and promote efficiency and transparency in the government domestic debt market.
	Financial Sector	✓ Implementing a centralized Electronic Data Warehouse (EDW) that will merge all the different information sets provided by banks to CBK ✓ Bill is to empower CBK to supervise and regulate digital lenders ✓ Screening and reporting of Suspicious Financial Transaction	✓ Anti-money laundering and countering the financing of terrorism ✓ Non-payment of dividends
	Data Quality	✓ Enhanced economic statistics with a range of new statistical surveys	✓ General government fiscal out turns on a quarterly basis by June 2022 ✓ Annual fiscal data of the public corporation sector by December 2021 ✓ Migration of the fiscal framework to GFSM 2014 based concepts by December 2021

During the program period, the government will not introduce or intensify restrictions on payments and transfers for current international transactions or introduce or modify any multiple currency practice without the IMF's prior approval, conclude bilateral payment agreements that are incompatible with Article VIII of the IMF's Articles of Agreement, or introduce or intensify import restrictions for balance of payments reasons. This is an overall requirement from IMF.

In addition, as table 2.6 shows, there are major similarities with the 1980s-1990s SAP that eventually failed to work in Kenya. Similarities are equally noted with those of conditions and requirements administered to Latin Americans when they were faced with economic crisis. Some of them include; tax use to raise fiscal revenue at the expense of aggregate demand (Taxation of capital income as well as excise taxes), increase of bureaucratic process by introducing other check points like second level audits instead of making the existing ones effective and IMF monitoring of internal affairs.

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*

Under the IMF Fiscal Consolidation Proposal, most of the tax cuts introduced in April 2020 were reversed effective 1 January 2021 in order to bolster government revenue as a show of upholding the government policy commitment towards fiscal consolidation. This, according to the government, resulted in additional revenue estimated at Ksh 115 billion on a full-year basis. It is important to note that these are resources technically withdrawn from an otherwise efficient private sector to a relatively less efficient public sector. In addition, the government introduced new revenue raising measures.

Illustration 1.7 shows the revenue increasing measures introduced in 2020.

In reviewing the IMF fiscal consolidation measures against the purpose and principles of good taxation, illustration 1.7 also highlights the measures that are considered counterproductive, given the economic situation in the country. Looking at the three objectives of taxation (allocation, redistribution and stabilization), allocation is recommended if the tax policy does not interfere with market determined allocation. Under this objective, tax is used to correct market failure and improve market efficiency in the economy.

However, the introduced taxes are on goods and services with high elasticity and will therefore create distortion and retrogression. The second objective, income redistribution, is meant to ensure fairness, equity and lessen inequalities in the distribution of income and wealth. Most taxes are on goods and services consumed by lower income group and are therefore meant to create more inequalities. The third objective of stabilization is meant for full employment and price stability in an economy. However, this will not happen when the public sector is competing with private sector in the use of resources. Rather, the public sector should complement the private sector by making it more productive.

The IMF fiscal consolidation measures are basically focused on revenue enhancement. With such a robust commitment, key questions must be asked. For example, is Kenya pursuing a right fiscal policy in lieu of the above? Has Kenya fallen short on this? The answer to these questions is obvious. Kenya's tax policy is revenue driven without regard to the key purpose of taxation in an economy. Policies such as broadening the tax net and reducing remaining tax exemptions are merely meant to increase revenue without paying attention to their adverse effect on government ability to raise revenue in long-term. In addition, the only reason for withdrawing the tax relief measures that were meant to cushion Kenyans against the pandemic was shortfall in revenue. Why would any government reverse measures meant to cushion its citizen amidst a pandemic without an alternative? Public revenue at expense of redistribution? The government through the support of IMF has continued ignoring the effect of tax in the economy particularly those adversely affecting the competitiveness of local products.

The canons of taxation as articulated by Adam Smith require that:

Each tax should be levied at the time, or in the manner that is convenient for the contributor to pay.

Every subject of the state should contribute towards support of the government, as nearly as possible, in proportion to to the revenue earned under the protection of the state, commonly referred to as the ability-to-pay principle. In light of this, the use of turnover taxes is highly suspect.

Every tax should take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. This canon implies that tax should not interfere with the market decision making, should be simple and discourage corruption.

The tax which everyone is bound to pay should be certain, and not arbitrary. That is the time of payment, the manner of payment, the quantity to be paid, should be clear and plain to the taxpayer.

The suggested fiscal consolidation measures should be evaluated against these canons.

