UNIVERSITY OF NAIROBI

SCHOOL OF LAW

A REVIEW OF THE KENYAN PUBLIC DEBT MANAGEMENT LEGAL FRAMEWORK

A RESEARCH THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF DEGREE OF MASTER OF LAWS

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### BIBLIOGRAPHY

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DECLARATION

Declaration by the Student

This proposal is my original work and has not been presented for a degree in any other university or institution.

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This thesis has been submitted with my knowledge and approval as the university supervisor

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ACKNOWLEDGEMENT

I would like to acknowledge my supervisor, Dr. Jackson Bett for his invaluable guidance and support. Despite his busy schedule, he found time to guide me.
DEDICATION

This work is dedicated to my family.
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<tr>
<td>EAC</td>
<td>East African Community</td>
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<tr>
<td>ELCA</td>
<td>External Loans and Credit.</td>
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<td>GDP</td>
<td>Gross Domestic Product.</td>
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<td>IBEC</td>
<td>Intergovernmental Budget and Economic Council.</td>
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<td>IEA</td>
<td>Institute of Economic Affairs</td>
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<td>IMF</td>
<td>International Monetary Fund.</td>
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<tr>
<td>KRA</td>
<td>Kenya Revenue Authority.</td>
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<td>MTDMS</td>
<td>Medium-Term Debt Management Strategy.</td>
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<td>NPV</td>
<td>Net Present Value.</td>
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<td>PDM</td>
<td>Public Debt Management.</td>
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<td>PDMO</td>
<td>Public Debt Management Office.</td>
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<tr>
<td>PFMA</td>
<td>Public Finance Management Act</td>
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<td>PFMR</td>
<td>Public Finance Management Regulations</td>
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<td>PPP</td>
<td>Public Private Partnership.</td>
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LIST OF LEGAL INSTRUMENTS


ABSTRACT

In the recent past, Kenyans have raised concern on the level of public debt in Kenya and the frequent government borrowing to meet fiscal deficit. Data indicates that Kenya’s debt has been increasing and there is fear that Kenya might be treading on unsustainable path. Despite these fears, there is in place a legal framework governing public debt management (PDM) under the 2010 Constitution of Kenya (CoK), the Public Finance Management Act (PFMA) and the Public Finance Management Regulations (PFMR). The objective of this study was to review the legal framework governing PDM in Kenya with a view to identifying any potential gaps. The review was done in accordance with literature on the salient features of a sound PDM legal framework. In reviewing the PDM legal framework, the research concludes that the current high level public debt in Kenya is not as a result of gaps in the legal framework as it encompasses to a large extent the salient features as identified by the IMF and World Bank. It recommends the need for public debt managers to strictly adhere to the laws governing PDM.
CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the Study

Public debt also referred to as government debt or sovereign debt, is the amount of debt a country owes another country or organization in terms of loans or security bonds. The concept of public debt is not new. It dates back to the ancient Greece and Rome to the late medieval Europe.1 Whereas any government can borrow money whether from foreign or domestic sources, the challenge facing many countries is the ability to manage and sustain its public debt.2 Public debt sustainability is one of the major economy policy issues facing both developing and developed countries. In order to ensure public debt sustainability, a country must put in place effective public debt management (PDM) mechanisms.3 Every country strives to ensure that even in the event of borrowing; it is able to effectively manage its public debt.

In Kenya, PDM has become questionable as Kenyans raise an alarm on the rate at which the government has been borrowing. In 2016, although IMF and World Bank still provided that Kenya could sustain its debts, experts from the two institutions indicated that with the current borrowing especially from China, Kenya was trading on unsustainable path.4 China’s loans which are usually non-concessional are growing rapidly and by 2015, 57% of the Kenyan external debt was owed to

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China. By the end of 2016, Kenyan external borrowing to undertake infrastructural development such as the Lamu Port project and the Standard Gauge Railway had risen to an alarming rate calling for an urgent action. In June 2016, the Kenyan public debt had risen by 30.62 percent to 3.62 trillion from 2.83 trillion in May 2016. This raised alarm on the country’s debt sustainability with experts warning of higher debt crisis if the government does not reduce on its budget spending and borrowing.

By January 2017, the National Treasury data indicated that Kenyan public debt had hit 4.5 trillion Kenyan shillings, translating to 52% of the Kenyan GDP, the highest debt level in the region. In April 2017, in a press release by World Bank on Kenyan economic outlook in 2017, it stated that Kenyan economic growth was decelerating, and recommended a number of structural reforms to accelerate growth. Amongst the reforms, World Bank recommended that, ‘credit access can be supported by reducing public sector borrowing and the transactions cost for accessing credit through better credit reporting’.

In the 2017/2018 budget, the Kenyan government planned to borrow more than Kshs. 800 billion. In February 2018, Kenya borrowed a second Eurobond after issuing the first one in 2014 raising the public debt-GDP ratio to 56%. The 220 billion Eurobond running for a span of 30

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9 Ibid.
years would cost Kenyans 323 billion as interest. This led to a public uproar amongst Kenyans with the economists warning that the continued borrowing would lead the Kenyan government to unsustainable level. However, in defending the second Eurobond, the National Assembly Majority leader Honorable Adan Duale during the Annual Prize Giving Day at Nairobi Muslim Primary Academy argued that Kenya had the capacity to repay the loan and it was borrowing for the purpose of investing in infrastructure.\(^{12}\) Since then, a debate continues to rage as to the rising Kenyan debt and Kenya moving towards unsustainable path and uneconomically dangerous debt levels. On 22nd February 2018, the IMF representatives appearing before the National Assembly’s Budget and Appropriations Committee indicated that indeed the Kenyan public debt and the budget deficit was worrying and it would lead Kenyan to unsustainable levels.\(^{13}\) In its report, Cytonn investments indicates that Kenya’s public debt will hit a crisis if the country does not invest in projects with high returns to enable the government repay the debts.\(^{14}\)

As the debate rages on Kenya’s rising debt burden and unsustainability, there are a number of issues that are of great concern to this study. In an interview with the Kenya Television Network (KTN) on 25th February 2018, Joseph Nderi, financial economist analyst in discussing whether the country was over borrowing brought out some of the concerns.\(^{15}\) Nderi argued that borrowing is not the problem but Kenyans should be concerned with the reasons for borrowing, the terms of borrowing which in most cases is on less favorable terms and the sources of borrowing as the


government continues to borrow from the foreign markets. He also stressed that the use of the public debt is of major concern as some of the public debt is used for the recurrent expenditure. Nderi’s concern is that whatever the public debt had been invested in is not delivering in terms of value vis-a-vis costs and in that regard Kenya’s investment of the first Eurobond has not shown any value or accounted for. In discussing the way forward, Nderi argues that Parliament which approves government borrowing is sleeping on its job and there is need to account for the public debt spending. 16

The debate on public debt sustainability raises a number of issues amongst them the accumulation of debt, terms of borrowing, use of the public debt, sources of borrowing and its implications. A sound legal framework outlining PDM, providing institutional framework and setting the limits on borrowing is recognized as an important element in PDM and sustainability. 17 It must ensure that it provides mechanisms which if implemented enhance public debt sustainability, good governance, transparency, accountability and professionalism. It encompasses both legal norms and a strong institutional framework that regulates the public debt sector. For instance, inconsistency in law, policies, inadequate accounting and transparency mechanisms are some of the reasons attributed to Puerto Rico’s debt dilemma in 2015. 18

As a result of the concerns on public debt crisis in Kenya, there is need to review the Kenyan legal framework to identify whether it has loopholes and if not whether the PDM law is not strictly followed. While PDM is part of the public finance, Awadzi and Gardner working with IMF have

16 ibid
provided the salient features that a sound PDM legal framework should encompass. First, it must define the scope of public debt, which includes the definition, relevant public debt institutions and public debt instruments representing liabilities.

Second, it must set out the objectives and principles of public debt management to guide debt managers; medium-term debt management strategy (MTDMS); and provide statutory basis of debt sustainability analysis (DSA’s). The objectives of the PDM in Kenya are provided under Section 62 of the PFMA and Section 193 of the PFMA Regulations. The 200 billion Eurobond will be paid with an interest of 323 billion, invoking the question whether the government is paying more to borrow. According to the Kenyan Quarterly Economic and Budgetary Review 2017/2018 the government has shifted more to external borrowing making it susceptible to financial risks as a result of exchange rate fluctuations and external loans disbursements. This has increased the costs of borrowing driving public debt higher yet the law requires that the government takes into consideration the cost of borrowing. Another objective requires the government to develop domestic markets to reduce borrowing costs. According to the World Bank Economic Outlook 2017, domestic borrowing in Kenya accounted for 53.7% in FY 2014/2015. However, in the preceding years the government has shifted more towards the external market. Whereas the government introduced the M-Akiba Bond in 2017 in a bid to develop the domestic market, there is need to create awareness.

Another area of concern is the extent to which the government abides with the fiscal responsibility principles as stipulated by the PDM legal framework. In Kenya, the recurrent expenditure usually

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20 Ibid p. 12.
21 Ibid p. 16.
exceeds tax collections. The World Bank in its Kenya Economic Update in 2017 has warned the
Kenyan government on spending public debt on recurrent expenditure in contravention of the law.
However, while launching its delivery portal in 2017, the President argued that despite the
increasing public debt, his government limited spending on development expenditure and not
recurrent expenditure. In 2018, the public debt was at 56% of the GDP. The need for the
government to adhere to the fiscal responsibility principles while borrowing is paramount.

Third, it must provide legal mandate to borrow, which includes the sources of government
borrowing either domestic or foreign, provide for who exercises the authority to borrow and
servicing of debt.\textsuperscript{22} Section 49(2) of the PFMA allows the Kenyan government to borrow either
from internal or external sources clearly identifying the sources of borrowing. The section vests
the power to borrow on behalf of the national government in the Cabinet Secretary responsible for
finance subject to approval of the parliament. While Section 192 of the Public Finance
Management Regulations (PFMR) requires the government to borrow for the purposes of
refinancing its debts or repaying a loan prior to its date of repayment, various concerns have been
raised by the public. So far the government has been procuring loans to repay outstanding debts,
which cannot even be account for.

The PFMA requires that the national borrowing be limited to the limit and thresholds set by the
Parliament and budget approved by Parliament.\textsuperscript{23} However, Parliament has argued that the lack of
power to approve new borrowing by government is the main reason behind the frequent
borrowings escalating public debt. In December 2016, the National Assembly’s Budget and

\textsuperscript{22} Ibid p. 18.
\textsuperscript{23} Section 50, PFMA 2012.
Appropriation Committee endorsed a Budget Policy Statement limiting the National Treasury borrowing beyond the 6% of the Gross Domestic Product (GDP).\textsuperscript{24} The treasury had proposed a limit of Kshs. 582 billion in its 2017-2018 budget policy. Parliament asked for amendment of the PFMA which only allows government to put a limit on the government borrowing but lacks the power to approve new borrowing creating a loophole.

Fourth, it must specify borrowing purposes but should not constrain government borrowing in case of unforeseen financial needs.\textsuperscript{25} This is specified under Section 192 of the PFMA Regulations. The argument has been that whereas the government has justified the purposes of its borrowing to invest in infrastructure, energy and key projects, most of the money borrowed is used in refinancing existing debts.

Fifth, it must indicate debt ceilings of what amount government can borrow.\textsuperscript{26} This ensures constrain of fiscal policy enhancing public debt sustainability. At the supranational level, the EAC Monetary Treaty requires that public debt does not exceed 50% of GDP in net present value (NPV) terms and this is reflected under the Kenyan PFMA Regulations. At the statutory level, Section 50(2) of the PFMA requires that public debt limits be set by the Parliament and should not exceed the levels set out in the MTDMS. In 2018, the Kenyan public debt was at 56% of the GDP in NPV ratio after the government procured the second Eurobond. High public debt to GDP ratio is likely to make a country’s public debt unsustainable\textsuperscript{27}. While the law is very clear that the public


\textsuperscript{25} Elsie Addo Awadzi, ‘Designing Legal Frameworks for Debt Management’ \textit{opcit} p.21.

\textsuperscript{26} Ibid p. 24.

debt to GDP ratio should be within the 50% mark, it is clear that the government is exceeding this public debt limit in contravention of the law.

Sixth, it should provide for borrowing by public entities such as local government, parastatals and state owned enterprises and establish the extent of public entity liability. 28 Seventh, it should indicate the contingent liabilities providing for the purpose, eligibility, who may issue guarantees, risk management etc. 29 While the Kenyan PDM legal framework provides for contingent liabilities, this is limited to guarantees and loans and it does not provide a comprehensive coverage of other contingent liabilities. There is need to increase the scope of contingent liabilities which arise from court judgments, natural disasters such as flooding and droughts. Eight, is the provision on government lending and on-lending 30. The objective is to help government mitigate its credit risks from lending. This is well stipulated under Section 57 and 145 of the PFMA which provides that the national and county government can only lend in accordance with the terms and conditions set out under the PFMA Regulations. However, a review of the PFMA Regulations does not provide for the said terms leaving a loophole.

Ninth, a PDM legal framework should also provide the institutional framework responsible for public debt management and sustainability. 31 This includes the role of the legislature, judiciary and executive; establishment of debt management office; committees; agents, advisors and dealers; and central bank as fiscal agent. Finally, it should include transparency and accountability, reporting and enforcement mechanisms. 32

29 Ibid p 33.
30 Ibid p 38
31 Ibid p 40.
32 Ibid p 49.
Whilst these key features as envisaged by Gardner and Awadzi are a guideline, they cannot be underscored. The IMF and World Bank’s, *Revised Guidelines for Public Debt Management*, also reflect these salient features.\(^{33}\) This study examines the Kenyan PDM legal framework with the objective of determining the loopholes and the strengths addressed in the legal framework in order to inform PDM and sustainability. The Kenyan legal framework on public debt management is provided for under the Constitution of Kenya 2010 (CoK), statutory law and guidelines. CoK is the primary legislation and brings with it a new impetus on public finance. In its definition of public debt, the CoK sets out the scope of public debt and grants the power to borrow money to the national government.\(^{34}\)

In addition to providing political powers, fiscal powers and institutional arrangements, a constitutional framework on public debt management should provide for accounting and reporting framework. The CoK provides for a reporting and oversight mechanism. The principles of public finance under Article 201 also envisage accountability, transparency and prudent use of public money. Article 10, is also key in public finance management as it requires public officers to adhere to the national values and principles of good governance. Chapter six of the CoK ensures that a State officer possess leadership and integrity when discharging his obligations on public debt.

The PFMA consolidated all the laws on public finance management such as the National Government Loans Guarantee Act (NGLGA), External Loans and Credit Act (ELCA) and the Internal Loans Act. It vests the power to borrow on behalf of the national government to the Cabinet Secretary of finance who can borrow either within or outside Kenya.\(^{35}\) In order to ensure


\(^{34}\) Article 214, CoK 2010.

