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Taxation vs Borrowing for Revenue Generation

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Presentation overview

- Government borrowing in Kenya
- Level and composition of tax revenue
- Tax policy challenges facing developing countries
- Comparative analysis
- Discussion

Why the Government needs funds

The government needs funds for 3 main reasons:

- **Financing recurrent expenditure** - salaries, repairs and maintenance of public goods, stock of hospitals and schools
- **Capital expenditure** - building new roads, bridges, railway, hospitals
- **Financing emergencies** - Famine, El Nino, disease break outs (Ebola), wars, disasters

Ways of raising funds by Government

- Borrowing (domestic and foreign)
- Taxes
- Sale of government property - shares in companies eg Safaricom
- Profits from investments - Dividends
- Grants from int’l organizations and govts

Government borrowing in Kenya

Government Borrowing

Defined as debt owed by the govt for financing operations

a) Treasury Bonds (Maturity over 2 yrs)

b) Treasury Bills (Maturity less than 2 yrs - 91 days, 182 days & 360 days)

c) Sovereign bonds - Eurobond

d) Borrowing from a supranational organization (eg the World Bank, IMF)

e) Borrowing from friendly countries - bilateral and concessionary loans

Government Borrowing - Categorization

This can be categorized based on debtors or tenure

- **By debt holders:**

✓ Internal debt (lenders within the country); and

✓ External/sovereign debt (owed to foreign lenders)

Sovereign debt usually refers to government debt that has been issued in a foreign currency

Government Borrowing - Categorization

This can be categorized based on debtors or tenure

- **By tenure:**

✓ Short term - for one year or less;

✓ Long term - for more than 10 years; and

✓ Medium term - between 1 and 10 years

Why should government borrow?

- Finance huge infrastructural capital projects - Superhighway, SGR
- To finance unforeseen events eg War, famine, drought
- Smooth government cash flows over the business cycle
- To adhere to the fiscal policy of not raising more taxes
- Monetary policy instrument:
  - Curb inflation (Mops out excess liquidity in the market)
  - Stabilize foreign exchange

Negative effects of Govt Borrowing

- “Crowding out” the private sector - Govt borrowing pushes up interest rates
- Private sector may find it more profitable to invest in bonds than lending to the local market (the default case in Greece)
- Continued and excessive borrowing could significantly hamper economic development and affect the country’s credit rating - Japan

Negative effects of Govt Borrowing

- Repayment of govt debt by printing more money would increase inflation and thus reduce the value of the invested capital

- Investors in bonds denominated in FX have exchange rate risk (depreciation)

- Countries issuing debt denominated in a foreign currency may be unable to obtain that foreign currency to service the debt

Negative effects of Govt Borrowing

- **Excess borrowing may cause the stock of debt to grow, forcing the government to default on its debt**

Famous cases of default:

Iceland in 2008 (debt 600% of GDP); and

After 2010, PIGS – Portugal, Italy Greece, Spain and Italy

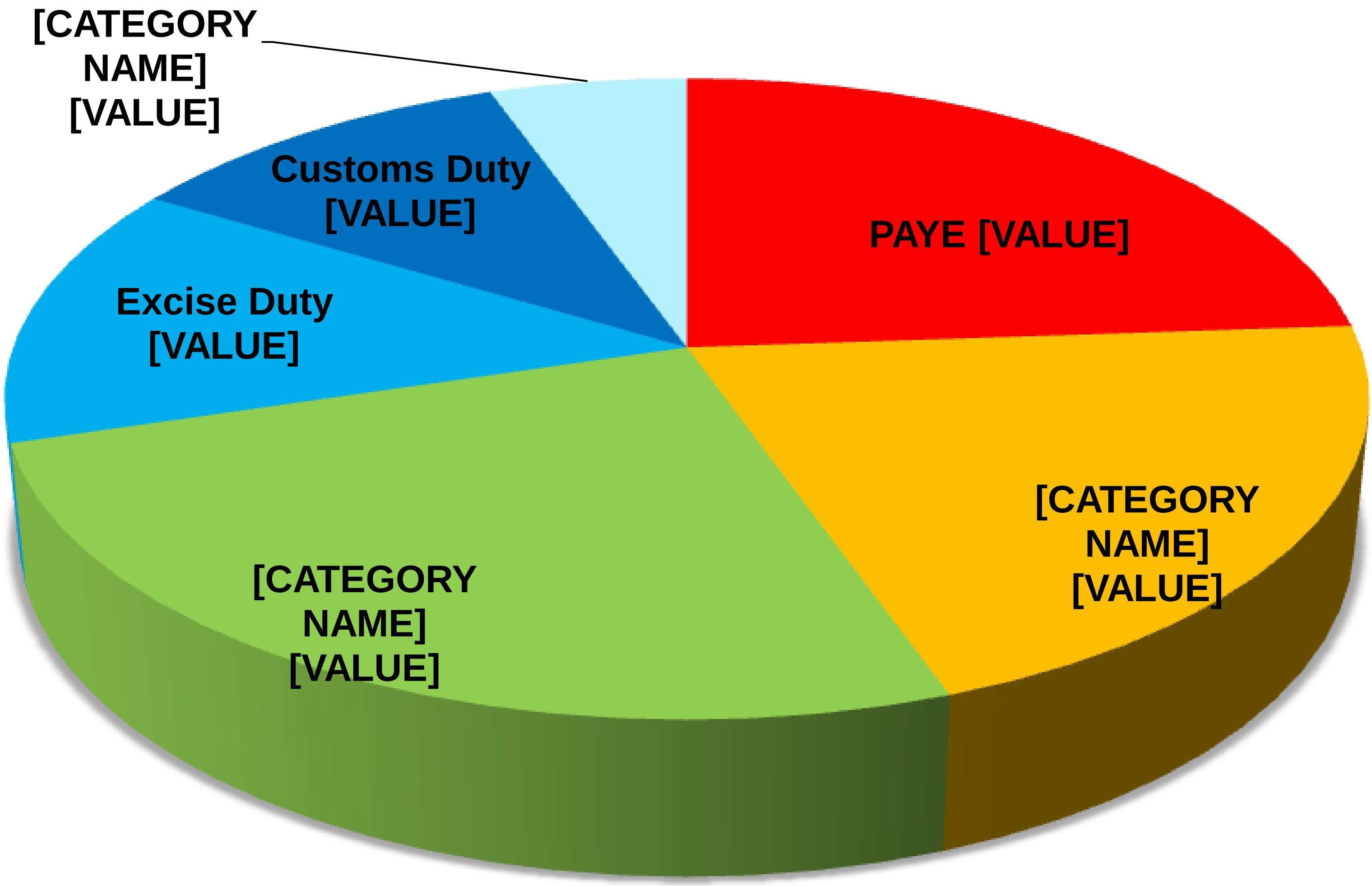
These countries had to implement severe austerity programs to pay down their debt

Factors to consider before borrowing

- Assess the expected value of the infrastructure to be constructed at least in future tax terms if not in direct revenues
- Purpose of the borrowing - development vs recurrent
- Determine the interest cost of the borrowing
- Determine if any future entitlements are being created by expenditures eg financing a public swimming pool may create some right to recreation where it did not previously exist, by precedent and expectations

Taxation for revenue generation

Composition of the national cake - 2013



Tax policy for Kenya

- Taxation is the only practical means of raising the revenue to finance govt spending
- Establishing an efficient and fair tax system is challenging especially due to majority of workers who are:

✓ Typically employed in agriculture or in informal sector where they are seldom paid a regular wage;

✓ Paid in cash “off the books”; and

✓ do not spend their earnings in large stores that keep accurate records of sales and inventories

Challenges in tax policy

- **Under staffed/motivated/paid tax officials?**
- **No computerized operations** - addressed by iTax
- **Data opacity** - informal structure of the economy makes it harder to collect data and prevents policymakers from assessing the potential impact of major tax changes
- **Tax refunds - a light at the end of the tunnel?**

Challenges in tax policy

- Marginal changes were often preferred over major structural changes:
  - Perpetuates inefficient tax structures
  - Modernizing our laws - Excise Bill, Income Tax Bill, VAT Act, 2013?
- Income tends to be unevenly distributed within the country
- Unexploited tax bases - personal income and property taxes and why their tax systems rarely achieve satisfactory “progressivity”

Comparative view

Analysis of debt as a % of GDP (2013)

Country	Debt to GDP ratio	Highest "PAYE" rate	VAT Rate
Brazil	56.80%	27.50%	19%
UK	90.60%	45.00%	20%
Japan	227.20%	50.84%	8%
Greece	175.10%	42.00%	23%
Italy	132.60%	43.00%	22%
Kenya	51.70%	30.00%	16%

Source: Eurostat

Way forward?

- Delicate balance between debt and tax increases
- Alternative financing models - PPPs, BOOT, BOT etc
- Increasing the tax base:
  - CGT
  - Estate tax?
  - Informal sector tax - rework ToT
  - Extractive industries tax?
- Debt to finance economically sound projects - payback
- Reduce recurrent expenditure - weed out “ghost workers”

Q & A

Session

Thank you

Caveat

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