2.5.1 Structural Adjustment Programmes

After independence, Kenya had high hopes for rapid economic growth and development. Though the performance of the economy was remarkable in 1960s, it slowed in 1970s and stagnated in the 1980s following the oil crisis of 1973. This first oil shock adversely impacted the Kenyan economy given the country's total dependence on imported oil products. The state's attempts to bolster economic growth through investments and Import Substitution Industrialization (ISI) strategies were unsuccessful.

As a result, the World Bank and the IMF advocated for Structural Adjustment Programmes (SAPs), as pre-conditions for financial assistance. These SAPs emphasized macroeconomic stabilization, privatization and liberalization. SAPs had far reaching effects on economic development in Kenya for they led to the unbundling of the pervasive control system and reduced the prominent role of government in the economy during the 1990s. The programme was equally instituted by IMF based on economic hardship the economy was going through during the period. A Summary of the SAPs is given in Table 2.7.

Table 2.7: ***Structural adjustment programmes***

Programmes	Policies	Objectives	Conditions
Structural Reforms	Liberalization	✓ Increase competition in the domestic economy. ✓ Promoting export-led growth instead of import substitution by reducing protection and control on access to exchange ✓ Efficiency gains through greater reliance on market forces and on the private sector ✓ Elimination of market distortions	✓ Adopting a flexible exchange rate policy ✓ Providing additional incentives for exporters and development of outward-looking competitive markets ✓ Eliminating barriers to foreign trade and foreign investment ✓ Deregulation of the private sector ✓ Reducing the role of government in the economy ✓ Phasing out public sector monopolies in specific markets such as the supply of agricultural inputs and outputs, credit, and foreign exchange, ✓ Removing or reducing controls on key prices ✓ Interest rate deregulation ✓ Cereals market liberalization ✓ Replacement of quantitative restrictions on imports with equivalent tariffs and rationalization of the tariff structure to reduce the wide variations in effective protection to different industries
	Privatization of commercial state enterprises	✓ Efficiency gains through greater reliance on market forces and the private sector	✓ Commercialization of the National Cereals and Produce Board ✓ Completion of the privatization of Kenya Airways, ✓ The contracting out of the management of the container terminal at the Kenya Ports Authority in Mombasa, ✓ Partial privatization of the telecommunications functions of the Kenya Posts and Telecommunications Corporation ✓ Government to divest its holdings in over 100 firms (including 43 tea factories in which it turned over the bulk of its shareholding to farmers)
	Budget rationalization	✓ To reduce budget deficit ✓ Improved fiscal management	✓ Expenditure reductions ✓ Restricting government functions ✓ Limiting recruitment into the public service ✓ Improving efficiency in managing recurrent expenditures ✓ Establishing transparency and accountability in public finances, with a view to preventing the misuse of public funds and off-budget outlays ✓ Introducing cost sharing for government services in higher education, health care, roads and agricultural support services.
	Institutional reforms	✓ To improve efficiency	✓ No budgetary expenditure commitments will be entered into without parliamentary approval. ✓ All government procurement contracts of more than KSh. 10 million will be awarded through public tendering, and the recovery of the misused public funds will be pursued vigorously (establishment of KACC, now EACC)

Programmes	Policies	Objectives	Conditions
Structural Reforms	Civil Service reforms	✓ Improving efficiency in the public sector	✓ Retrenchment of workers in the lower wage categories through a voluntary retirement incentive scheme ✓ Computerization of the employment rolls and the payroll to eliminate "ghost workers. ✓ Move some critical public functions, such as revenue collection under the Kenya Revenue Authority, outside the public service system to enforce performance standards. ✓ Enforcement of civil servIce code of conduct ✓ Reducing the overall size of the civil service for cost containment and improving working conditions in the civil service for efficiency.
	Monetary policy	✓ Money supply growth control and restore confidence in the banking system	✓ Making the Central Bank of Kenya more independent

The main similarity between the SAPs and Fiscal Consolidation is that they both have budget rationalization, Institutional reforms and monetary policy. SAPs were hypothesized to address the apparent economic problems of Kenya, which included weak management of the public sector that resulted into loss making public enterprises, poor investment choices, costly and unreliable infrastructure, price distortions through overvalued exchange rates, price controls and subsidized credits that led to inefficient resource allocation (World Bank, 1991). In addition, cost of wage was high in relation to productivity. These factors added to the cost of doing business and discouraged local and foreign investors in Kenya.