\(^{35}\) Section 49, PFMA 2012.
public debt sustainability in Kenya, the PFMA, requires the National Treasury to enforce fiscal responsibilities under the Act and public finance principles under the Constitution.\textsuperscript{36} PFMA also establishes PDM institutional framework. It establishes Public Debt Management Office (PDMO), Registrar of the National Government Securities under PDMO and Intergovernmental Budget and Control Council.\textsuperscript{37} In order to ensure transparency in public debt management, parliamentary service commission, judiciary, constitutional commissions and independent offices are charged with the monitoring, evaluation and overseeing of PDM.\textsuperscript{38} Part XIV of the 2015 PFMA Regulations provides for the guiding principles on national borrowing. It requires the policy framework for debt management to have a medium term debt management strategy which shall inform any national borrowing.\textsuperscript{39} It also lists purposes of national borrowing such as: financing national government budget deficit\textsuperscript{40}; cash management; repaying outstanding loan and repayment among others.\textsuperscript{41}

In the presence of the broad PDM legal framework in Kenya, the PDMO reported in 2016 that, Kenya had borrowed in the first seven months 171 billion Kenyan shillings, an increase of 46% from the previous year.\textsuperscript{42} This trend is increasing at an alarming rate as the cost of living remains unsustainable for most Kenyans due to public debt burdens. It is eminent that if the current Kenyan national government borrowing is not controlled it will lead to a public debt crisis. High level of borrowing also implies high level of serving debts.\textsuperscript{43} In effect, the inadequate revenue that Kenya

\begin{itemize}
  \item \textsuperscript{36} Section 15, PFMA.
  \item \textsuperscript{37} Section 55, PFMA 2012.
  \item \textsuperscript{38} Section 66, PFMA 2012.
  \item \textsuperscript{39} Section 185, PFMR 2015
  \item \textsuperscript{40} This has been the most common reason why Kenyan government has been borrowing.
  \item \textsuperscript{41} Section 192, PFMA Regulations 2015.
  \item \textsuperscript{42} PDMC, \textit{Medium Term Debt Management Strategy 2016} (PDMC 2016).
  \item \textsuperscript{43} Samuel Misati Nyandemo, ‘The National Public Debt Management Controversy’ (25\textsuperscript{Th} Economic Symposium ICPAK 2014).
\end{itemize}
Revenue Authority (KRA) collects to meet the budget is used to service public debt. Whereas expenditure continues to increase, revenue lags behind. In 2017, the budget stood at 2.6 trillion Kenyan shillings, while KRA targeted 1.7 trillion leaving a deficit of 700 billion. This will definitely lead to increased borrowing.

Kenyans must demand for accountability on national government borrowing on mega projects.\(^{44}\) Public debt repayment is a shared responsibility among the current and future generations. \(^{45}\) It is in no doubt that the Kenyan legal framework on public debt provides ‘strict procedures, accountability and reporting requirements.\(^{46}\) However, it has loopholes such as absence of parliamentary restrictions on new borrowing which has led to frequent government borrowing. This study reviews the Kenyan legal framework on public debt to determine how it can enhance PDM and sustainability.

1.2 Problem statement

The rate at which Kenya is borrowing is alarming and calls for the need to relook at the legal and institutional framework governing PDM and sustainability to identify the gaps. International financial institutions such as IMF and World Bank have warned that if Kenya continues to borrow at this rate then it will definitely get into a financial crisis. The current discussion on public debt in Kenya is not new. In the 1990s when donor funding was suspended in Kenya, the country experienced the worst debt economic growth at 3.9% of the GDP and the inflation recorded the highest levels. Since 2010 and in the preceding years, public debt in Kenya has gradually

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\(^{45}\) Sanghi and Johnson opcit.

increased. In 2013, the public debt increased from 44% of the GDP to 52.4% at the end of 2015. In June 2016, the debt had risen by 30.62 percent to 3.62 trillion from 2.83 trillion in the May 2016. In 2017, public debt had hit 52% of Kenyan GDP. Despite the increased public debt, in 2018 Kenya procured another Eurobond raising the public debt-GDP ratio to 56%, the highest ever in the region. This 220 billion Eurobond will run for a span of 30 years and will cost Kenyans 323 billion as interest. The second Eurobond is coming at a time when the government cannot account for the first Eurobond borrowed in 2014. Defending, the government has argued that it is borrowing for the purpose of investing in infrastructure. The question that most Kenyans now grapple with is whether the said infrastructural investments will have returns that will enable the government to repay its debt.

As Kenya grapples with public debt, several concerns have been raised. These concerns include the reasons for borrowing, the terms of borrowing which in most cases are less favorable and the sources of borrowing as the government continues to borrow from the foreign markets. The role of Parliament approvals and accountability has also been questioned. These concerns are raised at a time when Kenya has a legal framework governing public debt which include the CoK, PFMA and PFMA Regulations. These legal framework was adopted after the promulgation of the CoK to enhance public debt management as the previous legal framework had proved ineffective. The public debt legal framework establishes and sets out the powers of institutions involved in public debt, limit on borrowing, repayment, accountability and monitoring procedures, the same has been disregarded resulting in uncontrolled appetite for external borrowing.

Despite the legal framework providing for objectives of borrowing which include taking into consideration the costs of borrowing, most of the Kenyan public debt is on commercial terms owed to the foreign market. Data from the National Treasury indicate that most of the Kenyan debt is
procured from the foreign markets at a higher cost. For instance the second 220 billion Eurobond, will cost Kenyans 323 billion in terms of interest. Second, most of the foreign debt is on commercial terms. In 2015, 57% of the Kenyan external debt was owed to China which is on commercial terms. The impact is increased public debt stock. Whereas the law clearly stipulates that public debt should only be used for development expenditure, concerns have been raised on government using public debt on recurrent expenditure in disregard of the law. Further, while the law requires that the public debt to GDP ratio in NPV terms be maintained at 50%, in 2018, it was at 58%.

Parliament as an institution plays a critical role in PDM as it enacts the law and approves public debt borrowing. However, it is the same Parliament which has approved the second borrowing raising the question whether it is sleeping on its job. The parliament has already raised a concern that they lack the power to approve new borrowings under the legal framework in order to contain excessive borrowing. However, the Parliament has taken a back seat and no longer questions the limits of borrowing during the budget approvals. Despite the accountability mechanisms in place, public spending has been marred with corruption and wastage of public funds yet Kenyans are taxed to repay the public debt. If policy and legal considerations, and strengthening of transparency and accountability of the PDM is not taking into account, it is clear that Kenya will continue increasing its public debt stock. Based on the above concerns, this study seeks to review the existing public debt legal framework.

1.3 Justification

This study is very timely at a time when Kenyan public debt is increasing at an alarming rate. This trend is worrying and the need to come up with measures to avert public debt crisis is required.
With the continued borrowing by the Kenyan government coupled with poor public debt management and corruption, Kenyan public debt sustainability is at stake. The CoK, PFMA and PFMA Regulations provide a broad framework in public finance. However, there is scarce literature that specifically analyses PDM legal framework under the broad public finance framework. Globally, there exists ample literature on public finance, public debt/sovereign debt and public debt management. The available literature on public debt legal framework is general with most institutions and authors providing for parameters of what a sound legal framework should contain. However there is little literature that specifically addresses specific jurisdiction’s PDM legal framework. This study is justified as it examines the Kenyan PDM legal framework.

This study is justified as it will provide key recommendations to all stakeholders at both the national and county level such parliament, executive, PDMO, Central Bank of Kenya (CBK), agents, dealers, judiciary, constitutional commissions and independent offices that are charged with the monitoring, evaluation and overseeing of public debt management under Section 66 of the PFMA. Foreign and domestic lenders, public and other creditors shall also be provided with key information on public debt in Kenya. Other stakeholders include international community, World Bank, IMF, investors, policy makers and academia.

1.4 Research Objectives

The main research objective in this study is to review Kenyan legal framework on PDM to determine any loopholes in order to address the concerns raised on the current public debt crisis.

The specific objectives are:

a) Identify the gaps in the Kenyan PDM legal framework in order to address the current concerns on the Kenyan public debt crisis;
b) To analyze the institutional framework established under the legal framework and its effectiveness in public debt management; and

c) To provide policy and legal recommendations that will enhance PDM in Kenya.

1.5 Research questions

This research is based on following key research questions:

1. How can the current Kenyan legal framework on public debt address the current concerns on PDM and sustainability in Kenya?

2. What mechanisms can be put in place to restrict or restrain frequent borrowing beyond the debt ceiling by the government?

1.6 Research Hypothesis

This research is based on the following research hypothesis:

1. If well implemented, the CoK, PFMA and the PFMA Regulations provide a strong legal framework on PDM.

2. Unless legal and policy reforms are undertaken, the current rate at which Kenyan government is borrowing will lead to public debt crisis.

1.7 Theoretical Framework

In order to understand public debt and the essence of having a legal framework, this study is underpinned on the utilitarianism, classical and Keynesion theories of public debt. Classical views of public debt are argued to be pessimistic and stress that public debt is wasteful and unnecessary.\textsuperscript{47}

\textsuperscript{47} Ibid.
It inflicts unnecessary burden on the shoulders of the community. Marx in his first volume of *Das Kapital*, criticized the concept of public debt and characterized public debt as an instrument of the so-called primitive accumulation. Baron Montesquieu on the other hand was of the view that public debt does not benefit the country borrowing. In his view, he provided that it is the foreign country or institution that benefits from the interests accruing from repayment while the borrowing state transfers taxation to its citizens harming its industry. David Ricardo, building up on the arguments by Smith, argued that public debt was the worst source of public revenue ever invented. It did not have an advantage to the nation borrowing but instead to the nation lending which benefits from the interest accrued.

Classical theory of public debt has two shortfalls. It views public debt as an evil without considering its benefits. However this has not always been the point. Developing countries have been able to build infrastructure and ensure public welfare as a result of government borrowing. Another shortfall of classical theory is its traditional view on shifting of debt. However, this theory is relevant to this study when analyzing whether the current Kenyan government borrowing is necessary or beneficial. It is key in analyzing the purposes of borrowing, the costs and risks associated with government borrowing.

In order to address the shortcoming of classical theorist who saw no essence of a nation accumulating public debt, the Keynesion theory of public debt emerged in 1930’s as a result of the great depression. Keynesion theory was developed by John Maynard Keynes, who rejected the

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49 Baron De Montesquieu, *Spirit of Laws*
argument by classical theorists that public debt was a burden.\textsuperscript{52} In his view it was permissible for government to enter into sovereign debt in order to raise national revenue. In supporting government debt, Keynes linked government borrowing to deficit financing and government would borrow for any purposes to increase effective demand in the market. Keynesion theory is relevant in this study in explaining the justification of government borrowing.

The supporters of public debt point to the substantial benefits that accrue from government borrowing. Public debt is accrued by government in most cases for the benefit of society in that governments use the money to meet budget deficits. It is also as a result of power relations. An increase in government expenditure will automatically increase its government debt.\textsuperscript{53} Public debt is not a bad thing, however it must be used for the benefit of the people and not individuals.

The theory of utilitarianism was majorly expounded by Jeremy Bentham and John Stuart Mill requiring that all ethical decisions must seek to promote the common good of the people. According to utilitarianism, the outcome of an ethical decision is good. Utilitarianism is a form of consequentialism which requires that in making a decision it is ethical for one to consider the outcome of that decision.\textsuperscript{54} Bentham and Mill emphasized the need to ensure that any ethical action brought not only the common good but the good for the greatest number. In doing so the overall happiness of the people is promoted. According to Bentham, any ethical action must take into account the pain and pleasure brought by that action. He equated good with pleasure and pain with evil.\textsuperscript{55} As the debate on the Kenyan public debt crisis rages, the theory of utilitarianism will be relevant in identifying the outcomes associated with the borrowing. Some of the concerns raised

\textsuperscript{52} Steffen W Schmidt, Mack C Shelley and Barbara A Bardes, \textit{American Government and Politics Today} (Cencage 2015) p 331.
\textsuperscript{54} ibid.
in Kenya, is that the people of Kenya cannot see the value of the first and second Eurobond, though when borrowing the government had justified the borrowing for the purposes of investing in infrastructure. The theory of utilitarianism is therefore relevant in showing that in making the decision to borrow, the public debt managers need to take into consideration the common good of the greatest number.

1.8 Literature Review

Literature review on the Kenyan legal framework on PDM is very scanty. The literature reviewed focuses on effective legal and institutional framework for management of public debt. Awadzi argues that ‘sound public debt policies and debt management practices require robust legal underpinnings’ According to Awadzi, legal framework on public debt management is complex as it involves distinct but related concepts. However a sound legal framework on public debt management must contain both the public and private law component. It must contain the legal limits and mechanisms to ensure accountability and transparency. This article provides a good reading for designing legal framework on PDM which informs this study in reviewing the Kenyan legal framework.

Roy and Williams, state that a strong legal and institutional framework is vital in ensuring an efficient and effective PDM. Whereas the authors applaud developing countries for taking an initiative to review and consolidate laws on PDM, they argue that due to change of dynamics in the world there remains significant scope for improvement. Roy and William provide a practical guidance which countries can adopt to strengthen their PDM laws to reflect their institutional needs

56 Awadzi (n 28).
and constitutional guarantees. This publication is key in providing a benchmark on areas upon which the Kenyan PDM laws can borrow from, therefore enriching this study.

In his book, *Sound Practice in Government Debt Management*, Wheeler\(^{58}\) provides an insightful overview of how government debt can be managed. The author underscores the need for sound government debt management. According to Wheeler, prior to PDM reforms in the 1990s, government debt management was politically driven without taking into consideration the risks associated and external shocks that led to financial instability. This book discusses the historical development that led to the reforms in government debt management, providing an insightful read on the topic under study. This book also focuses on governance issues that arise on government debt management. On the issue of whether parliament should approve government borrowing the author provides that, the impact is that such a decision for parliament approval may lead to political considerations leading to delays in execution of transactions. He proposes the power to borrow and manage public debt to be vested with the Minister of finance, outlining the responsibilities of parliament and other government agencies. The author goes further to state cases where the ministry of finance delegates its powers to debt agencies adopted by the government, the legislation must provide for their responsibilities. This literature enriches this study by examining the Kenyan legal framework.

Allen and Tommassi,\(^{59}\) in the book ‘*Managing Public Expenditure: A Reference Book for Transitional Countries*’, provide a practical guidance for countries in management of public expenditure. Public debt is a source of government expenditure. This book is relevant for countries designing and implementing legislations that will enhance transparency and accountability in


managing public expenditure. According to the authors, a good legislation must provide for distribution of powers and responsibilities amongst debt managers. For example it should balance the relationship between parliament and the executive in the budget process. Whereas the book has not reviewed the legal framework on public debt which this study seeks to address in the Kenyan scenario, it provides key information on the structure of public expenditure that informs the study.

Gardner, is of the view that a sound legal framework on PDM must stipulate authorizations; status and servicing of debt; limitations on debt; purpose upon which the debt is raised; stakeholders relationships; country variation; and control, audit and reporting requirements. A sound legal framework should enhance the objectives of debt management. This article generally captures what a sound legal framework on public debt management should encompass without contextualizing the same. The author states that the authority to borrow should be granted to the Ministry of Finance and act as the sole issuer of government guarantees and loans. The purposes of borrowing include covering budget deficit, to service government debts and to maintain a liquidity reserve amongst others. Gardner provides a general view of a sound legal framework. This literature informs the analysis of Kenyan legal framework in order to identify the loopholes.

