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 govs
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

- PAYE [VALUE]
- Excise Duty [VALUE]
- Customs Duty [VALUE]
- [CATEGORY NAME] [VALUE]
- [CATEGORY NAME] [VALUE]
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)

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt to GDP ratio</th>
<th>Highest “PAYE” rate</th>
<th>VAT Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>56.80%</td>
<td>27.50%</td>
<td>19%</td>
</tr>
<tr>
<td>UK</td>
<td>90.60%</td>
<td>45.00%</td>
<td>20%</td>
</tr>
<tr>
<td>Japan</td>
<td>227.20%</td>
<td>50.84%</td>
<td>8%</td>
</tr>
<tr>
<td>Greece</td>
<td>175.10%</td>
<td>42.00%</td>
<td>23%</td>
</tr>
<tr>
<td>Italy</td>
<td>132.60%</td>
<td>43.00%</td>
<td>22%</td>
</tr>
<tr>
<td>Kenya</td>
<td>51.70%</td>
<td>30.00%</td>
<td>16%</td>
</tr>
</tbody>
</table>

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
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