Some of the SAPs were successful and helped Kenya achieve macroeconomic stability. For example, the monetary policy which helped reduce inflation from 46 percent in 1993 to 1.7 percent in 1995, made the Kenyan shilling remain strong amongst the trading partners. Consequently, the country has been losing its competitiveness which eventually saw the fall of Import Substitution Industrialization (ISI). This proposal has found its way yet again into the current IMF proposal.

The SAP proposal helped reduce the budget deficit from 11.4 percent of GDP in 1992/93 to 2.5 percent in 1994/95; money supply growth was brought under control and confidence in the banking system was restored. The real GDP, that had stagnated in 1992/93, begun to recover, growing by 3 percent in 1994, and by 5 percent in 1995. But this was also associated with more inward-looking-policies brought about by Import Substitution Industrialization (ISI). The current account significantly improved in 1993 and 1994 though it worsened in 1995 as imports continued to grow following liberalization.

However, these gains were short-lived as progress in economic reform slowed in 1995, and some setbacks occurred. This is because government abandoned some of the programs once it received financial assistance. SAPs were also seen as a political, overly economic approach, characterized by excessive conditions and the absence of genuine ownership by the government coupled with lack of political good will from the government. SAPs also failed to consider the political implications of reforms and the risks these policies posed towards the stability of the country. All these contributed to the slow implementation of SAPs.

The export-led development did not work for Kenya since most of Kenya's exports were adversely affected by liberalization of the agricultural inputs. A modified version of ISI strategy that would have enabled nurturing of high value-adding and labor-intensive local industries for exports would have been better. SAPs were also anti-poor - they emphasized anti-inflationary macroeconomic stabilization policies and pushed for private sector and free market development, controlling budget deficits, privatization of public sector enterprises and services, dissolving parastatals, eliminating subsidies and cutting public support for social services (education and health). Cost sharing on education and health had adverse effects on the most vulnerable Kenyans.

2.5.2 Comparative Analysis

Globally, countries have experienced incidents of speedy debt accumulation. Rapid buildup of public debt led countries into financial crises. Countries that have experienced financial crisis had engaged in a combination of unmanageable fiscal and financial sector policies coupled with structural and institutional weaknesses.

In the first wave of rapid debt accumulation in the 1970s and 1980s Mexico and Indonesia had rapid government debt accumulation episodes but only Mexico suffered a triple crisis in 1982. The challenges began when the U.S. Federal Reserve began tightening monetary policy in the late 1970s. Both Mexico and Indonesia faced rising interest rates and currency pressures, Indonesia responded with fiscal and monetary policy tightening trade liberalization and privatization. On the contrary, the Mexican government had a timid response making it to slide into currency and debt crisis. Despite experiencing a debt and financial crisis Mexico has achieved remarkable economic progress. Currently, it is the 15th largest economy in the world in nominal terms, has one of the world's most open economies, is 11th largest by purchasing power parity and has diversified its export structure. These crises were characterized by excessive external borrowings coupled with heavily defended currency.

The case of Mexico - experience with debt accumulation

The build up to the Mexico crisis was the 1970s heavy borrowing in foreign currency, majorly US dollars, against its future oil revenues. The borrowing happened despite the fact that Mexico's foreign currency earnings had increased tremendously thanks to the tripling of oil prices. The increase in foreign revenue would have stopped Mexico from borrowing. However, it continued to do so from World Bank. Even when the Mexican public debts worsened, the World Bank insisted that Mexico could still contract debts. It has been pointed out that lending money to Mexico was the World Bank's way of keeping its hold on Mexican authorities (Treviño, 1995)

In a span of a decade (1972 and 1982) the Mexican government debt rose by almost 20 percentage points of GDP to 32 percent. In the same period the country's external debt grew from 19 percent to 30 percent. In spite of a peg to the U.S. dollar, inflation averaged 84 percent between 1982 and 1987 and the current account deficit broadened. The debt crisis also led to a banking crisis forcing the government to nationalize the entire banking system. Between 1981 and 1982 the Mexican currency *The Peso* collapsed and depreciated by more than half by 1987. The debt problem in Mexico can be attributed largely to the rise in interest rates due to tightening monetary policy in US for which Mexico had no control over. Further, it can be attributed to the accumulation of huge external debt , a choice made by Mexican leaders who pursued expansionary fiscal, that broadened fiscal and current account deficits. (Treviño, 1995; Koh, et al., 2020).