Blommestein and Horman, state that one of the greatest challenges facing African economies is avoiding falling back into unsustainable public debt. In order to address public debt sustainability most of the African countries have adopted the OECD standards in public management. According to the authors, despite a number of countries benefiting from external debt relief under

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60Gardner (n 28).
multilateral debt initiatives, public debt levels and structural vulnerabilities is still a key challenge. They recognize good governance as a key element in PDM and sustainability in Africa. The authors give a brief description of South Africa, Uganda, Nigeria and Kenya on public debt management. This article published in 2007, stated that the Kenyan institutional framework by then was weak, characterized by understaffing and high turnover. However, by 2010, Kenya had promulgated a Constitution stipulating principles of public finance, national values and principles of good governance. It has also enacted the PFMA which provides a strong legal framework which the authors had not foreseen. This study reviews the current PDM legal framework.

A report by the IMF, *Country Report No. 15/31*, published in 2015 recognizes that Kenya has made tremendous developments in its economic growth. The report also recognizes that the debt management had been sustainable and reserve buffers increased. However despite these improvements, the report indicates that the Kenyan economy remains vulnerable to exogenous risks such as fiscal risks, financial sector risks and global market exposures. Whereas this report indicates key milestones in the Kenyan public debt management, there are many issues that are unforeseen such as the transparency and accountability of the borrowed money for the benefit of the Kenyan people. The report, although it indicates the key reforms Kenya has undertaken to improve its public management; it doesn’t interrogate the legal framework which is the scope of this study. However, this report provides the background knowledge key in understanding PDM in the Kenyan scenario.

Sanghi and Johnson, critically analyze the rate of Chinese lending and its impact on national debt. China remains the largest creditor to Kenya at 57%. Most of the China’s loans are non-

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64 Sanghi and Johnson (n 9).
concessional raising the Kenyan public debt stock. The authors are very pessimistic on China’s lending to Kenya. They argue that Kenya still has ‘a heavy debt burden and China’s loans can bring the debt to unsustainable levels’. This is the problem that this research seeks to address. Although international financial institutions like IMF and World Bank have in their recent reports indicated that Kenya’s public debt sustainability is within the set threshold, the current rate at which the country is borrowing remains alarming. Whereas the authors do not interrogate the role of the law in addressing the problem, the report brings out the problem that will face Kenya in its PDM and sustainability. It is argued that China is a favorable lender because it doesn’t provide governance restrictions unlike the traditional lenders. However, their interest is very high and the investments programs such as the SGR which China has financed have been marred with corruption.

Owino and Mutai,⁶⁵ focus on domestic debt and its impact on Kenyan economy between the periods of 1996-2007. In this article published in 2008, it provides literature review to understand the development of Kenyan public debt management. The authors argue that in Kenya domestic debt has been used to finance external debt creating potential risks and challenges. The authors recommend the need to consider legal limits on borrowing if any country has to sustain its public debt. They reviewed the existing legal framework which has been amended and consolidated under the PFMA. The enactment of the 2010 CoK also brought about key changes on the PDM. Under the previous External Loans and Credit Act, Cap 422 Laws of Kenya, there was lack of limit on borrowing and the authors recommended the need to review the legal framework. This study reviews the current legal framework on public debt management.

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⁶⁵ Owino and Mutai (n 5).
Driessen,\textsuperscript{66} in his recent article published in 2016, analyses how the United States issues debt. In his article he recognizes the role of a strong legislative framework.\textsuperscript{67} This study shall look at legal limits imposed on Kenyan national treasury and how it has been exercised.

Ngugi,\textsuperscript{68} in his study, found that the government of Kenya has relied heavily on government debt, grants and aid as a source of finance. The result has been accumulation of public debt. The government has continued to borrow in order to finance the said debts at the expense of economic development and domestic consumptions. Ngugi recommends the need to contain government borrowing and reduce the cost of government borrowing. He focuses on the nexus between government borrowing and economic development in Kenya. This study focus on the review of the Kenyan PDM legal framework to find out any gaps and in the absence of gaps, whether the enforcement mechanisms are sufficient to deal with any contravention of the law. The African Forum and Network on Debt and Development (AFRODAD) in its book, \textit{Domestic Debt Management in Kenya: A Case of Kenya}\textsuperscript{69} argues that domestic borrowing has been given less attention as more attention is on external debt. This study has focused on domestic borrowing.

From the literature reviewed above, it’s clear that there is scanty literature on Kenyan PDM legal framework. Whereas most of the literature has focused on the public debt, none critically analyses the potential of the legal framework to address the concerns relating public debt management in Kenya.

\textsuperscript{66} Grant A Driessen, ‘How Treasury Issues Debt’ (Congressional Research Service 2016).
\textsuperscript{67} Ibid.
\textsuperscript{69} AFRODAD, \textit{Domestic Debt Management in Kenya: A Case of Kenya}(AFRODAD 2011)
1.9 Research Methodology

This study examines the Kenyan legal framework on PDM, the CoK, PFMA and PFMA Regulations. This study employs qualitative research method. Qualitative research method is explorative in nature and seeks to understand facts, opinions and underlying reasons of the issue under study. It is relevant because PDM as a concept shall be explored in relation to legal framework. This study does not involve numerical data or statistics, hence quantitate research method shall be irrelevant as this study only seeks to review the PDM legal framework to determine the gaps. The research method employed descriptive survey design which explains the state of affairs as they exist.

Primary data in this study involved the review of the legal framework, the CoK, PFMA and PFMA Regulations. This study therefore analyzed the provisions of the legal framework to provide an in-depth understanding visa vis the public concerns on public debt. The secondary data collection technique entailed going through the relevant books, articles, journals, conference papers and information from the Internet on public debt management and sustainability. This study therefore relied on the secondary data to obtain general information on public debt management and the public concerns on public debt.

1.10 Chapter Profile

This study comprises of five chapters.

The first chapter introduces the topic under study. It provides the background, statement of the problem, justification of study, objectives, research questions, hypothesis, literature review, research methodology and the theoretical framework.
The second chapter discusses the concept of public debt, its historical development and the rationale for government borrowing linking the same to the topic under study. It briefly introduces the legal framework governing PDM in Kenya.

The third chapter reviews the Kenyan legal framework on public debt in detail. This review is informed by the IMF and World Bank Guidelines on PDM, and literature on a sound legal framework. It contextualizes the problem under study.

Chapter four discusses the institutional arrangements of PDM under the Kenyan PDM legal framework and how the governance structure enhances accountability and transparency.

Chapter five provides the conclusions and key recommendations from the study.
CHAPTER TWO

2.0 PUBLIC DEBT IN KENYA CONCEPTUALIZED

2.1 Introduction

This chapter discusses the concept of public debt and a brief overview of the Kenyan PDM legal framework. It discusses its historical development and justification. The objective of this chapter is to provide the reader with an in-depth understanding of what public debt entails. It further identifies the sources of PDM law in Kenya.

2.2 The Historical Development and the Concept of Public Debt

2.21 Introduction

By 2017, the issue of public debt in Kenya was discussed more frequently and openly as the government continued to borrow more money to fund infrastructural projects and meet its budget deficit. Before delving into the Kenyan legal framework on public debt, it is relevant to understand what public debt is, its historical development and justification. The term ‘public debt’ has two terms: public and debt. According to the legal dictionary, a debt is money owed or due to be paid because of an express agreement. This definition indicates that a debt arises out of an agreement or a contract. It is an obligation owed by a person or entity to another. However for a debt to arise there must be a deficit. Public means people in general.

The government borrows money on behalf of the public. There are three major sources of government funding: tax and non-tax sources such as grants; borrowing from both foreign and domestic sources and withdrawals from current cash balances. Public debt is therefore a source of government revenue.
2.22 Historical Development of Public Debt

Government funding through public debt is not new. It existed during the ancient times. However, there is no general and definite definition of public debt. It will vary from one jurisdiction to another. Whichever definition adopted, it must be clear and explicit. Some scholars argue that, when defining the concept of public debt, there are various cross cutting issues that arise and must be taken into consideration.\(^1\) First is the question of whether, when defining the concept of public debt one should look at either the gross or net debt. Second is the question of whether it should only apply to the central government or the general government. In most of the countries when defining public debt the level of government considered is the central government. Finally, is the question of whether one should distinguish between foreign and domestic debt. The scope of definition will determine the government’s liability towards payment and increases the creditors trust that the government will be able to repay.

Whereas Kenya has a devolved and national government, government borrowing is limited to the national government and the County government can only borrow upon national government authorization and guarantee. It also indicates the debt instruments which are either loans or government securities.

Despite the lack of consensus on the definition of public debt which will vary from one jurisdiction to another, the history of public debt is tied to the evolution of the state itself.\(^2\) It dates back to the ancient Greece and Rome to the late medieval Europe.\(^3\) In Greece, the concept of public debt dates

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\(^1\) Jean-Claude Chouraqui, Brian Jones and Robert Bruce Montador, ‘Public Debt In Medium Term Perspective’ (OECD, 2011).


back in 400BC during the Peloponnesian war.\textsuperscript{4} The Peloponnesian war (431-404BC) occurred in Ancient Greece between the Athenian and Peloponnesian league led by Sparta.\textsuperscript{5} During this war Athens was devastated economically leading to default and renegotiation of her public debt obligations. Following the war, the Greek interim government borrowed money from the victorious Spartans which was repaid in full by the succeeding government marking the first discernable cases of government debt.

The Romanians on the other hand, had avoided public borrowing during this period and instead accrued surpluses during peaceful time and taxes.\textsuperscript{6} This policy was perpetuated by Emperor Augustus who became the first emperor of Rome in 27 B.C to 14 A.D.\textsuperscript{7} However, the long period of wars under the Roman Empire during this period had taken a toll of the Roman economy and its high taxation to fund government led to the fall of the Roman Empire.\textsuperscript{8} The negative consequences of the war such as steep taxes, inflation and the close of trade roots affected its economy. During this period Augustus favored private enterprise and free trade by abolition of taxes.\textsuperscript{9} Government revenue was provided for from the Provincials by non-Roman citizens. It is recorded that this tax system was oppressive.\textsuperscript{10} In Rome, loan interest was seen as an evil that led to discord and was highly prohibited. In the 60BC, the Roman Empire experienced a financial

\textsuperscript{4} Mathew Lynn, \textit{Bust: Greece, the Euro and the Sovereign Debt Crisis} (Wiley Publishers 2010).
\textsuperscript{6} Jean Andreau, ‘Personal Endebtment and Debt Forgiveness in the Roman Empire’ \url{http://www.cadtm.org/Personal-endebtment-and-debt} accessed.
\textsuperscript{9} Ibid.
\textsuperscript{10} Sven Gunther, \textit{Taxation in the Greco-Roman World: The Roman Principate} (Oxford University Press 2016); JA Boek, ‘Taxation in the Late Roman Empire: A Study on the Character of the Late Antique Economy’ (Mphil Thesis, Leiden University 2006).
crisis as a result of unlimited private borrowing and high taxes by the government. It was not until the fall of the Roman Empire that public borrowing begun to be considered.

Public debt developed in different stages each with its own unique characteristics. The first stage was the ancient and medieval times until the end of the seventeenth century. Salsman, records that government funding as it exists in the modern government today also existed in governments in the ancient and medieval times. However, government funding in the ancient and medieval times had unique differences not seen in the modern state funding. Salsman notes that funding from the public as we understand it now did not exist in medieval times as private borrowing preceded public borrowing. It involved the borrowing in the form of commodities and not money. The loan was for short term and was not for government ordinary expenditure but mostly for funding wars. Another peculiar characteristic of public debt in medieval times is that the debt instruments such as securities did not exist. Instead kings, popes and monarch pledged their own property as security and borrowed on their own accounts. For instance, in ancient Greece the government would borrow from temples to fund wars instead of borrowing from the general populace. It was not until the twelfth century that public borrowing secured by future interest was introduced in Italian cities.

It was not only in Rome that public debt was seen as unnecessary and evil, this justification was prevalent during the ancient and medieval period characterized by thinkers such as Thomas Aquinas. During this period public debt was highly condemned, as it was seen as sinful and

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12 Ibid.
13 Stasavage 2017 (n 78).
wasteful. This is attributed to the traditional economy system during that period which was mainly farming. Farmers believed that a head of a household or a country should produce enough for the household and reserve resources for emergency. A government must be able to finance its expenditure without borrowing.

Government borrowing was also condemned by theological values such as usury due to the biblical teachings that no one should lend expecting anything in return. The doctrine of usury which meant that no one should profit from money lending had its origin in the Christian values and natural law theory. Thomas Aquinas argued that the taking of an interest on a loan runs counter to natural justice and righteousness. It was unfair. The prohibition of usury hindered the development of financial systems which would provide credit to the government. It was difficult for the concept of public borrowing to flourish during this period.

The public debt in modern state and public finance originated in the seventeenth century during the Financial Revolution and the Enlightenment Age. During this period the rule of law and constitutionalism had developed. Public borrowing was justified in the case of emergency such as wars. As early as 17th century public debt had been recognized by political economists as an alternative to financing expenditure especially for extraordinary expenses like war. This resulted

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15 Ibid.
17 Ibid.
18 Aaron Kirschenbaum, ‘Jewish and Christian Theories of Usury in the Middle Ages’ (1985) 58, Jewish Quarterly Review 270.
22 Charles Davenant, An Essay upon Ways and Means of Supplying the War (3rd edn, Jacob Tonson 1701).
from the argument that taxes were inadequate to finance extra-ordinary expenses such as war hence the need for an alternative source such as public loan. However, critics of public debt to fund war saw this as a waste of government money as it was a risky business without any benefit.23

Between 19th and 20th century arguments against public debt became so prevalent.24 They argued that public debt shifted financial problems to future generations.25 This was unfair and unjust for the future generations. Supporters of public debt such as Karl Rau, on the other hand argued that this was untrue as future dependents also benefited from the public debt. Financial theorists such as Laveleye argued that it was better to raise taxes than to incur debts.26 David Ricardo one of the greatest theorists was of the view that public debt was advantageous in private capital preservation than taxes.27 Adam Smith also criticized public debt that it negatively affects the amount of private capital and leads to its erosions. In the 20th century public debt received much justification, as long as it stimulated economic growth. It was during this period that the world experienced first and second world wars. Keynes stipulated that government borrowing even for unprofitable projects still benefited the community through creation of jobs hence it was never wasteful as asserted by Adam Smith.28 He called for an expansion of the public sector but did not support the deliberate creation of government budget deficit.29 The concept of public debt therefore gained roots during this period as various governments continued to borrow in order to improve on their economy and meet budget deficit.

25 Ibid.
26 Ibid.
29 Ibid.
Since then, various governments have continued to borrow to finance budget deficits and developments. It is the duty of government to finance public goods and services.\textsuperscript{30} Traditionally this was done through taxation.\textsuperscript{31} Public debt allows a government to spend more than its own revenues.

