Policy Brief

Public Debt Sustainability

Evolution of Public Debt in East African Community (EAC)

The East African Community (EAC) has experienced an increase in public debt over the past decade. While external borrowing has been instrumental in financing infrastructure projects, among other investments, concerns have been raised on the sustainability of debt and its potential impact on economic growth and development. This policy brief examines EAC's debt situation, its drivers, implications, and proposes policy measures to manage public debt sustainably.

Policy Recommendations

- Address the problem of low revenue mobilization, governments in the region need to strengthen tax administration.
- Control runaway spending that has resulted in fiscal deficits, EAC countries should adopt comprehensive budgets that outline their spending priorities and set limits on spending.
- Governments in the region should strengthen and implement prudent debt management strategies to alleviate the effects of the rising debt on the economy.
- EAC countries could explore alternative sources of funding that are less susceptible to currency risk, such as concessional loans from international financial institutions or issuing debt in local currency.

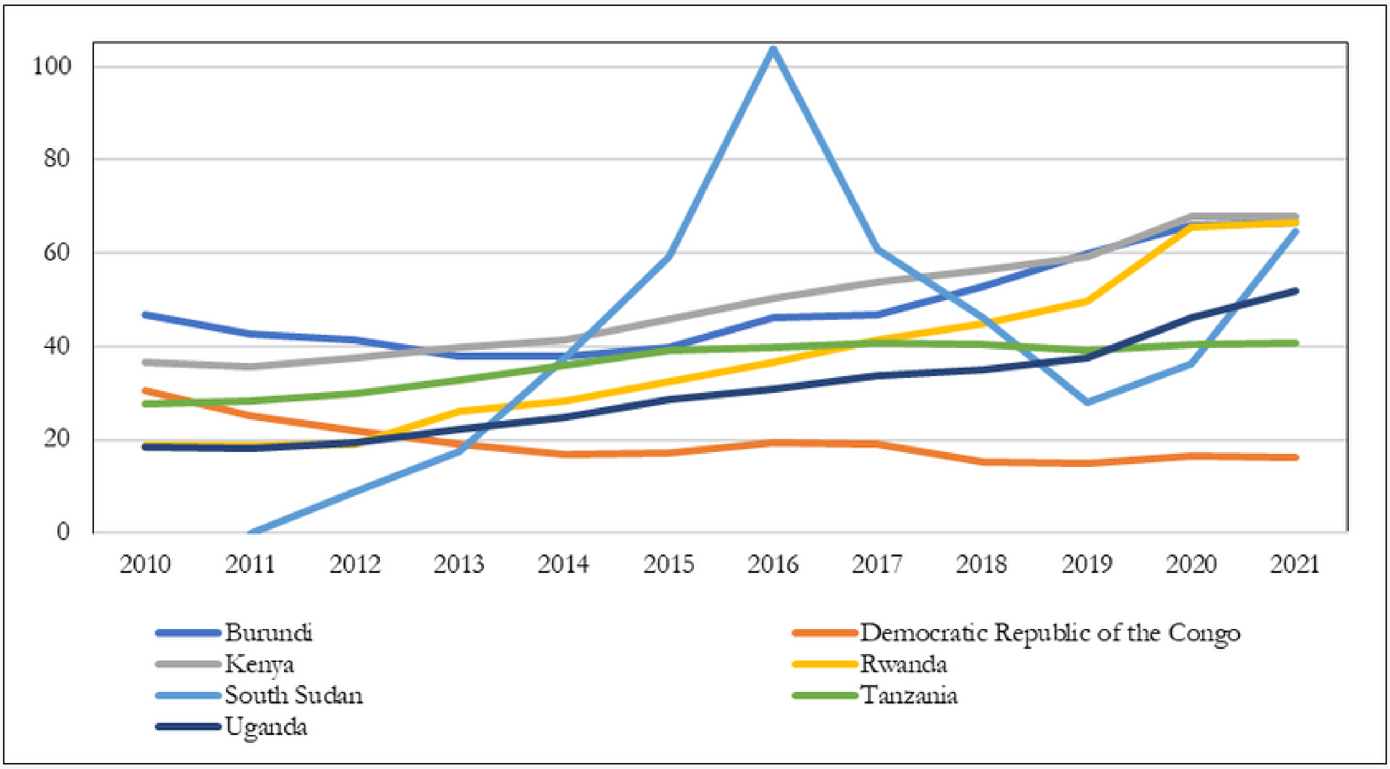
EAC Debt in Numbers