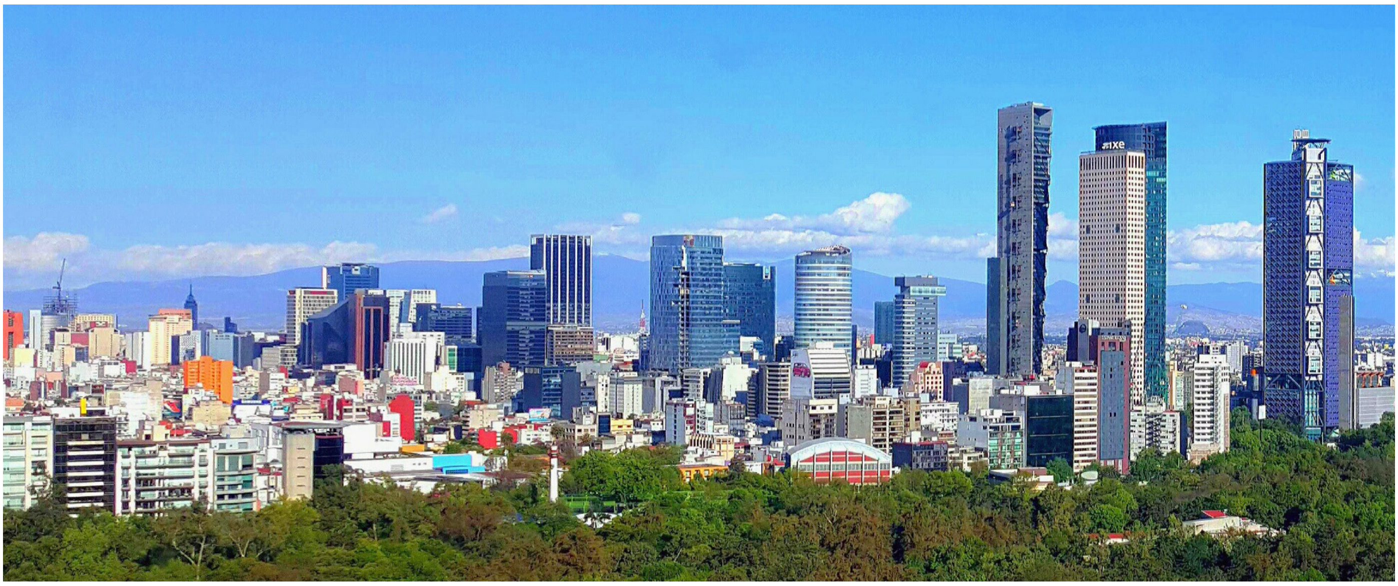
In early 1989, the Mexican government and its institutional lenders agreed that Mexico must eliminate its debt overhang and restore economic growth in order to be assured of future debt.

To save Mexico from the debt crisis, the U.S. Treasury Secretary, Nicholas Brady, developed the "Brady Plan" that supported Mexico's request for debt and debt-service reduction through the use of international resources that would "enhance" the collateral on new debt instruments issued by Mexico. The improved collateral lowered the risk associated with lending to Mexico, thus decreasing the interest costs on new debt and served as a guarantee to lenders that they will be repaid and in turn reduce the owed amounts. With the Brady Plan in hand, Mexico secured support from its most critical institutional creditors for a restructuring program on a scale that had never before occurred in the world credit market. The Brady Plan was indisputably successful. Mexico's debt overhang diminished dropping from 76.3 percent of GDP in 1986 to 33 percent of GDP in 1993, creating an environment for investment, stability and growth (Treviño, 1995).

Two fundamental lessons became clear in the Mexican case : Countries should not depend too much on foreign savings specially if they are short term and need to keep a close eye on their exchange rate as it should be reserved to absorb external shocks.

Further, government commitment is key in getting out of a debt crisis. In the wake of its debt and financial crisis, the Mexican government agreed to refrain from intervening in the foreign exchange market using international reserves, but rather to stabilize its currency using indirect fiscal and monetary policy. Further, the Government committed to disclose information regularly on a number of variables and policy decisions in a systematic and transparent way and proceed with structural reforms.

Mexico City skyline



Source of Photo: *Wikimedia Commons, the free media repository https://commons.wikimedia.org/wiki/File:Mexico_City_Reforma_skyline_(cropped).jpg*

Debt accumulation : Case of Indonesia in the 1970s and 1980s

In contrast to the case of Mexico whose debt increased rapidly during 1972-80 in the time oil revenues increased, Indonesia's central government debt at first declined by almost 20 percentage points of GDP as oil revenues enhanced fiscal positions. However, between 1980 and 1987, government debt scaled rapidly from 14 percent of GDP in 1980 to 46 percent of GDP in 1987. Further, the worldwide recession of the early 1980s worsened the current account deficit to 6 percent of GDP in 1983.