\textbf{2.23 Public Debt in Kenya}

Public debt in Kenya as we know it today is not new. During the colonial period public debt was not given much attention and countries were allowed to borrow to account for deficit. Generally the 1960s saw a number of African countries gain independence with a lot of expectations.\textsuperscript{32} African leaders believed that independence from the colonial powers would accelerate economic growth and enhance the welfare of its people.\textsuperscript{33} After independence Kenya experienced a rapid economic growth at annual average of 6.6\% through public investments. However in mid 1970s, Kenya’s economic growth slowed. It decreased to 3.4\% per annum between 1973 and 1976 as a result of the oil crisis, bum cycle in the coffee and tea prices between 1976 and 1979, the collapse of the EAC in 1977 and the second oil shock in 1979.\textsuperscript{34} These economic shocks had a negative impact on Kenya’s economic growth and resulted in budget deficit financed through public debt.

In the 1980s, Kenya was among the large aid recipients in Africa. Kenya received a large amount of donor aid to finance her development projects. Kenya invested the foreign aid in infrastructure

\textsuperscript{31} Robert W McGee, \textit{The Philosophy of Taxation and Public Finance} (Springer 2004);
\textsuperscript{33} ibid.
especially in the rural areas. Most of the debt during this period was aid related, though some had been contracted on commercial terms. However, Kenya continued to experience the economic shocks witnessed in the late 1970s.\textsuperscript{35}

The 1990s saw the Kenyan economy decline as development assistance declined too.\textsuperscript{36} The multilateral donors suspended the donor aid as a result of the Kenya’s mismanagement of development assistance and the public resources.\textsuperscript{37} The 1990s saw Kenya get into a debt crisis. Kenya’s economy fell into recession leading to shortage of foreign exchange and the government for the first time begun to accumulate public debt.\textsuperscript{38} Kenya witnessed its worst debt economic growth at 3.9\% of the GDP and the inflation recorded the highest levels.\textsuperscript{39} In 1993 the public debt ratio to the GDP was at 131.8\%. It was in the 1990s that Kenyans were fleeced over Kshs. 500 million in the Goldenberg scandal.\textsuperscript{40} It was during this period that Kenya resorted to domestic borrowing which was expensive and short term to finance its expenditures after donor aid was frozen.\textsuperscript{41} There were no clear economic policies then and the political policies that the government adopted scared multilateral donors who reduced their donor support and investment. The Kenyan government was put under pressure by the World Bank and IMF to change its macro-economic policies including adopting a liberalized market and good governance.\textsuperscript{42} As a result of declined donor aid funding, in 1993 the public debt ratio to the GDP was the highest at 131.9\%.\textsuperscript{43}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{35} Were (n 126)15.
\item \textsuperscript{36} FS O’Brien and TCI Ryan, ‘Aid Reform in Africa: Kenya Case Study’ (World Bank 1999).
\item \textsuperscript{37} Ibid.
\item \textsuperscript{38} Christabel Mwikali Matiti, ‘The Effect of Selected Determinants on Public Debt in Kenya’ (Master’s Degree Thesis, University of Nairobi 2013).
\item \textsuperscript{39} Nyandemo (n 52).
\item \textsuperscript{40} Government of Kenya, \textit{Report of the Judiciary Commission of Inquiry into the Goldenberg Affair} (Judiciary 2005)
\item \textsuperscript{41} Kenya Debt Relief Network (KDRN), ‘Kenya’s Public Debt Crisis: An Overview of the Current Status, Insights and
\item \textsuperscript{42} Golden Berg Report (n 134) p. 32.
\item \textsuperscript{43} Were (n 126).
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Public debt in Kenya has been gradually increasing since. In 2013, the public debt increased from 44% of the GDP to 52.4% at the end of 2015. In 2014, Kenya procured the first Eurobond to invest in infrastructure. During this period half of the Kenyan public debt was owed to foreign markets. Most of this public debt is owed to China. The government continued to borrow and in 2016, there was a public outrage at the rate at which the government was borrowing to undertake infrastructural development such as the Standard Gauge Railway and the Lamu Port. In June 2016, the Kenyan public debt had arisen by 30.62 percent to 3.62 trillion from 2.83 trillion in the May 2016. By January 2017, the National Treasury data indicated that Kenyan public debt had hit 4.5 trillion Kenyan shillings, translating to 52% of the Kenyan GDP, the highest debt level in the region. In February 2018, Kenya borrowed a second Eurobond after issuing the first one in 2014 raising the public debt-GDP ratio to 56%. The rate at which the government is borrowing has raised public outrage and fears that the country is moving towards unsustainable path.

2.3 Legal Foundations of PDM Law in Kenya

At the domestic level, the sources of the legal framework governing PDM in Kenya are envisaged under the CoK, PFMA and PFMA Regulations.

a) Constitution

Which level of the government has the authority to borrow on behalf of the government is very fundamental in ensuring public debt management. Kenya has two levels of government: national

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44 World Bank (n 12).
45 Sanghi and Johnson (n 9).
and devolved. In the CoK Article 214 (2) in defining public debt, contemplates that it is only the national government that can raise and guarantee loans or issue and guarantee securities. The devolved government has no power to borrow on behalf of the national government unless the national government guarantees the loan or with the approval of the County governments assembly.\textsuperscript{49} The 2015 Medium Term Debt Management Strategy recognizes that the current power of the devolved government to borrow should be cautioned unless there is in place a mechanism for accountability and government ability to manage such debts.

Article 206 of the CoK established a Consolidated Fund in which all money raised or received by or on behalf of the national government are paid.

The CoK also provides the general political powers and structures of public finance. It establishes the judiciary, executive and legislature each with a role in public finance. It establishes the devolved and national government each with specific powers in regard to public borrowing. The CoK allocates fiscal powers amongst various political institutions. The legislature (national assembly and Senate) have powers over public finance such as exercising oversight over revenue and its expenditure and enacting of legislation.\textsuperscript{50} Whereas the CoK stipulates the functions of the Legislature in government borrowing, the challenge arises as to how such power is to be balanced without the legislature encroaching into the powers of the executive and allocation of resources. Independent institutions such as the Controller of Budget\textsuperscript{51} and Auditor General\textsuperscript{52} have been established. The role of the Controller of Budget is to oversee the implementation of the budgets

\textsuperscript{49} Article 212, CoK 2010, \textit{Domestic and External Debt in Developing Countries} (UNCTAD Discussion Papers No. 188 March 2008).

\textsuperscript{50} Article 95 and 96, CoK 2010.

\textsuperscript{51} Article 228, CoK 2010.

\textsuperscript{52} Article 229, CoK 2010.
of the national and county governments by authorizing withdrawals from public funds under the Equalization Fund,\footnote{Article 204, CoK 2010, the Equalization Fund is used only to provide basic services including water, roads, health facilities and electricity in marginalized areas to the extent necessary to bring the quality of those services in those areas to the level generally enjoyed by the rest of the nation, so far as possible.} county revenue funds,\footnote{Article 207, CoK 2010.} Consolidated Fund and other public funds.\footnote{Article 206, CoK 2010.} Public debt is a charge on the consolidated fund. The role of the Auditor General is to audit and report within six months of a financial year public debt, confirm whether or not public money has been lawfully applied and in an effective way.\footnote{Article 229, CoK 2010.} Whereas the CoK has guided principles on public finance and established the various institutions theoretically, practically the transfer of the powers to independent institutions lacks the adequate checks and balances.

The CoK also sets out the principles of public finance relevant to public debt. These principles are meant to ensure that the purposes for which public debt is incurred are effected. Kenya has been marred with poor governance such as corruption, misuse of public funds and wastage. Constitutional entrenchment of the principles of public finance is a clear indication of the importance that Kenyans attach to them as national values.

a) **The Public Finance Management Act of 2012 (PFMA) and PFMA Regulations 2015.**

The PFMA is the key primary legislation regulating Kenyan public finance. It provides a broad framework on public finance. Public debt is an integral part of the detailed public finance. Some jurisdictions have laws specifically for public debt management and policy. The PFMA covers all aspects of law regarding public finance in Kenya such as budget process, responsibilities of the two levels of government with regard to management and control of public finance. Section 49 of
the PFMA grants the power to borrow on behalf of the national government to the Cabinet Secretary.

Section 49 (2) of the PFMA provides that a loan may be raised either within Kenya (domestic) or from outside Kenya (foreign). This categorization indicates that the sources of public debt in Kenya can either be domestic or foreign. Defining what constitutes domestic or foreign public debt varies from one jurisdiction to another. Available literature indicate that in determining whether public debt is domestic or external, it will depend on the definition adopted which falls in three categories. The first definition focuses on the mode of currency issued. Domestic debt refers to debt owed in domestic currency while foreign debt refers to debt in foreign currency. This definition is limited where certain countries adopt the denomination currency of other countries. However currency denomination is important in determining the currency risk associated with interest rates.

The second definition provides that in other instances, domestic debt may be considered as debt owed to residents while external debt is owed to foreigners or non-residents. Finally the third one focuses on the place the debt is issued and the law regulating the debt. The classification adopted in Kenya is the third definition. This implies that domestic debt refers to debt raised within Kenya while foreign refers to public debt raised outside Kenya.

While the PFMA and CoK does not stipulate the sources from which the government can borrow explicitly, this has been stipulated under Section 187 of PFMA Regulations of 2015. Public debt can also be categorized as short term, medium term or long term debt. This categorization is

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58 Ibid.
based on the term of duration until payment is due. Short term is considered to be debt payable in a less than one year whereas long term is payable after ten years. Medium term falls within one year and ten years.

Another key feature of the PFMA is its provision with regard to the restrictions on government borrowing. Whereas most public debt management legislations grant the power to borrow to the national government, according to IMF this power should not be absolute. It should be subject to controls in order to enhance accountability and sustainability.

2.4 Conclusion

In ancient and medieval times, public borrowing was condemned as it was seen as wasteful, unnecessary and sinful. Usury was highly prohibited. It was not until the end of 17th Century, that the concept of public borrowing took root. However it was only justified on the ground of enhancing economic growth and borrowing for purposes of war. During this period various theorists such as Adam Smith also condemned public borrowing on grounds that it was unjust and unfair. Nevertheless supporters of public borrowing such as Keynesian, refuted these claims and argued that it was justifiable for government to borrow. Public debt took root during the financial revolution and Enlightenment age. The CoK provides for the political institutions and divides the fiscal powers amongst the different institutions.

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59 Adam Smith opcit
CHAPTER THREE

3.0 A REVIEW OF THE KEY SALIENT FEATURES OF THE KENYAN PUBLIC DEBT MANAGEMENT LEGAL FRAMEWORK

3.1 Introduction

The legal framework governing public debt management in Kenya is the CoK, PFMA and the PFMA Regulations. This chapter reviews the Kenyan PDM legal framework with the aim of identifying any existing gaps in order to provide policy considerations that would seek to strengthen the same. It is important to note that, a PDM legal framework seeks to provide requirements that regulate government borrowing, sources of borrowing, public debt limits, purposes of borrowing, principles and objects governing public debt, contingency liabilities, government lending and on-lending among others.

3.2 A Review of the Kenyan Public Debt Management Legal Framework

A sound PDM legal framework must ensure that the government borrowing is done at the lowest cost and takes into consideration the vulnerabilities that may occur. The content of a PDM legal framework will determine how a country manages its public debt as it provides the legitimacy of a government’s actions. It provides the legal basis upon which a government can borrow, repay, lend and service its debt.¹

According to Awadzi, a sound PDM legal framework should provide for the: scope of public debt; what guides PDM; legal mandate to borrow; purpose of borrowing; debt ceilings and government

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lending and on lending in addition to the PDM institutional framework. Gardner on the other hand provides that, sound public debt legislation should provide: authorizations; status of debt; servicing of debts; debt limitations; purposes for which the debt is borrowed; institutions relationships; control, audit and reporting requirements; and country variations. It is therefore agreed that a sound PDM legal framework must ensure that it encompasses these key elements and provides an institutional framework that will implement the same. In relation to the proposed elements of a sound PDM legal framework, this chapter reviews the Kenyan PDM legal framework informed by IMF and World Bank Guidelines for PDM, 2014.

A. Scope of Public Debt

PDM requires strong accountability by the public debt managers. In order to do so, the public debt managers must have an understanding of the scope of the public debt which they are required to regulate. There is no globally accepted definition of what constitutes public debt. However, according to IMF, public debt definition should encompass the institutional coverage and the debt instruments. The institutional coverage indicates the public institutions subject to the debt liabilities. The debt instruments on the other hand represent the liabilities of the public institutions covered in the law.

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4 Muriuki Muriungi, ‘Towards a Legal Framework on Sovereign Debt Restructuring: A Developing Countries’ Perspective’ (Master of Laws Degree, University of Nairobi 2015).
The definition of public debt in Kenya is contemplated under Article 214(2) of the CoK. The institutional coverage in defining the scope of public debt ensures certainty and enhances the creditor’s confidence. It is fundamental as it clearly stipulates who is responsible for the public debt liabilities. The Kenyan definition of public debt refers to the debt of the general government which is subject to the country’s debt liabilities.\(^7\)

Whereas the county government;\(^8\) county and national government entities;\(^9\) and the urban and cities can borrow, national government has to guarantee such debt and liability.\(^10\) Whereas Section 177 of the PFMA allows the urban areas and cities to borrow, this can only be borrowed from and through the County government. This will amount to the County government public debt as stipulated under Section 2 of the PFMA.\(^11\) In some jurisdictions such as Mauritius,\(^12\) Sierra Leone and Moldova,\(^13\) public debt is defined in terms of the entire public sector.\(^14\) The Sierra Leone Public Debt Management Act of 2010 defined public debt as financial liabilities that accrue as a result of borrowing by the government, local councils and public enterprises defining it in terms of the general public sector.

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\(^7\)A according to Article 212 of the CoK, a County government can only borrow, if such a loan is guaranteed by the national government and upon the approval of the County Assembly. 
\(^8\) A according to Article 212 of the CoK, a County government can only borrow, if such a loan is guaranteed by the national government and upon the approval of the County Assembly. Once a loan borrowed by the County government is guaranteed by the national government, it becomes a public debt as defined under Article 214 of the CoK. 
\(^9\) A national or county government entity is any department, agency, authority, body or any other entity declared to be a national or county government entity in accordance with Section 4 and 5 of the PFMA. 
\(^10\) PFMA 2012, s 51, 140 and 177. 
\(^11\) Section 2 of the PFMA defines County public debt as, “all financial obligations attendant to loans raised and securities issued by the county government”. 
\(^12\) In Section 6 (1) and (2) of the Mauritius Public Debt Management Act 2008, public debt is defined as debt incurred by the Central Government, the Rodrigues Regional Assembly, the local Government and a public. 
\(^14\) OECD, African Central Government 2013 Statistical Yearbook (OECD 2013) 120.
A sound definition of public debt should also envisage the debt instruments covering all the government liabilities. Public debt instruments will vary from one country to another. The Kenyan definition of public debt under the CoK encompasses the debt instruments which include the loans raised and securities issued and guaranteed by the national government.\(^{15}\)

While what constitutes securities is not broadly envisaged in the Constitutional definition of public debt, the same is provided in the PFMA and PFMR. The definition of security is contemplated under Section 2 of the PFMA and includes both the national government security,\(^{16}\) and the county government security.\(^{17}\) Security includes Treasury bill, Treasury bond, Treasury note, government stock and any other debt instruments issued by the national or county government.\(^{18}\)

Some jurisdictions define public debt broadly depending on the country’s institutional and political framework. Whichever definition a country adopts, the PDM legal framework should envisage both the institution coverage and debt instruments. In a nutshell, the Kenyan definition of public debt encompasses both the institutional coverage and debt instruments.