According to the World Bank, the debt-to-GDP ratio for EAC countries has been increasing in recent years. In 2010, the average debt-to-GDP ratio for these countries was approximately 27.7%, while in 2021, it increased to around 48.8%, but there are cross-country variations. Specifically, Kenya's debt-to-GDP ratio increased from 36.7% in 2010 to 67.8% in June 2021, while Tanzania's debt-to-GDP ratio increased from 27.6% in 2010 to 40.7% in 2021.

For Uganda, the debt-to-GDP ratio was at 51.8.2% in 2021 up from 18.4% in 2010 while Rwanda's debt-to-GDP ratio was at 51.8% in 2021 up from 18.8% in 2010. Burundi's debt to GDP ratio has also been on the rise and increased from, 46.9% in 2010 to 66.6% in 2021. South Sudan's debt to GDP ratio grew exponentially from 8.9% in 2012, peaking at 104% in 2016 before dropping in subsequent years to 64.7% in 2021. However, DRC has shown relatively lower debt to GDP ratios over the years, decreasing from 30.6% in 2010 to 16.1% in 2021.

Notably, the EAC member countries reported a sizeable increase in their public debt as share of GDP between 2020 and 2021. This increase in attributable to increased funding needed in response to the COVID-19 pandemic and underperformance in revenue at the height of the pandemic.

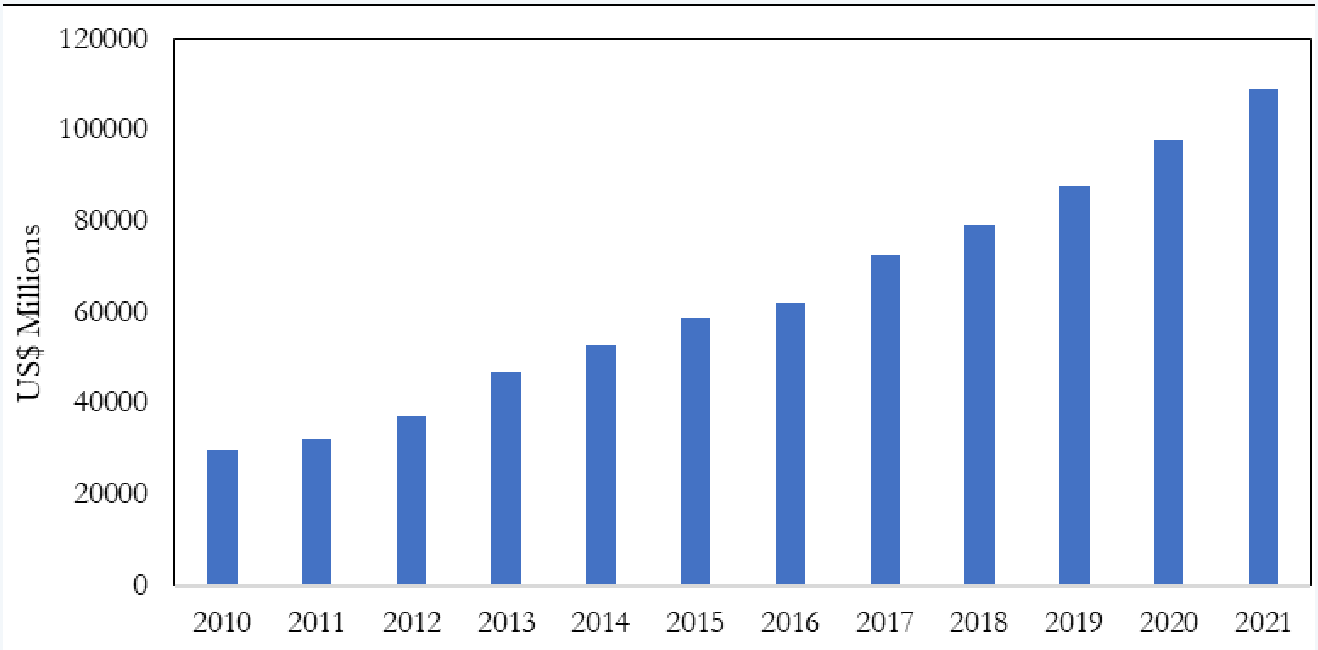
Figure 1: Total Debt to GDP Ratio for EAC Countries (2010-2021)