Unlike in the case of Mexico, the authorities in Indonesia responded with Fiscal consolidation. Faced with intermittent currency pressures in 1983 and 1986 the authorities allowed the domestic currency, the rupiah, to depreciate amid tightly enforced capital controls, high reserves accounting to 15 percent of total debt and a small share of short-term debt- 15 percent of external debt (Koh, et al., 2020. Arndt and Hill 1988). In addition, the authority tightened monetary policy with modest increase in short term interest rate and state-owned enterprises ordered to move funds from state owned banks to the central bank. With a declined inflation and minimized capital flight, other reforms were instituted including: deregulation of the banking system, introduction of value-added tax, trade liberalization and privatization of state enterprises (Koh, et al., 2020).

In the dovish tilt that has defined interest rates lately, two noteworthy central banks have actually loosened monetary policy: the People's Bank of China and the Reserve Bank of India. China and India comprise a third of the world's population. The two economies have grown by an average of 9 per cent in the last five years. The People's Bank of China (PBC) has limited currency appreciation. The undervalued exchange rate has also encouraged import substitution. The relationship between China's currency and the economy is interesting because its export-dependent economic system works differently from that of other countries. From 2010 to 2020, major reforms spearheaded by the Chinese government have increased China's market orientation and have opened-up the Chinese economy. Its publishing of local currency notes ensures that forex rates remain fixed or in a tight range. It ensures that Chinese exports remain cheaper and the country maintains its edge as a manufacturing, export-oriented economy. Above all, China tightly controls the foreign money coming into the country, which impacts its money supply.

Both countries have experienced large foreign exchange inflows. But China, in contrast to India, has managed this remarkable achievement while limiting currency appreciation, interest rate increases and keeping inflation low. This has prompted some commentators to state that the RBI "should learn how the Chinese do their exchange rate management" (Surjit Bhalla, Business Standard, May 12, 2007).

Many debt crises including Mexico's, Brazil's and Slovak republic's have been associated with managed exchange rates that led to overvalued currencies during years of rapid growth, debt buildup and capital inflows but eventually succumbed to speculative attacks. Many of the countries that have experienced a debt crisis including Indonesia, Mexico, Uruguay and Thailand borrowed heavily in foreign currency.

Uruguay, for instance, had almost its entire public debt denominated in U.S. dollars in the mid-1990s. Following currency depreciations, they faced difficulties in meeting debt service obligations and experienced sharp jumps in debt ratios. In the early 2000s Europe and Central Asia nations that borrowed from non-resident lenders faced credit crunches as a result of tightened liquidity conditions for global banks. In the first wave of debt crisis, some countries like Argentina, Brazil, Chile and Peru used public debt to finance current government spending and populist policies which led to the overly expansionary macroeconomic policies that caused debt crises.

Drawing from the Mexican case, it follows that, strategies for debtor clubs usually result in lowest common denominator solutions and negotiated financial packages must be ample, simple and flexible as much as possible.

Ternate (City), Indonesia (2010)

Source of Photo: *Wikimedia Commons, the free media repository https://commons.wikimedia.org/wiki/File:Ternate_(City),_Indonesia_(2010).jpg*

2.5.3 Public Borrowing and Public Debt Legal Underpinning

Borrowing by the Government of Kenya is governed by the Constitution, the Public Finance Management Act (No. 18 of 2012) and the National Fiscal policy. The authority to borrow from within or outside Kenya is given to the National Treasury under section 50 of the PFMA 2012. The terms and conditions of the loan should, however, be in writing and in line with the fiscal responsibility principles and the financial objectives set out in the most recent Budget Policy Statement and the national debt management strategy of the medium term.

The guiding principle of borrowing is espoused in section 50(1) of the PFMA 2012. It 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. There should also be measures put in place to ensure level of public debt is sustainable.

Loans constitute public debts and the terms are contained in the Loan Agreement. Article 214 of the Constitution of Kenya defines a public debtas all financial obligations attendant to loans raised or guaranteed and securities issued or guaranteed by the national government. Article 214(2) as read together with section 50(6) of PFMA 2012 provides that the public debt is usually a charge to the consolidated fund unless the Cabinet Secretary determines otherwise through regulations approved by Parliament.