\(^{15}\) A guarantee ‘means any absolute or conditional promise, commitment or undertaking by the national government to partially or completely re-pay any loan to a county government or any person’

\(^{16}\) PFMA s 53.

\(^{17}\) Ibid, s 144.

\(^{18}\) CoK, Art 260.
B. Objectives of PDM, Principles, Medium Term Debt Management Strategy and Debt Sustainability Analysis.

a) PDM objectives

Literature indicates that an effective PDM legal framework should provide a framework that guides PDM.\textsuperscript{19} This includes the objectives of PDM, PDM strategy and annual borrowing plans.\textsuperscript{20} The essence is to enhance accountability and transparency.\textsuperscript{21} They guide the conduct of public debt managers and can be effective in measuring public debt sustainability. In Kenya, the PDM objectives are set out under Section 62 of the PFMA\textsuperscript{22} and Section 193 of the PFMA Regulations.\textsuperscript{23} Whether the government takes into account the objectives of PDM as stipulated in the legal framework is debatable.

i. \textit{Government’s financing needs and its payment obligations are met at the lowest possible cost over the medium to long term, with a prudent degree of risk.}

In the recent past, economists have argued that, if the current public borrowing is not controlled then it will expose Kenyan to financial risks. In its Budgetary Review FY17/18, the PDM Office reports that the gross public debt increased to Ksh 4,486.8 billion by 30th September 2017. This increase was attributed to the 55.5\% of the external debt as a result of exchange rate fluctuations

\begin{footnotesize}
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\item \textsuperscript{19} opcit
\item \textsuperscript{20} Awadzi (n 28) 16.
\item \textsuperscript{21} IMF and World Bank Guidelines 2014.
\item \textsuperscript{22} Section 62(3) of the PFMA stipulates the objectives of the PDM office which include interalia: minimize the cost of public debt management and borrowing over the long-term taking account prudent risk; promote the development of the market institutions for government debt securities; and ensure the sharing of the benefits and costs of public debt between the current and future generations.
\item \textsuperscript{23} Section 193 of the PFMR mirrors the objectives of the PDM Office under Section 62(3) of the PFMA which include: Ensure that the government’s financing needs and its payment obligations are met at the lowest possible cost over the medium to long term, with a prudent degree of risk, and to promote development of the domestic debt market while ensuring the equitable sharing of benefits and burdens of public debt between the current and future generation.
\end{itemize}
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and external loans disbursements.\textsuperscript{24} This has been attributed to government shift from domestic borrowing to external borrowing.

This triggers the question whether the government has taken into consideration the costs associated with public borrowing, ensuring that these costs are met at the lowest possible costs with prudent degree of risk. According to the Moody Global Credit Rating Agency, it reported in October 2017 that, Kenyan government high cost borrowings will continue to drive the country’s public debt to higher level.\textsuperscript{25} In placing the BI long term issuer rating of the government of Kenya on review for downgrade, Moody’s focused on the: persistent, large, primary deficits and high borrowing costs which continue to drive government indebtedness higher; government liquidity pressures risk rising in the face of increasingly large financing needs; and uncertainties weigh over the future direction of economic and fiscal policy, in part due to evolving political dynamics.\textsuperscript{26} However, the Cabinet Secretary for National Treasury refuted this claim arguing that Moody’s analysis was based on desk review analysis and not on raw data from the Treasury.\textsuperscript{27}

Data from the National Treasury indicate that, indeed high primary deficits and borrowing costs continue to drive public debt higher. In its annual public debt report FY16/17, Kenya’s public debt was at 56.4\% of the GDP by June 2017.\textsuperscript{28} In addition to the increased borrowing costs, the government payment costs are an area of concern. In the fiscal year 2016/2017, the government

\begin{flushleft}


\textsuperscript{26} Ibid.


\textsuperscript{28} Government of Kenya (n150).
\end{flushleft}
spent 19% of its revenue to repay public debt interests, an increase from 10% in the last five years. The government needs to put in place mechanisms to mitigate these risks and high cost in borrowing and payments of public debt as it is required by the law.

ii. Promote development of the domestic debt market

The second PDM objective requires that the government should develop domestic debt market. In the 1990s, foreign funding in Kenya was frozen by World Bank in a bid to ensure that the government accepted structural adjustments in PDM. It was upon this development that the Kenyan government shifted focus to developing the domestic debt market. The government has indicated in its annual public debt report for the FY15/16 that, it remains committed to developing domestic markets for government securities as a way ‘of reducing economy’s vulnerability to exogenous shocks and diversifying its investor base and lowering the cost of borrowing’. IMF in its recent report indicates that Kenya’s public debt is owed to external debtors. The advantage of domestic borrowing is that it is usually issued in local currency and mitigates against the risks associated with external borrowing such as fluctuations in foreign currency. The law is not clear on whether domestic borrowing can be solely be denominated in the local currency making it susceptible to foreign exchange rates fluctuations.

Kenya has a developed and mature financial sector consisting of commercial banks, insurance and pension companies. The government needs to develop this domestic debt market which has a combined asset base of more than 80%. In the FY14/15, domestic borrowing accounted for

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29 Ibid.
33 Ibid
53.7% of public debt.\textsuperscript{34} However, in the FY15/16, the government shifted towards external debt amounting to 54%.\textsuperscript{35} The World Bank projected that this would increase in the FY16/17 to 56.5%. In the first quarter of FY17/18 external debt accounted for 51.5% while domestic debt was at 48.5%.\textsuperscript{36}

In the 2017 MTDMS for FY17/18, the government recognizes that the development of the domestic market is important in hedging against the exchange rate risks on external debt. In a bid to develop domestic market, data from the National Treasury indicate that the government in 2017 launched the M-Akiba Bond, a mobile platform that allows investment into the Treasury bonds at low as Kshs. 3000.\textsuperscript{37} Kenya is the first country to launch such an online platform that would enable the low earning Kenyans to buy government bonds. The government has also increased the maturities of treasury bonds and by August 2017, the maturity of Treasury bond was seven years. The government continues to develop the domestic debt market. However, there is need for increased awareness of the key steps such as M-Akiba Bond. In 2015, Kenyan domestic public debt was at 26% of the GDP mostly issued as treasury bonds (66%) and treasury bills.\textsuperscript{38}

\textit{iii. Ensuring the equitable sharing of benefits and burdens of public debt between the current and future generation.}

The final objective of PDM as entrenched in the PDM legal framework requires that PDM must ensure that there is equitable sharing of the burdens and benefits of public debt by the current and

\textsuperscript{34} World Bank, \textit{Kenya Economic Outlook} (World Bank 2017).
\textsuperscript{35} Ibid.
\textsuperscript{36} Ibid.
\textsuperscript{37}Ibid.
\textsuperscript{38}IMF Opcit
future generation. This is a fundamental element of PDM. Figures from Central Bank of Kenya (CBK) indicated that by September 2017, each Kenyan owed creditors Kshs, 97,000 as public debt. However, the question whether the public debt burdens should shift to future generations has resulted into a heated debate between the liberalists and conservatives. Conservative economists argue that the burden of public debt should shift to future generations who pay in the form of interest and principal. Their argument is that the current generation pays taxes of past public debt, so any current public debt should be paid by future generations. Liberalists on the other hand are of the view that, in loan finance, there is no need to repay debts as the same would be refunded and only the interest would be at stake. The future generation will benefit from the interest and will be at that time tax recipients.

The PDM legal framework clearly sets out the objectives of PDM. The public debt managers have an obligation to ensure that in whichever public debt policy decision they make, they consider the said objectives. It is no doubt that Kenyan public debt continues to increase. This is attributed to the high financial needs that the government faces. However, adhering to the objectives of PDM should be mandatory.

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b) Principles of PDM

In addition to setting out the objectives of a PDM, the legal framework also provides for the principles that guide PDM. These principles enhance accountability and transparency in public finance. The CoK encapsulates the principles of public finance under Article 201 which guide PDM. The equitable sharing of revenue between the national and county government takes into account ‘any provision that be made in respect of the public debt and any other national obligations’.

The adherence and compliance of these principles is mandatory. They have been elevated to a constitutional level and require that all state organs abide by them. The national values and principles of good governance stipulated under Article 10 of the CoK further enhances good public policy decision making such as public debt. This reflects the responsibility that Kenyans have placed on public finance. Public policy decisions in PDM must abide by these principles as encapsulated in the CoK. Failure to do so is a violation of the CoK.

In addition to the principles enshrined under the CoK, the PFMA and PFMR provide fundamental fiscal responsibility principles that public finance institutions and state organs need to abide and comply with. Financial fiscal responsibility principles are also envisaged under Section 15 of the PFMA. In regard to public debt, Section 15(2) (c) of the PFMA requires that over the medium term, public debt should only be used for financing development expenditure and not recurrent expenditure. Development expenditure is discretionary in nature and is made on new government

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45 Article 203, CoK 2010.
46 PFMA Regulations 2015, s 26.
programs such as the Standard Gauge Railway Project. Recurrent expenditure on the other hand is non-discretionary and applies to ongoing programs or activities. However, Kenyan recurrent expenditure has increased calling for the need to rationalize recurrent expenditure to ensure that public debt is on a sustainable path.

Concerns have been raised on government spending public debt on recurrent expenditure. During the launching of government’s delivery portal in April 2017, the President argued that despite the increase in public debt, his government was spending the money on development expenditure in accordance with the law. However, despite the government’s assertion that public debt was not used on recurrent expenditure, the World Bank reported that development expenditure had been moderated and in contrast recurrent spending had increased to 15.6% of GDP in FY15/16 and was expected to hit to 16% in FY16/17. World Bank has further warned the government from spending public debt on recurrent expenditure rather than development expenditure in accordance with the PFMA and PFMR. The spending of public debt on recurrent expenditure has no benefits for the future generations.

Second, fiscal responsibility principles require that public debt and obligations to be maintained at a sustainable level to be approved by the national government and county assembly. Public debt sustainability ensures that a country is in a position to repay its debts. In the FY15/16 Annual PDM

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48 Ibid.
49 Ibid.
52 Ibid.
53 PFMA, s26.
Report, the government indicates that the country’s debt is sustainable.\textsuperscript{54} However, concerns have been raised in regard to the increased public debt as a percentage ratio of the GDP in NPV terms has increased.\textsuperscript{55} IMF still reports that despite the increased public debt, Kenya’s public debt is still at sustainable levels.\textsuperscript{56} There is need for the government to relook at its increased borrowing and the impact on public debt sustainability.

Third, the fiscal responsibility principles require short term borrowing to be restricted to cash flows, and where there is a bank overdraft facility it should not exceed five per cent of the most recent audited national government revenue. Finally, the National Treasury has an obligation to ensure that the level of national debt does not exceed the level specified in the annual MTDMS. Each year, the PDMO is required to prepare a MTDMS providing for the current DSA.

The compliance of the fiscal responsibility principles and objectives is key in enhancing public finance. The PFMA requires that all institutions engaging in public finance adhere to the fiscal responsibility principles and PDM objectives as set out under the PFMA.\textsuperscript{57} For instance the PFMA requires that the National Assembly Budget Committee\textsuperscript{58} ensures that the judiciary, parliament, government entities, county government and the senate adhere to the principles of fiscal responsibility and public finance. Further the fiscal responsibility principles are included in the Budget Policy Statement,\textsuperscript{59} supplementary budget,\textsuperscript{60} Budget Review Outlook Paper,\textsuperscript{61} MTDMS,\textsuperscript{62}

\textsuperscript{55} Nyandemo (n 52).
\textsuperscript{56} Ibid.
\textsuperscript{57} PFMA 2012, s 102.
\textsuperscript{58} Ibid, s 7.
\textsuperscript{59} Ibid, s 25(4).
\textsuperscript{60} Ibid, s 44(3).
\textsuperscript{61} Ibid, s 118 (2) (c).
\textsuperscript{62} Ibid, s 140.
and county fiscal strategy paper.\textsuperscript{63} Raising of loans\textsuperscript{64} and guarantee of loans\textsuperscript{65} must be done in accordance with the fiscal responsibility principles and objectives as set out under the PFMA.

PDM objectives and fiscal responsibilities have been constitutionalized and entrenched both in the PDM primary legislation and policy documents. Public debt policy decision makers must ensure that they abide by them to ensure prudent public spending, public borrowing and repayments.

c) **Medium Term Debt Management Strategy (MTDMS)**

A sound PDM legal framework needs to provide for the MTDMS. MTDMS articulate a government’s short term strategy that enables it to meet its medium term PDM objectives approved by the legislature. Awadzi argues that MTDMS should focus on central government borrowing only and the minister responsible for finance should be mandated to ensure its preparation.\textsuperscript{66} The legal framework should also provide for the approval of MTDMS by the Cabinet. The adoption of MTDMS in Kenya seeks to enhance public debt sustainability.\textsuperscript{67} It is well anchored under the PFMA and PFMR.

Section 33 of the PFMA requires the Cabinet Secretary to prepare MTDMS annually and submit to Parliament. The MTDMS will include the; total stock of debt; sources and principal risks associated with national government loans and guarantees; assumptions underlying the debt management strategy; and analysis of the sustainability of the amount of debt, both potential and

\begin{itemize}
\item \textsuperscript{63} Ibid, s 140.
\item \textsuperscript{64} Ibid, s 49
\item \textsuperscript{65} Ibid, s 58.
\item \textsuperscript{66} Op cit.
\end{itemize}
actual. The main objective of the MTDMS is to provide the national government’s actual and potential liabilities in respect of the loans and guarantees and how the government plans to deal with those liabilities. The MTDMS is prepared and updated by the PDM office. It is prepared on an annual basis in consistent with the budget policy framework. It is then submitted to the Cabinet Secretary and the Commission on Revenue Allocation. The Kenyan PDM legal framework entrenches a MTDMS. So far the PDM office has been publishing the annual MTDMS. They are accessed on the National Treasury website.

d) Public debt sustainability analysis

In addition to providing for MTDMS, a sound legal framework should provide for debt sustainability analysis (DSA). DSA ensures that the government is able to sustain its debt and provide a sound public debt management. Whereas, it is not mandatory to provide for DSAs in a PDM legal framework, entrenching the same entrenches the practice. Awadzi argues that, where DSA is statutorily entrenched, the legal framework should clarify the responsibility of its preparation, approval and frequency of its preparation. DSA is entrenched both in the PFMA and PFMR. Section 15(2) of the PFMA, recognizes public debt sustainability as one of the fiscal responsibility principles that both the national and county government must comply with and adhere to. The DSA is prepared by the PDM office on annual basis. The DSA is then presented to the Cabinet Secretary for approval who later submits the same to Parliament for consideration.