Data Source: IMF

EAC's external debt has risen rapidly between 2010 and 2021, reaching USD 109.2 billion in 2021, a more than 3 times increase from USD 29.9 billion in 2010.

Figure 1: Total Debt to GDP Ratio for EAC Countries (2010-2021)

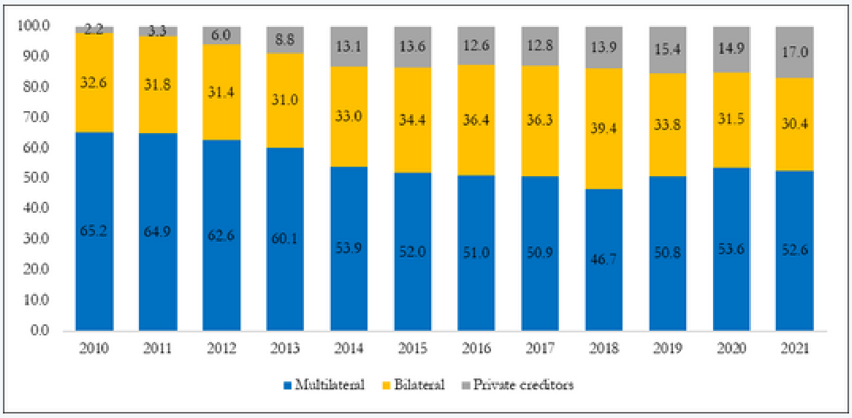


Data Source: Compilation based on World Bank Data, 2022.

The steep rise in the region's external debt stock since 2010 is mainly driven by Kenya, Uganda and Tanzania who have been borrowing heavily from international markets. At the end of 2021, the bulk of EAC's external debt was owed by Kenya (38%), Tanzania (26%) and Uganda (18%). The least amount of debt was held by Burundi which constituted only 1% of the total external debt due to the political instability and economic challenges limiting its ability to access international markets.

Figure 3 below shows a significant increase in the use of private creditors (commercial banks and bondholders) by EAC countries, but EAC debt remains predominantly multilateral.

Figure 3: Share of external debt, 2010-2021 in percentage



Source: Compilation based on World Bank Data, 2022.

Debt Sustainability in the Region

Despite the rising debt levels, the African Development Bank (AfDB) notes that the debt sustainability of EAC countries varies widely, depending on factors such as their level of economic development, debt composition, and debt management capacity. For example, Tanzania's debt is mostly concessional and owed to multilateral institutions, while Kenya's debt is more commercial and issued in international capital markets.

According to the IMF's most recent debt sustainability analyses, the debt levels of the EAC countries are generally manageable, although there are significant variations among them.

Kenya’s debt is **sustainable** because of the fiscal consolidation under the IMF supported program. However, the **overall risk of debt distress remains high.**

Uganda’s debt continues to be **sustainable** in the medium term with limited space to absorb shocks. The **overall risk of debt distress is moderate.**

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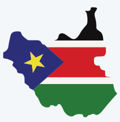
Rwanda’s debt is **sustainable with a moderate risk of overall debt distres**s because of its susceptibility to adverse market conditions & climate shocks.