Article 206 of the Constitution of Kenya as read together with Section 50 (7) of the Public Finance Management Act, the Cabinet Secretary shall ensure the proceeds of any loan are paid into the Consolidated Fund or into any other public fund established by the National Government or any of its entities as the Cabinet Secretary may determine in accordance with regulations approved by Parliament.

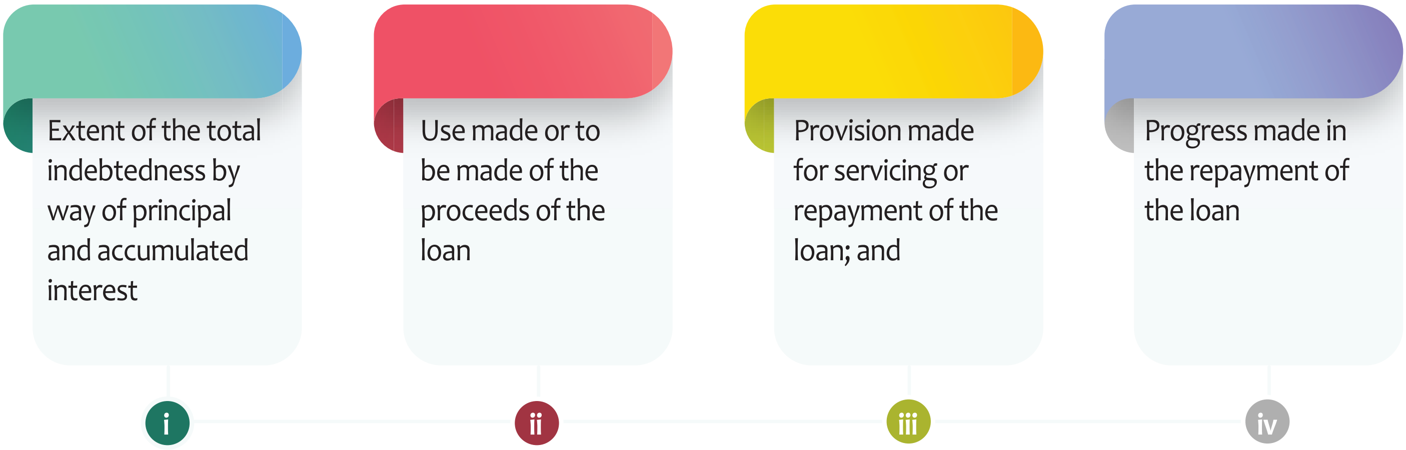
Through section 11(1)(b) of PFMA the National Treasury is mandated to manage the level and composition of national public debt, national guarantees and other financial obligations of the national government and develop a framework for sustainable debt control. It is on this basis that before any loan agreement is executed, the National Treasury must certify that the given credit facility will not exceed the margin of national indebtedness.

A resolution duly moved and passed by Parliament as provided for in Section 15(2)(d) of PFMA sets the national indebtedness limits. The National Treasury ensures that the limits are maintained at sustainable levels. This means that the set margins should not be exceeded at any given time. The GOK should, therefore, borrow or obtain money subject to the limit set by Parliament. The same should be in accordance with the fiscal policy of Kenya and financial objectives set out in the most recent budget policy statement approved by Parliament. (See section 50(2-5) of the PFMA). Such money or purchase of goods or services should be expended in accordance with the given agreements.

A key fiscal principle is that borrowing for the mid-term should be used only for the purpose of financing development expenditure and not for recurrent expenditure. (See section 15 (2) (c) of the PFMA.

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

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



Borrowing for county governments must be guaranteed by the national government and with the approval of the county assembly as stipulated by article 212 of the Constitution as read together with section 52 of the PFMA. Section 32 of PFMA provides that each year, a report is prepared on the total number of loans guaranteed with details on the parties, the interest rates and terms of repayment.

The Cabinet Secretary for the National Treasury is required to submit a Debt Management Strategy of the medium term to Parliament each year pursuant to section 33 of PFMA. The same includes a stock of all debts, the sources of loans, the nature of guarantees, risks associated with the debts and the sustainability plan.

Every loan or grant advanced to the Republic of Kenya comes with its set of terms which are largely determined by the lender depending on the intended use of the facility. It is however important to safeguard the interest of the country by ensuring that the acquired facility will not be at variance with the legal provisions on public finance and that it is in tandem with the national fiscal policy. Such assurance is given by the National Treasury and the office of the Attorney General.