68 PFMA 2012, s 63.
69 Ibid, s 64.
72 Awadzi (n 28) 18.
73 PFMA 2012, s 63; PFMA Regulations, s 194.
74 PFMA 2012, s 63(c).
The statutory entrenchment of the DSA, and the requirement that the same be tabled before the Parliament for consideration, provides a strong legal framework for public debt sustainability in Kenya. This notwithstanding, at the practical level, the increased public borrowing has raised critical questions on whether the public debt will be sustainable in the long run. On November 22, 2017, IMF provided that while the Kenyan public debt is sustainable, the continued public debt accumulation is alarming and may lead Kenya to unsustainable path.\textsuperscript{75} The Kenyan government reported in its annual public debt report FY15/16, that Kenya’s public debt is within the 50\% limit of GDP in NPV terms in line with the PFMR and EAC convergence criteria.\textsuperscript{76}

C. Legal Authority to Borrow

The authority of a government to borrow is very fundamental and a key component of the PDM legal framework. A sound PDM legal framework must provide in clear terms which institution can borrow on behalf of the government. To avoid legal uncertainties, the law should explicitly provide for the authority not only to borrow but also to conduct public debt operations, and indicate the governance and transparency safeguards.\textsuperscript{77} The authority to borrow will encompass the sources of borrowing, the institution with the mandate to borrow, servicing of the debt and relevant controls to promote accountability, transparency and discipline.\textsuperscript{78} In addition to the legal mandate to borrow, a sound PDM legal framework will grant a government institution with responsibilities regarding overall public debt policies.\textsuperscript{79}

\textsuperscript{76} Government of Kenya, Annual Public Debt Report FY15/16 p46.
\textsuperscript{77} Awadzi (n 28)19.
\textsuperscript{78} Sundararajan, Peter Dattels, and Hans Blommestone (eds), \textit{Coordinating Public Debt and Monetary Management} (IMF 1997) 97.
\textsuperscript{79} Ibid.
a) **Sources of borrowing**

Sources of government borrowing include residents, non-residents, institutions and other governments.\(^{80}\) The sources of government borrowing can either be from within (domestic) or outside (external) the country.\(^{81}\) However, the definition of what constitutes domestic or external debt may have some consequences on costs and risks.\(^{82}\) Whether external or domestic, each source of borrowing has its own vulnerabilities and costs. External borrowing increases a country’s access to resources to finance its budget and expenditure while domestic borrowing transfers resources within a country.\(^{83}\)

Whichever source, in order to mitigate risks associated with both domestic and external borrowing, PDM legal framework needs to provide a clear distinction between domestic and external sources for borrowing and the requirements that may exist for each source. There exists three ways in which a distinction between domestic and external debt can be made.\(^{84}\) First, is in relation to the residence of the creditor. In this case, domestic debt refers to debt owed to residents and external debt as debt owed to non-residents. In the modern world, characterized by a lot of cross-border trade and movement, this definition would be problematic. Further a country is required to track the residence of the creditor and even determine their relationship with the government.

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\(^{83}\) Ugo Panizza, ‘Domestic and External Public Debt in Developing Countries’ (UNCTAD Discussion Paper No. 188 2008).

\(^{84}\) Ibid.
Second, the distinction can focus on the currency in which the debt is denominated. Debt denominated in foreign currency will refer to external debt while domestic debt will be denominated in local currency. This definition is problematic in countries that adopt currencies of other countries. In the last scenario, the distinction between domestic and external debt is determined by the law governing the transaction or the place of issue. Debt accrued outside a country’s jurisdiction will refer to external debt while that accrued within a country’s jurisdiction is domestic debt.

Whichever definition of debt a country adopts, the legal framework should explicitly indicate the preferred definition taking into consideration the risks and costs associated.\textsuperscript{85} The Kenyan PDM legal framework envisages public debt as debt accrued either within or outside the country.\textsuperscript{86} This classification of public debt is premised on the jurisdiction in which the debt is issued and the law governing the transaction regardless of the denomination of the currency and the residence of the creditor. Domestic debt is borrowed from the local market while external debt is borrowed from the foreign market. The legal framework clearly identifies the sources of government borrowing.

\textbf{b) Who exercises the authority to borrow}

Which institution has the authority to borrow domestic or external debt on behalf of the government is fundamental and the PDM legal framework need to clearly stipulate it. The authority to borrow can be vested in legislature or the legislature may delegate this power to the executive by an Act of Parliament subject to limitations and legislature approval\textsuperscript{87} The US and

\begin{footnotesize}
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\item \textsuperscript{86} PFMA 2012, s 49(2); FMA Regulations 2015, s 187 (2).
\item \textsuperscript{87} Awadzi (n 28) 20.
\end{itemize}
\end{footnotesize}
Australia have vested the power to borrow money on behalf of the government on the legislature under their constitution.\(^8\) However, in most jurisdictions, the Constitution requires that the legislature delegates the authority to borrow on behalf of the government to the Executive by an Act of Parliament, within a broad framework set out under legislation.\(^9\)

In Kenya, the CoK under Article 211, requires that the legislature through legislation provides for the terms by which the government can borrow and impose the reporting requirements. Following the CoK promulgation, the PFMA was enacted in 2012. The PFMA vests the power to borrow on behalf of the government in the executive, subject to the restrictions and approval of the legislature.\(^9\) The Cabinet Secretary for the National Treasury can raise or guarantee loans; or issue or guarantee securities on behalf of the national government. This is subject to a number of restrictions envisaged under Section 50 of the PFMA.\(^9\)

First, the national government must ensure that when borrowing, its financial needs and payments obligations are met at the lowest costs possible in the market.\(^92\) This should be consistent with prudent risk and ensure that the public debt is sustainable. Second, public borrowing shall be limited to the laws regulating public debt management.\(^9\) These laws include the CoK, PFMA and PFMR. The borrowing shall not exceed the limit set by parliament. Third, the borrowing is limited to the budget and loan allocations as approved by Parliament.\(^9\) Fourth, in guaranteeing a debt, this can only be done in accordance with the terms of criteria agreed upon by the Intergovernmental

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\(^8\) Australia Constitution, Art 51; US Constitution, Art 1 s8.  
\(^9\) Awadzi (n 28) 20.  
\(^9\) PFMA 2012, s 49.  
\(^9\) The County government can only borrow based on the restrictions envisaged under Section 141 of the PFMA 2012.  
\(^9\) Ibid, s 50(1).  
\(^9\) Ibid, s 50(2).  
\(^9\) Ibid, s 50(3).
Budget and Economic Council (IBEC). Fifth, the borrowing shall be limited to the national and county government thresholds set and approved by the Parliament. The PFMR indicate that public debt shall not exceed 50% of the present net value GDP and the county government public debt is limited at 20% of the total annual audited revenue.

Sixth, the public debt incurred by the national government and all proceeds of loan raised by the national government shall be a charge on the Consolidated Fund. Consolidated fund is defined under Article 206 of the CoK as, a fund where all the monies raised or received by or on behalf of the government are paid. Seventh, all proceeds of loans raised shall be paid under the Consolidated Fund. However, the Cabinet Secretary through Regulations approved by Parliament, may allow public debt and loans raised by national government to be charged on other public funds. Eighth, the Cabinet Secretary to establish a sinking fund or funds for the redemption of loans raised by the national government. This must be approved by the Parliament. A sinking fund is defined as, ‘a fund created by setting aside out of earnings at stated intervals monies sufficient to provide for the gradual repayment of debt’.

Ninth, the Cabinet Secretary is allowed to appoint advisers, agents and writers for the purpose of raising and issuing loans, and managing or redeeming national government securities.

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95 Ibid s 50(5).
96 However, there are certain categories of money that need not to be put in the Consolidated Fund. First, is the money that is excluded from the Consolidated Fund and payable to another public Fund that is specifically established for that specific purpose? Second, is the money retained by the State organ that received it for the purpose of defraying its expenses and should be provided by an Act of Parliament.
97 PFMA 2012, s 50(7).
98 PFMA Regulations 2015, s 207.
99 PFMA 2012, s 50(8).
101 This is in accordance with Article 227 of the CoK and the Public Procurement Disposal Act.
Tenth, any other expenses incurred in the connection with national government borrowing or issuance of government securities is a charge on the Consolidated Fund or any other Public Fund as the Cabinet Secretary may direct.\textsuperscript{102} Finally, ‘the costs, interests and principal payments made by the national government concerning loans to each level of the government shall be passed to the relevant level of government.’\textsuperscript{103} The Cabinet Secretary is required to submit to the Controller of Budget and Parliament a copy of the said expenses and costs at the end of each quarter.\textsuperscript{104}

The restrictions on borrowing by the national government as indicated under Section 50 of the PFMA seeks to ensure effective PDM, public debt sustainability, transparency and accountability. However, the PDM legal framework also grants authority to borrow to other public officials and entities in accordance with the law. The county government; county and national government entities;\textsuperscript{105} and the urban and cities can borrow. However, the national government must guarantee such debt and liability.\textsuperscript{106}

\textbf{c) Public debt repayments}

A government needs to be in a position to repay its debt within the agreed period of time without burdening its citizens. A sound PDM legal framework needs to stipulate how the government will repay its debts plus the related costs and expenses. Clear public debt service/repayment obligations provide assurances to the creditor. Further, a sound PDM legal framework should require parliament approval of public debt servicing. As Kenya continues to borrow and the increasingly high public debt, it is inevitable that the government will spend more on the servicing of these

\textsuperscript{102}PFMA 2012, s 10.
\textsuperscript{103}PFMA 2012, s 50(11).
\textsuperscript{104}PFMA 2012, s 50(12).
\textsuperscript{105}A national or county government entity is any department, agency, authority, body or any other entity declared to be a national or county government entity in accordance with Section 4 and 5 of the PFMA.
\textsuperscript{106}PFMA 2012, s 51, 140 and 177.
debts. Section 192 of the PFMR allows the government to borrow for the purpose of refinancing outstanding debt or repaying a loan prior to its date of repayment.

Government borrowing to repay earlier loans has raised concerns among Kenyans. Increasing debt stock automatically increases the servicing amount. By the end of 2016, the government of Kenya had spent kshs 1050 million to repay guaranteed debts. This not only increases the costs of PDM, but affects public debt sustainability. Whilst the PFMR allow the government to borrow to repay public debt, there is need to have restrictions taking into consideration the costs of payments. The Cabinet Secretary should table to the Parliament reasons for borrowing to repay loans to be approved by Parliament. Public participation should further be enhanced as they are the one that bear the costs of public debt.

D. Borrowing Purposes

To ensure accountability and prudence use of public money, an effective PDM must provide for the purposes of government borrowing. Awadzi argues that borrowing purposes should not be restrictively narrow or unduly constrain the government in the case of unforeseen financing needs. The PDM legal framework may provide for specific borrowing purposes or general/any lawful fiscal purposes.

Section 192 indicates the specific borrowing purposes by the government. First, is financing national government budget deficits. This is the most common reason the government has invoked

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109 Awadzi (n 28)21.
110 Ibid.
when borrowing. In the fiscal FY16/17 the fiscal deficit was at Ksh 709.4 billion (equivalent to 9.2 percent of GDP) against a targeted deficit of Ksh 871.6 billion (equivalent to 11.7 percent of GDP). Including grants, the fiscal deficit stood at 8.9 percent of GDP against a targeted deficit of 10.9 percent of GDP. Second, government can borrow for the purposes of cash management. The national treasury and the CBK work together to ensure coherence of monetary policy and fiscal responsibility. Third, government may borrow for the purpose of honoring obligations under outstanding national government guarantees. Fourth, the government will borrow for the purpose of refinancing debt or repaying a loan prior to its date of repayment. Fifth, the government may borrow for the purposes of addressing any emergency such as: mitigating against adverse effects caused by an urgent and unforeseen event in cases where the Contingency Fund has been depleted; and mitigating against significant balance of payment imbalances. Finally, the PFMR gives room for the government to borrow in order to meet any other development policy objectives that the Cabinet Secretary shall deem necessary. However, this can only be done in accordance with the law. Parliament approval is not mandatory, and it leaves room for the government to borrow for any development policy.

E. Public Debt Ceiling

A sound PDM legal framework should provide public debt limitations on how much a government should borrow. This not only enhances fiscal responsibility but ensures that a country is able to sustain and repay its debts. However, the effectiveness of public debt ceilings will vary from one

\[111\text{ Government of Kenya, 2017 Budget Review and Outlook Paper p 8.}\]
\[112\text{ Mario Pessoa and Mike Williams, ‘Government Cash Management: Relationship between the Treasury and the Central Bank’ (IMF 2012).}\]
jurisdiction to another depending on the political environment and institutional framework. According to Awadzi, public debt ceilings can be established as political commitment, supranational ceilings, constitutional ceilings, statutory ceilings, annual ceilings set by Parliament or ministerial action.

In Kenya, the public debt ceiling is established at the supranational level, statutory and by ministerial action. Kenya has an obligation under EAC Monetary Treaty to ensure that its public debt limit does not exceed 50% of its current GDP in NPV terms. At the statutory level, the PFMA provides that Parliament is the body mandated to set public debt ceilings. The PFMA requires that public debt limits as set by Parliament should not exceed the levels set out in the MTDMS.

A sound PDM legal framework should indicate the type of ceiling either in relative or nominal terms. Nominal ceilings which are absolute numbers that limit upper debt limit have been adopted in Denmark and US. In the year 2016, according to the public debt annual Report 2015/2016,

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115 Supranational public debt ceilings are established by regional treaties and require member state to abide by them. The East African Community (EAC) requires member states to ensure that their public debt ceiling does not exceed 50% of the current net value of GDP.
116 Constitutional public debt ceilings are entrenched in the Constitution elevating it to a constitutional status. The advantage of constitutional public debt ceiling is that it is not subject to arbitrary changes due to constitutional amendment procedures. However, it can lead to rigidity in times of financial crisis. Whether to establish a constitutional public debt or not should be informed by the apparent legal implications.
117 Most of the countries have in place statutory debt ceilings established under the law governing PDM.
118 In countries such as Canada, Japan and Spain, the Parliament is mandated to establish debt ceilings under the annual budget. This allows for flexibility.
119 In this scenario, the Minister sets the public debt ceiling in a secondary legislation. However, in order to avoid too much discretion by the Minister, these Regulations need to be approved by Parliament.
120 PFMA 2012, s 50(2).
122 Awadzi (n 28).
the Kenyan public debt was within the 50% limit as set out by the PFMA Regulations and the EAC convergence criteria.\textsuperscript{123}

In Kenya, the public debt ceiling is limited to the gross public debt. There is no legal limit on the domestic or foreign borrowing. A sound PDM legal framework should also classify the scope of the public debt ceiling. PDM legal framework should also provide explicitly for the effect of surpassing public debt ceiling. The Suriname’s National Debt Act 2002, invalidates any agreement that is in breach of the public debt ceiling. In Kenya, public debt limit is set and approved by Parliament through the MTDMS.\textsuperscript{124} However this is only applicable where the Parliament does not side with the Executive.