Burundi is at **high risk of debt distress** rating though the debt is sustainable due to the government’s commitment to fiscal consolidation from the unwinding of COVID-related spending and improvement in revenue collection.

The Democratic Republic of Congo (DRC) **remains at moderate risk of debt distress** with substantial space to absorb shocks.



South Sudan’s debt is **assessed to be sustainable** given the current recovery in oil prices though the risks to **overall debt distress remain high**.

Implications of Public Debt in the Region

Increased borrowing, especially from external sources, has increased EAC economies to risks of currency depreciation. This is because they need to repay the debt in foreign currency, which becomes more expensive when the local currency depreciates. Again, as the debt level builds up, investors become more sensitive to vulnerabilities arising from weak economic fundamentals and pull their money out of the country, weakening the currency. For example, in Uganda, the high levels of public debt denominated in foreign currency have contributed to currency depreciation, leading to higher inflation. In Kenya, there is high demand for the US dollar to service external debt and pay for imports. As a result, the Kenya shilling has weakened considerably against the US dollar and other major currencies leading to high inflation with the prices of basic commodities rising unprecedentedly.

Public debt has led to crowding out of private investment in the region. When governments borrow heavily to finance their expenditure, they tend to crowd out private investment by increasing interest rates. This makes it difficult for private businesses to access credit, leading to lower investment, lower economic growth, and fewer job opportunities. For example, in Tanzania, the high levels of public debt have led to high interest rates, which have negatively affected private investment and economic growth. Similarly in Uganda, domestic borrowing by the government has led to an increase in interest rates, undermining the private sector. Additionally, the 2018 World Bank Group Kenya Economic Update (KEU) states that the high levels of public debt in Kenya can deter private sector investment, particularly foreign investment. The report suggests that high levels of public debt make the country less attractive to foreign investors, as it increases the perceived risk associated with investing in the country.

High increase in debt levels have also led to downgrading of a majority of EAC's member countries' credit rating. This can result in higher borrowing costs and limited access to external financing. For example, in Rwanda, the high levels of public debt have led to a downgrade of the country's credit rating, reducing its access to international capital markets. Similarly in Kenya, a global ratings agency, Standard and Poor (S & P), recently cut Kenya's ratings outlook from stable to negative. This was due to concerns about Kenya's capacity to service its debt because of constrained international markets access and underperforming domestic bonds issuance.[vii] The implication is that these countries will now have to borrow at a higher cost due to dampened investor confidence.

Debt servicing crowds out spending on critical sectors such as health, education, and social protection. A 2019 publication by UNICEF pointed out that 25 mostly poverty-stricken countries spent a higher proportion of government expenditures on debt services than they did on education, health and social protection combined. In Kenya for example, the high levels of public debt have contributed to fiscal vulnerabilities, leading to budget cuts in key social sectors. Similarly in Uganda, there has been a growing pressure on taxes to finance debt liabilities at the expense of other priority budgetary items, such as education and health.

Drivers of Public Debt in the Region

East African countries have low revenue mobilization which together with growth in expenditures has led to persistent fiscal deficits and accumulation of public debt. According to the latest World Bank data, the tax to GDP ratio has remained low in the region, averaging 14.6% in 2019[The majority of EAC member countries have been running persistent budget with government expenditures exceeding revenue collections. This has led to increased borrowing to finance the deficits. The region's fiscal deficit was at an estimated 4.1% of GDP in 2018.[ii] In Kenya for example, the budget deficit has been on arising trend from FY 2017/18 from 6.7% of GDP to peak at 8.2% of GDP in FY 2020/21. The high fiscal deficit in the FY 2020/21 was in part due to the COVID-19 pandemic but given that Kenya is currently under an IMF program aimed at supporting fiscal consolidation, the country's fiscal deficit is projected to decline to 5/7 percent in FY 2022/23 and below 4 percent of GDP over the medium term.