SECTION 3

Conclusion and Recommendations

3.1 Introduction

This section highlights the main findings of the study, the conclusion and recommendations.

3.2 Conclusion

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. The following are the study's conclusions per objective:

3.2.1 Debt composition, cost and sustainability

Public debt denominated in foreign currency comes with major risks that can lead to pressure on the exchange rate , monetary policy distress and a financial crisis. From 2013 to 2020, external debt in Kenya increased from Kshs. 843,562 million to Kshs. 3,515,812 million. This reflects a foreign debt growth rate of 316.8 percent accounting for more than 51.2 percent of the total public debt. This means the country will require foreign currency 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 growth in public debt is largely being driven by demand for imports and poor domestic production of exportable goods and services.

To avoid the current 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.

The increase in commercial loans has increased the cost and risk of public debt in Kenya. This is against the acknowledgement given in government's debt and borrowing policy 2020 which envisage concessional and semi-concessional borrowing to minimize cost, risk and ensuring public debt is at a sustainable level. Concessional and semi-concessional debts have low interest rate coupled with long average time to maturity and grace period.

3.2.2 Public Expenditure trends and their role on debt crisis in Kenya

Kenya is currently going through a twin risk reflected in the public budget deficits and public debts. They are primarily the cumulative result of chronic macroeconomic imbalances, which were not resolved when conditions were still favourable. Kenya's public debt stock increased from Ksh 1.894 trillion in June 2013 to Ksh 6.693 trillion in June 2020 which reflects a 253.4 percent growth in the overall public debt over the period. Over the same period, this growth in public debt has doubled the growth of nominal GDP. For public debt to be sustainable, its growth should remain below that of nominal GDP.

The public budget deficit and debt problem are intertwined with the external deficit. This highlights the effects of increase in public debt, a lack of substantial improvement of the country's international competitiveness and low productive capacity to match domestic and foreign demand.

Given the real data, the actual economic performance reported by the government is highly exaggerated. It was noted that the real GDP is far less the nominal GDP. This was realized after Kenya rebased its data. The rebasing was simply the withdrawal of price effects on the data and incorporation of unclear data from informal sector. The true data considers the country's purchasing power and it reveals that the public debt stood at 144.2 percent of the real GDP. Use of nominal data has given the government room to indulge in excessive and risky fiscal expenditure and public debt.

The public actual recurrent expenditure registered 20 percent growth between 2013 and 2020 while that of actual development expenditure had an average annual growth rate of 8.3 per cent. This is against an average of 5.5 percent annual growth in inflation. Drivers of the recurrent budgeted and actual expenditure growth is not clear and depicts a big mismatch in the public actual expenditures. The steep upward trajectory of recurrent expenditure and the high proportion of recurrent expenditure in the budget is highly unsustainable and a ticking time bomb. In addition, from the financial year 2014/2015 the recurrent expenditure accounts for over 70 percent of the budget . This is contrary to the Public Finance Management Act 2012 which stipulates that over the medium term, a minimum of thirty percent of the national and county governments' budgets shall be allocated to the development expenditure. This has not been the case.

From 2017/2018 financial year, the actual expenditure was higher than the budgeted. This failed to meet the basic principles of public finance which stipulates that the budget estimates should be close to the actual situation as much as possible.

The overshoot in actual expenditure shows an over commitment meaning the National Treasury does not observe the prerequisites of managing 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. This calls for regular reviews of the budget through public participation.

Review of public financing shows that ordinary revenue is less than recurrent expenditure for the period 2013/2014-2019/2020. This means that part of recurrent expenditure and entire of development expenditure is being financed from debt.

Kenya's phenomenon of borrowing externally to pay debt interest is an explosive debt path since what is being borrowed to pay interest attracts interest as well. This path is riskier as the current government has demonstrated preference for more expensive commercial loans. The expensive debt not only raises the cost of debt but also snowballs a debt crisis. This 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 the debt to rise more rapidly than the GDP growth rate. As indicated in section 1, the growth rate in debt is way above the economy's capacity to generate enough income to settle debt obligations. The riskier part is that external borrowing has surpassed the domestic borrowing and the cost of borrowing spiking due to the Government's increased preference for commercial loans. With the country unable to generate adequate foreign reserves to facilitate settlement of external debt, Kenya might be forced to default on debt if the current trend persists.