\textbf{F. Contingent Liabilities}

Contingent liabilities are liabilities that are incurred depending on the outcome of future events.\textsuperscript{125} These events are usually uncertain future events that are outside the control of the government and the occurrence of the event, its value and timing of payment is usually unknown and cannot be definitively determined.\textsuperscript{126} They include guarantees, indemnities and other potential liabilities. A sound PDM legal framework should provide explicitly the legal authority to create contingent liabilities either explicit or implicit.\textsuperscript{127} Explicit contingent liabilities are those that give rise to conditional payment obligations and that arise out of contractual, statutory sources or ex ante policy commitments.\textsuperscript{128} Implicit contingent liabilities only arise after an event has occurred or a

\begin{footnotesize}
\begin{enumerate}
\item[123] Public debt annual report 2015/2016
\item[127] Ibid.
\item[128] Ibid.
\end{enumerate}
\end{footnotesize}
condition realized.\textsuperscript{129} For instance in June 2017, Kenyan government had to guarantee a loan on behalf of Kenya Airways in a bid to restructure the same as a contingent liability. Financial management of contingent liabilities is very critical and it includes risk evaluation and management.

Awadzi provides that a sound PDM legal framework should indicate who is eligible for government guarantees, indemnity and other potential liabilities, provide for the purposes for which the government contingent liabilities may be assumed, who may issue guarantees and risk management of contingent liabilities.\textsuperscript{130} Taking into consideration the elements of sound legal framework on contingent liabilities as envisaged by Awadzi, contingent liabilities in Kenya represent an additional fiscal risk.\textsuperscript{131}

\textbf{a) Scope}

Providing for contingent liabilities enable the government mitigate fiscal risks and avoid borrowing when such liabilities arise in future. A sound PDM legal framework should have adequate coverage of all contingent liabilities - both explicit and implicit. In Kenya, the contingent liabilities covered include debt guarantees, public private partnerships (PPPs), pension liabilities and pending bills.\textsuperscript{132} However, it does not provide comprehensive coverage of other contingent liabilities apart from government publicly guaranteed debt. Implicit contingent liabilities that may arise out of natural disasters or claims against the government are not covered.

\begin{itemize}
\item \textsuperscript{129} Aliona Cebotari, \textit{Contingent Liabilities: Issues and Practice} (IMF 2008).
\item \textsuperscript{130} Ibid.
\item \textsuperscript{131} IMF, \textit{Kenya: 2014 Article IV Consultation Staff Report; Press Release; and Statement by the Executive Director for Kenya} (IMF 2014) 5.
\item \textsuperscript{132} PFMA Regulations 2015, s 26(2) (f).
\end{itemize}
It is reported that the assumption of implicit contingent liabilities in most jurisdictions is very low. Yet implicit contingent liabilities always arise requiring the government to make payments. For instance in the fiscal year 2011/12, Kenya paid approximately 0.12% of its budget on implicit contingent liabilities. The focus of the legal framework on loan guarantees leaves a loophole on how the government can deal with the other contingent liabilities which is then left under the discretion of public debt managers. Anything can pass for contingent liability putting at risk the overall debt sustainability.

b) Reporting

An effective contingent liability reporting mechanisms ensures transparency on the actual contingent liabilities portfolio and management of the fiscal risks. The Kenyan PDM legal framework does not provide specific reporting system for contingent liabilities. The reporting mechanism is part of the general public debt and focus on the publicly guaranteed debt. The PDMO also maintains a data base on both loans issued and guaranteed by the government.

Contingent liabilities are usually treated as off-balance sheet items and in most cases ‘information on its portfolio and monitoring of its performance maybe lacking’. To monitor the performance of the government guarantees, the PDM legal framework under Article 213 of the CoK, Section 50 and 58 of the PFMA, requires the Cabinet Secretary to publish and publicize annually a report providing the amount of government guarantee that year. The PDMO publishes and publicizes

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134 Ibid.
135 PFMA 2012, s 63.
136 Awadzi (n 28) 34.
137 PFMA 2012, s 32.
the annual public debt reports every year stipulating the stock and payments publicly guaranteed debt.\textsuperscript{138} In addition, information on contingent liabilities should be provided in the MTDMS, budget,\textsuperscript{139} national government entity financial statements,\textsuperscript{140} annual report prepared by the Cabinet Secretary responsible for public investments,\textsuperscript{141} county annual financial statements,\textsuperscript{142} Budget Policy Statement,\textsuperscript{143} indicating the statement of debt guarantees, nature and risks associated with contingent liabilities.

To ensure accountability and transparency, money payable in regard to guarantee is a charge of the Consolidated Fund and can only be paid after the authorization of the Controller of Budget.\textsuperscript{144} The Cabinet Secretary is required to further provide details of this payment to Parliament. In this report the Cabinet Secretary must stipulate the: details of the guarantee; circumstances leading to the payment; reasons why the borrower failed to pay; and any other information considered relevant.\textsuperscript{145} Under the Public Private Partnership (PPP) Act,\textsuperscript{146} the PPP Facilitation Fund is established to provide a source of liquidity to meet contingent liabilities in a PPP Project.

Although the Contingencies Fund and County Emergency Funds Act, 2011, provide for when money can be advanced from the Contingency Fund, there is no clear demarcation on its

\begin{thebibliography}{9}
\item National Treasury, ‘Publications’ \url{http://www.treasury.go.ke/publications/pdmo/category/157-annual-debt-management.html} accessed 9 December 2017. See Section 194 of the PFMA Regulations which provide for functions of the PDMO.
\item\textsuperscript{139} PFMA 2012, s 38 (1) (d).
\item\textsuperscript{140} Section 81 (2) (c)of the PFMA requires the accounting officers of national government entity to include in its annual financial statement the amount of an guarantees issued by the national government in respect of the entity during that financial year.
\item\textsuperscript{141} PFMA 2012, s 89 (2) (e).
\item\textsuperscript{142} PFMA 2012, s 163.
\item\textsuperscript{143} PFMA Regulations 2015, s 29.
\item\textsuperscript{144} PFMA 2012, s 60.
\item\textsuperscript{145} PFMA 2012, s 60(3)
\item\textsuperscript{146} Government of Kenya, \emph{Public Private Partnerships Act No. 15 of 2013} (Government Printers 2013).
\end{thebibliography}
relationship with public debt. Where the government borrows in order to address implicit contingent liabilities, then it should have exhausted the Contingent Fund.

c) Eligibility

The eligibility for government contingent liabilities can either be restricted to the public sector entities or open-ended beneficiaries. The PDM legal framework in Kenya for the eligibility of the government's guarantees and indemnities is open-ended and does not restrict it to the public sector entities. Section 58 of the PFMA allows the government to guarantee loans to any other borrower. However, in order to avert default of government guaranteed debts, the government is required to use the objective criteria in evaluating the eligibility of national and county government. This ensures that, the government only guarantees loans that are justified on policy grounds to reduce on fiscal risks. Section 202 of the PFMA Regulations provides the eligibility and the evaluation criteria for the government guaranteed debts.

d) Purposes, who can create and approval contingent liabilities

Further a sound legal framework must stipulate the purposes upon which government contingent liabilities may be assumed, the legal authority to create contingent liabilities and exercise oversight over fiscal risks, approvals and risk management. The PFMA Section 58 (a) requires that the government guarantee only loans that finance capital projects and those that will spur economic growth. The National Treasury is the body with the legal authority to guarantee loans or any other contingent liabilities.

147 PFMA Regulations, s 183.
149 Awadzi (n 28) 35.
A sound PDM legal framework needs to indicate whether contingent liabilities must be approved by the Executive or Parliament. Most countries require Parliamentary approvals of contingent liabilities to ensure accountability and justification. In Kenya, the issuance of government guarantee must be approved by both the Cabinet Secretary and Parliament. To enable the Parliament in approving the guarantee, the Cabinet Secretary prepares a paper which indicates the government total contingent liabilities under the debt to be guaranteed. In June 2017, the government approved the $750 million guarantee to restructure the Kenya Airways (KQ) which was later approved by Parliament.

e) Risk Management

The 2014 IMF and World Bank Revised Guideline for PDM require that PDM legal framework indicate risk management on government contingent liabilities and debt portfolio. In Kenya, the Cabinet Secretary is required to undertake a risk assessment of the debt guarantee and provide the mechanisms to mitigate the same before presenting the same to the Parliament for approval. The PDMO processes the issuance of the ‘loan guarantees including assessment and management of risks in national government guarantees’, including contingent liabilities inherent in PPPs projects indicating the methods for the risk assessments. The Cabinet Secretary participates in the negotiations on contracting of the guaranteed loan and advises the borrower on the best financial terms available and signs the agreement on behalf of the government.

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150 Moldova requires parliamentary approval of government guarantees under Article 31 of its PDM law.
151 PFMA 2012, s 58(4).
153 PFMA 2012, s 59.
154 PFMA 2012, s 63 (g).
155 PFMA Regulations 2015, s 194(d).
156 PFMA Regulations 2015, s 201(2).
The 2017 MTDMS for FY2018/2019 – FY2018-2019, indicates that the contingent liabilities as a result of direct and indirect guarantees to state owned enterprises and counties pose fiscal risks and is likely to lead to the increase of public debt stock and servicing cost affecting public debt sustainability. Recognizing the potential risks associated with the financial management of contingent liabilities, the National Treasury established the Fiscal Commitments & Contingent Liabilities Unit (FCCLU) under the PDMO in June 2015. The role of the FCCLU is ‘risk evaluation and management; and advise the Directorate of PDMO in regard to fiscal commitments and contingent liabilities that arise out of government projects under the PPP program and in general. Assessing and managing contingent liability’s risk is very critical.

G. Government Lending and On-Lending

A sound PDM legal framework should provide explicitly the requirements for government lending and on-lending in meeting certain policy objectives. A government can borrow a loan and on-lent to another entity. However, where the legal framework provides for government lending and on-lending it must put in place mechanism to mitigate the government against credit risks and ensure that its own debt obligations are fulfilled in a timely manner. In Kenya, the PFMA allows both the national and county government to lend money. A public officer is prohibited from lending money on behalf of the national government and national government entities.

Government lending and on-lending terms and conditions are very fundamental as such a transaction entails fiscal risks for government where it borrows the money it lends. The sufficient

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157 Awadzi (n 28) 28.
159 Awadzi (n 28) 38.
161 PFMA 2012, s 57 and 145.
162 Ibid, s 191.
lending and on-lending terms and conditions enable the government to pay its debts within the required time.

To mitigate against credit risks and market based interest charges, the Cabinet Secretary and the County Executive Member for finance before lending government money to any entity ‘accept the money payable under the loan in any currency considered appropriate’ in consultation with the CBK and can revise the security upwards at any time. The security must be given in the name of national or county government. To ensure accountability and transparency in government lending, the money loaned by the government can only be used for development or from any other authority approved by the Parliament. The PDMO keeps timely, comprehensive and accurate records of outstanding lending and on-lending and publicizes the same in the annual public debt reports.

### 3.3 Conclusions

A review of the PDM law indicates that it envisages the salient features of a sound PDM legal framework as provided for by IMF and World Bank 2014 Guidelines on PDM. These features include the: scope of public debt; objectives and fiscal responsibility principles; legal authority to borrow; borrowing purposes; public debt ceiling; contingent liabilities; and government lending and on-lending. This is an indication that the PDM legal framework as embraced in the CoK, PFMA and PFMA Regulations was well designed taking into considerations international best practices.
practices. Its implementation will therefore depend on the institutional arrangements and coordination.
CHAPTER FOUR

4.0 PUBLIC DEBT MANAGEMENT INSTITUTIONAL FRAMEWORK IN KENYA

4.1 Introduction

This chapter interrogates the role of the PDM institutional framework in implementing the PDM legal framework in Kenya. An effective PDM legal framework is one that provides for a strong institutional framework to provide oversight and accountability over the borrowing authority. The sustainability of public debt requires the coordination of all PDM institutional framework. Whereas PDM involves a number of institutional arrangements, this chapter limits its discussion to the role of the legislature, executive, PDMO and the CBK as a fiscal agent of the National Treasury.

4.2 The Public Debt Management Institutional Framework in Kenya: A Review

A sound PDM legal framework should lay down the institutional arrangements for public finances and in so doing grant fiscal powers to the different political structures. Kenya, being a devolved government, both the national and county government have the powers to borrow, though the county government borrowing must be guaranteed by the national government. The legislature, executive, a debt management department in the specific ministry of finance, debt management committees, agents, advisors and dealers form the PDM institutional framework in most jurisdictions.
A. The Role of the Legislature in PDM

The legislature plays a critical role in PDM which includes the enactment of the PDM legal framework, approval and oversight.\textsuperscript{295} Whereas the legislature establishes the broad PDM legal framework, it has put in place oversight mechanisms to ensure that PDM is done in accordance with the said PDM legal framework. The essence is to promote public debt sustainability by ensuring that public debt managers abide by the set financial objectives, fiscal responsibilities, purposes of borrowing and confine to the limitations required.

Literature indicates that the legislature can approve every transaction, specific transactions only or provide a blanket annual approval under certain terms and conditions.\textsuperscript{296} In countries such as Ghana,\textsuperscript{297} the legislature must approve every transaction in regard to public borrowing. While it ensures transparency, parliament approval on a case by case transaction maybe inefficient as it is time consuming and maybe uncertain due to the political nature of parliamentary decisions.\textsuperscript{298} This in turn increases the transaction costs. There is need to balance legislature accountability and good governance with the executive flexibility in borrowing. In some countries, legislature approval is mandatory in regard to specific transactions only such as borrowing above the specified threshold or external borrowing.\textsuperscript{299} In most jurisdictions, the legislature will provide blanket approval for all borrowing transactions in accordance with standard terms and conditions. Parliament then exercises PDM oversight through the budget process. \textsuperscript{300}


\textsuperscript{296} Awadzi (n 28) 40-41.

\textsuperscript{297} Article 181(4) of Ghana’s Constitution requires that the ‘terms and conditions of loans shall be laid before the Parliament and shall not come into operation unless they have been approved by a resolution of Parliament’.

\textsuperscript{298} Irwin (n 164).

\textsuperscript{299} World Bank, \textit{Managing Public Debt: From Diagnostics to Reform Implementation} (World Bank 2007) 57.

In Kenya, the legislature as a representative of the people plays a critical role in public finance including the PDM. It enacts the broad PDM legal framework and approves the policy framework on PDM. It also provides check and balances on government borrowing. The legislature is required to ensure that the national and county government and their entities limit their borrowing to the public debt thresholds and purposes of borrowing. Where the national government guarantees any loan, it has to be in accordance with limits sets and where it exceeds, the executive must submit a draft loan guarantee to Parliament for approval.\textsuperscript{301} The National Treasury sets out the government borrowing level in the MTDSs which is then approved by parliament annually. Whereas the PFMA Regulations requires that national and county government borrowing be limited to 50% of the GDP and 20% of the County’s audited revenue for that year respectively, Parliament lacks the power to approve new borrowings.\textsuperscript{302} Parliament has argued that the failure to approve new borrowings by the government has hindered its ability to curb the government’s appetite for borrowing. However, there is need for Parliament to be granted the power to approve new borrowings which have potential risk on public debt stocks.