Most of the EAC member countries rely heavily on external financing, including official development assistance (ODA), to finance their development projects: however, in recent years, there has been a decline in development assistance, particularly in the form of grants. For example, between 2013 and 2017, the total amount of grants received by Tanzania declined from USD 929 million to USD 547 million, while in Uganda, grants declined from USD 928 million to USD 666 million over the same period These countries have had to borrow to finance their development and other expenditure needs.

The need to finance infrastructure developments has also been a major driver of public debt accumulation in the EAC. Most of the EAC member countries are currently undergoing significant infrastructure developments, including the construction of roads, railways, airports, and ports. These projects require significant financing, which has led to increased borrowing by the governments.

For example, in Tanzania, the government has invested heavily in infrastructure development, including the construction of the Standard Gauge Railway and the Julius Nyerere Hydropower Project. In Kenya, the projects funded by loans include the Standard Gauge Railway line and the Jomo Kenyatta International Airport Airfield Expansion among others. In Uganda, the loans have financed the Karuma and Isimba hydropower projects, and the expansion of Entebbe International Airport among others. Borrowing to finance these projects has contributed significantly to the country's public debt levels.

Poor debt management and lack of transparency in public debt have been significant factors contributing to the increase in debt levels in East Africa. According to a World Bank report, close to 40% of low-income developing countries had never published data on debt or had never updated the information in the last two years as of November 2021. [i] This lack of accountability and oversight in the borrowing process has enabled governments within the region to take on large amounts of debt without proper consideration of the long-term implications or the ability to pay it back. This has led to unsustainable levels of debt that are difficult to manage and can stifle economic growth. Also in many cases, the true extent of the debt is not fully disclosed, making it difficult for citizens and other stakeholders to understand the implications of the debt and hold governments accountable for their borrowing decisions. This lack of transparency has also made it easier for corrupt practices to take place, further exacerbating the debt problem.

Policy Recommendations

- **To address the problem of low revenue mobilization, governments in the region need to strengthen tax administration**. Digitalization of revenue administration through investing in technology such as electronic filing and payment systems can support tax compliance and a result enhanced revenue mobilization. Also, the countries should simplify tax systems, reduce the number of tax exemptions, and make it easier for taxpayers to understand their obligations. Ultimately, governments should take steps to address corruption, and reduce leakages of revenues collected. Such measures could include strengthening anti-corruption laws, improving transparency in public procurement, and increasing the accountability of public officials as corruption is a major obstacle to revenue mobilisation.

- **To control runaway spending that has resulted in fiscal deficits, EAC countries should adopt comprehensive budgets that outline their spending priorities and set limits on spending.** This will ensure that government spending is aligned with development objectives and is sustainable over the long term. Governments should prioritize spending on essential services such as health, education, and infrastructure, while reducing spending on non-essential items such as travel and entertainment. This may involve making difficult choices and implementing unpopular measures, but it is necessary to ensure the sustainability of public finances.

- **Governments in the region should strengthen and implement prudent debt management strategies to alleviate the effects of the rising debt on the economy,** particularly countries classified as high risk like Kenya and Burundi. Boosting debt transparency by providing accurate, comprehensive, and timely data will help build trust with investors, support domestic capital markets, and reduce debt service costs. Those involved in public debt acquisition should ensure that the debt acquired is invested in projects that generate high economic returns and have a significant impact on poverty reduction.

- **EAC countries could explore alternative sources of funding that are less susceptible to currency risk, such as concessional loans from international financial institutions or issuing debt in local currency.** The fact that a large portion of the debt in the EAC is denominated in foreign currency makes it susceptible to external exchange rate shocks. Currency depreciation or appreciation can significantly affect the value of the debt, making it more expensive for the countries to repay their debts

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