Aother implication of a rising budget deficit and debt is that more future budgets will be devoted to payment of interest. Debt finance will therefore force government to abandon other important functions such as health and education. This is critical given that in the financial year 2020/2021, approximately 65 percent of ordinary revenue and 55 percent of total revenue went into payment of loan interest. This is not only difficult to sustain but also creates generation equity problem as Kenyans will have to pay more interest in future because the government borrowed more today.

The rising deficit and debt that grow at a higher rate than the economy is a pointer that the government has not been using debt to pay for intelligently planned investments. It also shows slow economic growth and weakened ability to raise more ordinary revenue that would significantly reduce the need for external financing of fiscal balance.

3.2.3 Analysis and review of monetary policy and its role on debt crisis in Kenya

In recent years, Kenya has suffered weak export performance. The country has been losing market share since 2013, while the other non-resource intensive Sub-Sahara Africa countries are, on average, gaining market share. This means that the country is running a current account deficit. The decline in exports and expansion of imports by the country is largely associated with decreased competitiveness due to poor use of the monetary policy.

The probable reason why currency depreciation is shunned in the country is that it could increase the stock of public debt and annual interest expenses .

This would also make the government's borrowing costlier due to the higher average interest rate . This makes the country to direct its monetary response towards a strong domestic currency.\

This is shown when purchasing power parity works against the country by raising imports of goods that were initially sought domestically.

With a defended currency , the country has had uncompetitive production. Kenya's real economy is stagnant despite growth in population and expanding debts. Increasing imports and reducing exports means that the country will continue to experience current account deficit. This deficit is then financed by capital inflows from external borrowings includeing the costly commercial loans to bridge the widening deficit.

Kenya's real effective exchange rate (REER) has been on an appreciating trend in recent years. The country has also suffered from weak export performance as it uses its monetary policy to manage the exchange rate, arguably to safeguard against the risk of the exchange volatility.

However, it denies the country its initial markets access as the domestic prices rise and foreign prices fall, meaning that the exports are not stimulated as the cost of imports keeps on rising.

As a result, the country has been constantly borrowing in order to pay for its import of goods and services.

3.2.4 IMF proposals review and analysis

IMF proposes that the Medium-term inflation target of 5 percent +/- 2.5 percentage points should be maintained. This bolsters the argument that, a 5 percent +/- 2.5 percentage points band will help monitor inflation. In addition, a monetary policy consultation clause (MPCC) that provides for consultation with the Executive Board should be triggered if inflation falls outside the band. Due to the SAPs, the monetary policy condition helped control inflation by lowering it from 46 percent in 1993 to 1.7 percent in 1995. However, this made the Kenya shilling remain strong amongst the trading partners. Consequently, the country has been losing its competitiveness that eventually saw the fall of Import Substitution Industrialization (ISI).

Comparing SAPs success to the current IMF proposals, it is noted that SAPs gains were short-lived as economic reform pregress slowed in 1995. This is because the government abandoned some of the programs once it received financial assistance. In addition, SAPs were seen as an overly economic approach, characterized by excessive conditions coupled with lack of political good will on the part of the government. SAPs also failed to consider the political implications of reforms and the risks that these policies posed for the stability of the country. All these contributed to the slow implementation of SAPs. These risks are not addressed in the current proposals.

3.3 Recommendations

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 of Kenya, 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 effectiveness and transparency in the management of public resources.

The following are the study's recommendations:

1. **More borrowing should be in domestic denominated currency.** The National Treasury and IMF, should review the domestic-foreign debt mix policy so that more public debt is denominated in domestic currency that promotes domestic productivity. The study shows that foreign borrowing is required due to the need for more imports. The government should promote domestic production by using more domestically borrowed resources.

2. **Revise monetary policy:** The study calls for a move of the country's exchange rate closer to its equilibrium. With this, taxes on imported inputs can be reduced thus upgrading the productive capacity.

3. **Where foreign debt is a must, the government should move away from the 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. It 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 beyond reasonable doubt 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, mid or end of a financial year.** Such a move will reverse the regular overshooting of actual expenditure. 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. The non-adherence to prudent management of financial resources emanates from regular reviews of the budget.

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 should 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 an independent body should be carried out regularly.** This is provided for in the law. Government should be more consistent in the way it reports the public finance data and make it easier to track the planned versus actual data. In addition, ensuring consistency of data across various government documents/sources. There is also the 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 wastage incurred through commitment fees thus, eliminating 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.** The government can actualise this through spearheading prudent spending and cutting on wasteful and nonpriority expenditures. The purpose and principles of good taxation should be applied to ensure the effectiveness of tax measures.

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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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