To enhance oversight of the public debt through reporting and accountability the parliament approves the annual budget estimates,\textsuperscript{303} draft loan guarantee,\textsuperscript{304} budget policy statement, PDM Regulations, and deviation from financial objectives in a Budget Policy Statement by the national government or new government.\textsuperscript{305} Parliament cannot under any circumstances approve any deviation from the fiscal responsibility principles. Parliament approval is required where the

\textsuperscript{301} PFMA 2012, s 58.
\textsuperscript{303} PFMA Regulations 2015, s 39.
\textsuperscript{304} PFMA Regulations 2015, s 204.
\textsuperscript{305} PFMA 2012, s 16.
Cabinet Secretary seeks to make payments out of the Contingence Fund, \(^{306}\) and establish a public fund.\(^{307}\)

The legislature also plays a critical role with regard to government loans which must be approved by Parliament. Loans guarantees on behalf of the County government or any other borrower must be approved by Parliament. It has to ensure that those loans are procured and prudently used for the purposes enlisted under Section 192 of the PFMR and the government has the ability to repay before approving them.\(^{308}\) The objective is to ensure that the government only borrows when it is necessary and Kenyans are protected from frivolous borrowing. Theoretically, the PDM legal framework requires the legislature to scrutinize government borrowing and in doing so put the interests of Kenyans first. This was informed by the previous PDM legal framework which allowed the government to procure loans without the approval of Parliament, leading to debts for dubious projects which had no value and funds diverted to offshore accounts by corrupt government officials.

Despite these mechanisms, the trend in government borrowing has increased over the years to meet budget deficits and repay loans. This is attributed to the failure of the Parliament to exercise its oversight role. Jamah argues that this is as a result of the ruling party having the majority in Parliament and hence leaving the legislature subservient to the whims of the executive.\(^{309}\) He further provides that there is need to subject government procurement of loans to public participation as it is Kenyans who will shoulder the burden of loan repayments.

\(^{306}\) PFMA 2012, s 22.

\(^{307}\) PFMA 2012, s 24(4).

\(^{308}\) PFMA 2012, s 50.

B. The Role of the Executive

As indicated in Chapter three, a sound PDM legal framework should explicitly provide for the Minister of Finance to exercise PDM power, oversight role over PDM and delegation of its power if necessary. In Kenya, the PDM powers are exercised exclusively by the Executive on behalf of the national government. The County executive exercises the County PDM powers but under the auspices of the national executive.

Awadzi argues that a sound PDM legal framework should grant the Cabinet Secretary with oversight power over PDMO function such as approving of the MTDMS and review of public debt reports before submission to Parliament. The Kenyan PDM legal framework requires the National Treasury to prepare the Budget Policy Statement, Budget Review and Outlook Paper to be approved by Cabinet Secretary before submitting to Parliament.\(^{310}\) The Cabinet Secretary submits within four months reports of all loans raised to the National Assembly to enhance transparency and accountability.\(^{311}\) The role of the Cabinet Secretary in PDM cannot be underestimated as he is the one who manages the budget process at the national level and in doing so submits the budget estimates to National Assembly for approval.\(^{312}\)

C. The Role of the Public Debt Management Office

The need to have a centralized PDM agency or single unit reduces on fragmentation and enhances coordination.\(^{313}\) Countries are now adopting a separated PDM agency separate from the monetary

\(^{310}\) Ibid s 25 & 26.
\(^{311}\) Ibid s 27.
\(^{312}\) Ibid s 36.
authority. It places PDM to public debt managers who possess the expertise and experience hence cutting on costs and reducing on fiscal risks.

The Kenyan PDM legal framework centralizes all the debt functions in one single unit, the PDMO. Section 62 of the PFMA establishes the PDMO, which is now operational under the National Treasury. The PDMO is divided into three technical departments: Resource Mobilization (Front Office); Debt Policy, Strategy and Risk Management Office (Middle Office); and Debt Recording and Settlement (Back Office) in accordance with the IMF and World Bank PDM Guidelines. The front office executes transactions in the financial markets, middle office deals with risk management while the back office handles the settlement of transactions and maintains financial records. The PFMA and PFMR not only provide for the explicit establishment but also clarify the legal status and functions of the PDMO.\textsuperscript{314} The PDMO is required to maintain all the data on public debt;\textsuperscript{315} prepare and update the MTDMS; and prepare and implement the government borrowing plans.

Singh has argued that the location of PDM agency or office is very important as it will determine its autonomy.\textsuperscript{316} To ensure autonomy, PDM agency can be established either as an independent office to improve operational efficiency or a separate office but operating under the Ministry of Finance. Kenya has adopted the second alternative as the PDMO is established as an independent office under the National Treasury. This ensures the separation of PDM from the general monetary policy, hence reducing costs over the medium term and development of the domestic debt

\textsuperscript{314} PFMA 2012, s 63; PFMA Regulations 2015, s 194.
\textsuperscript{315} Maintains all data for all loans taken by the national government, county governments and their entities including other loans guaranteed by the national government;
\textsuperscript{316} Singh (n 375).
market.\textsuperscript{317} To ensure operational autonomy from political interference the PDM legal framework need to provide for the role of the PDMO in technical analysis and decision within the established legal framework.\textsuperscript{318}

In addition to discharging its duties at the national level, the PDMO is required to assist the County government in its debt management and borrowing at the request of the County executive.\textsuperscript{319} The National Treasury has indicated that it will pursue a number of strategic interventions through the PDMO to support the County government in managing public debt.\textsuperscript{320} These interventions include: strengthening the county PDM arrangement; providing technical assistance to the County Treasuries in preparation of the County MTDMSs; and upgrading the debt recording system under the IFMIS to capture, analyze and report county borrowing; and provide accurate and timely information on county borrowing.\textsuperscript{321}

\textbf{D. The Role of the Central Bank as a Fiscal Agent}

A sound PDM legal framework should provide for the legal authority to appoint primary dealers and other government securities. The PFMA vests the legal authority to appoint advisors, agents and underwriters for the purpose of rising and issuing loans, managing and redeeming national government guarantees to the Cabinet Secretary.\textsuperscript{322} The PFMA only provides for the legal authority to appoint the advisors, agents and underwriter, whereas their roles depend on the agreements that they enter into with the Cabinet Secretary.

\textsuperscript{318} Ibid.
\textsuperscript{319} PFMA 2012, s 65.
\textsuperscript{320} GoK, 2017 Budget Policy Statement 64.
\textsuperscript{321} Ibid.
\textsuperscript{322} PFMA 2012, s 50(9).
The relationship between the treasury and the Central Bank of any country is based on the interactions between the management of public debt and monetary policy operations.³²³ In most jurisdictions, the Central Bank plays the role of the fiscal agent in addition to exercising its monetary authority.³²⁴ However, where the Central Bank acts as a fiscal agent, both the PDM and Central Bank legal framework need to reflect this role.³²⁵ It should also clarify the scope of this agency relationship.

In Kenya, the CBK implements the monetary policy, manages the foreign exchange reserves and domestic debt in Kenya’s financial market.³²⁶ The role of the CBK as a fiscal agent of the government is provided for under Section 4A (1) (e) of the Central Bank Act.³²⁷ The scope of the Central Bank as a fiscal agent in PDM may include ‘managing auctions, registry services and cash management transactions’ on behalf of the government.³²⁸ The CBK, on behalf of the National Treasury, auctions and manages the domestic debt through issuance of Treasury Bills and Bonds.³²⁹ The objective is to help the National Treasury finance the budget through domestic borrowing.

A strong financial market is critical for PDM as it maintains the stability of debt market, hence the CBK plays a key role in developing the secondary market for government securities and yield curve.³³⁰ In developing the domestic market, the CBK has been at the forefront in developing

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³²³ Pessoa and Williams (n 281).
³²⁵ Pessoa and Williams (n 281).
³²⁸ Awadzi (n 28)46.
³³⁰ Ibid.
treasury securities such as the infrastructure bonds and special bonds,\(^{331}\) in addition to the Treasury bills and bonds. The CBK further manages the Central Securities Depository and maintains the domestic debt data bases. In addition to the fiscal agency relationship, the CBK is the advisor and banker of the government. The Cabinet Secretary and the County Executive Committee member for finance are required to consult with the Central Bank of Kenya on the currency considered appropriate when accepting any money payable under a loan.\(^{332}\)

4.3 Conclusion.

The legislature, executive, PDMO and CBK provide a strong institutional framework on PDM in Kenya. The role of the Parliament is to enact the PDM legal framework, approve the policy framework, provide checks and balances on borrowing. In so doing the parliament must ensure that public debt borrowing is limited to the set thresholds and purposes of borrowing. However, the legislature in Kenya lacks the power to approve new borrowings leaving the executive with the power to borrow as long as it is within the limits set. This has led to the increased borrowing by the executive. The role of the executive is to borrow and guarantee loans on behalf of the national government, exercise oversight over the general PDM and delegate its powers where necessary. The executive is therefore required to regulate the financial control of the public money and ensure that the public debt is within the sustainable levels. In Kenya all the functions related to the public debt are centralized within a single unit; the PDMO. The PDMO is an independent office within the National Treasury. The Cabinet Secretary therefore delegates all operational decisions on borrowing and debt management to the PDMO. The CBK is the government fiscal

\(^{331}\) Infrastructure bond is a bond issued by the government to specifically finance infrastructural projects such as road, rail and hospitals.

\(^{332}\) PFMA 2012, s 57 and 145(2).
agent which implements the monetary policy, manages the foreign exchange reserves and the domestic debt in Kenya. However, there is need for coordination and sharing of information.
CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This study sought to review the Kenyan legal framework to identify the loopholes in a bid to address the general concerns on Kenyan PDM. This chapter provides the conclusions drawn from the study and recommendations.

5.1 Conclusion

This study was based on three key objectives: to review the Kenyan PDM legal framework and identify the gaps; to analyze the PDM institutional framework and its role in PDM; and to provide policy considerations that will enhance PDM.

In reviewing the PDM legal framework, this study concludes that the PDM legal framework in Kenya (CoK, PFMA and PFMA Regulations) complied to a large extent to the 2014 IMF and World Bank PDM Guidelines and related literature on the salient features of a sound legal framework as provided by Gardner and Awadzi. The PDM legal framework in Kenya provides for the scope of public debt; the objectives and principles of PDM; MTDMS; DSA; legal authority to borrow, sources of borrowing and public debt repayments; borrowing purposes; public debt ceilings; contingent liabilities including the scope, reporting, eligibility, purposes, who can create contingent liabilities and risk management; government lending and on-lending. All these features are included in the PDM legal framework.

The PDM legal framework envisages the institutional arrangements governing the PDM in Kenya that involves a number institutions to enhance accountability and transparency. Each institution
has to coordinate with the others. The role of the legislature is to provide oversight, approval and establish the PDM legal framework. The CBK acts as the fiscal agent of the national government in domestic borrowing and develops the domestic market. The PDMO is a department of the National Treasury which undertakes the operational functions of PDM. The Executive on the other hand borrows on behalf of the national government through the Cabinet Secretary.

The PDM legal framework has in place key mechanisms to ensure fiscal accountability and responsibility on PDM. These mechanisms include preparation and publication of key documents by public debt managers at both the county and national level to ensure transparency. The National Treasury publishes the MTDMS, the annual debt management reports, monthly public debt bulletins, report on fiscal commitment and contingent liabilities, external public debt register on its website for easy access. The PDM legal framework further requires annual reports approved by Parliament to ensure transparency.

In determining any gaps in the PDM legal framework, whereas the PFMA covers contingent liabilities, it does not provide comprehensive coverage of other contingent liabilities apart from government publicly guaranteed debt. Implicit contingent liabilities that may arise out of natural disasters or claims against the government are not covered. The National Treasury has indicated in its Budget Policy Statement in 2017-2018, that contingent liabilities are usually not indicated in the budget hence are not subject to parliamentary budget oversight creating a loophole.

It is not clear in the PDM legal framework whether domestic borrowing should be exclusively denominated in domestic currency. The lack of clarity on the denomination of domestic borrowing can make it susceptible to foreign fluctuations and exchange risks. However, the PDM legal
framework requires that, the Cabinet Secretary and the County government to consult with the CBK on the denomination of currency when repaying loans.

While the PDM legal framework provides for the purposes of borrowing, law does not explicitly indicate whether Parliament approval is necessary when government intends to borrow.

The Kenyan PDM legal framework stipulates that the national, county government and national government entities can only lend money in accordance with the terms and conditions of the PFMA Regulations approved by Parliament. However, the said terms and conditions are not stipulated under the PFMA Regulations creating a loophole.

The study found out that in some instances the government does not strictly comply with the PDM legal framework and this has negative impact on public debt sustainability. This study concludes that the government is not strictly adhering to the objectives of PDM that it takes into consideration the costs of borrowing over the long term taking into consideration prudent risks. This is evidenced by its shift from domestic borrowing to external borrowing in the FY2016/2017 exposing the country to external exchange rates fluctuations and external loans disbursements increasing the public debt level. Most of the Kenyan debt is owed to external debtors. In addition most of the public debt owed to China is on commercial terms. Borrowing on commercial terms not only increases the cost of borrowing and payment of public debt, but has also increased the public debt stock.

The government continues to develop the domestic debt market. It has launched the M-Akiba Bond to allow Kenyans to buy government bonds as low as KS. 3,000. However, there is need for increased awareness on the same. The government has also increased the maturity of the treasury bonds to seven years.
In accordance with the fiscal responsibility principles that require public debt to be kept at sustainable levels, recent data indicate that indeed the public debt to GDP ratio in 2018 was standing at 56% in contravention with the 50% limit of GDP in NPV terms in line with the PFMA Regulations and EAC convergence criteria.

This study indicates that indeed the Kenyan government continues to borrow and its public debt stock has increased over the years. This high public debt stock in Kenya is not as a result of a weak PDM legal framework, but primarily it is a result of high primary deficits, borrowing costs and payment costs and failure to strictly adhere to the PDM legal framework. The lack of parliamentary power to approve new borrowings has led to the increased borrowing by the executive without taking into consideration the risks associated. Based on the above, this study concludes that the Kenyan PDM legal framework encompasses the salient features of a sound PDM legal framework. Strict compliance of the PDM legal framework and effective coordination between the institutional arrangements on PDM is key in addressing PDM and debt sustainability.

5.2 Recommendations

Based on the above conclusion, this study makes the following recommendations:

Immediate

a. Transparency and reporting:

The cabinet secretary finance and PDMO to make more accessible to the public reports on status of public debt transactions at county offices and hospitals to encourage accountability and public participation.

b. The cabinet secretary finance to make a deliberate shift to domestic borrowing to minimize on costs

c. The cabinet secretary finance to stop further borrowing on commercial terms
d. The government should strengthen the coordination between the PDM institutional arrangements to enhance accountability and transparency. While the legal framework has put in place a number of reporting mechanisms such as the annual MTDMS, DSA, and Budget Policy Statements amongst other key documents, this information must be accurate and reported in a timely manner. There is need to strengthen coordination between the PDM institutional arrangements to enhance accountability and transparency.

Medium term

a. Legislation by parliament:

To empower parliament to examine and approve new borrowings
To empower parliament to set annual public debt ceilings
To define the scope of contingent liabilities
To clarify currency denomination in domestic borrowing
To provide for the fate of borrowing transactions that are unauthorized or flout set ceilings

Long term

a. The CBK as a fiscal agent of government domestic borrowing in collaboration with other institutions such as PDMO should play a key role in developing the domestic debt market. Whereas the government launched the M-Akiba bond, there is need for increased awareness for it to be successful.

b. There is need for the government to involve and incorporate public debt experts in PDM decision making such as the Institute of Economic Affairs (IEA) especially in analyzing risks.
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