

# **DEBT AND THE PRSP CONDITIONALITY: THE KENYA CASE**

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All errors remain my own.

## *Abstract*

*The Kenyan economy had a growth of  $-0.3\%$  in the year 2001, the lowest growth in the post independence era. This decline in growth performance coincided with the period when the government was involved in grass-root consultations with civil society and other stakeholders, to find out the causes of poverty and what they perceive as the best steps towards poverty reduction. This paper examines the current debt problem in Kenya and the options available for funding emerging priorities as identified in the PRSP. The paper concludes that implementing a PRSP would only be effective after the high debt burden is resolved, structural and institutional weakness addressed and significant growth achieved.*

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## **1. Introduction**

The debt crisis of the early 1980s turned Kenya into a highly indebted nation. The debt problem was exacerbated by macroeconomic mismanagement in the 1990s, leading to a reduction of donor inflows. The government has thus resorted to occasional debt rescheduling and expensive short-term domestic borrowing to finance its expenditures. Debt induces uncertainty and affects private investment via high interest rates and the development of the financial sector. High interest rates dictate that a large proportion of expenditure must be allocated to interest payments. Debt distorts the economy and complicates macroeconomic management.

In Kenya, debt service has crowded out funding for capital and social expenditures. After debt servicing and salaries, there is little left for core functions of the government, basic infrastructure, education, health and other essential services, to create an enabling environment for the private sector. Table 1 below shows the composition of government expenditure.

Kenya's experience is typical. Positive shocks, like the coffee boom of the mid 1970s, were perceived as permanent additional resources and not saved but used to finance expanded government programmes and additional recruitment. On the other hand, negative shocks like the oil crisis of the 1980s were perceived as temporary and therefore financed, without implementing any long-term adjustment. Furthermore, a combination of low international interest rates and an over valued exchange rate enhanced the value of borrowing and reduced the exchange rate risk. The removal of controls on capital flows, trade and foreign exchange markets in the 1990s has increased the vulnerability of the country and calls for more prudent debt management-- both of the size and portfolio-- and the development of strategies that are better integrate with financial openness.

Analysts observe that the high growth performance recorded in the early 1970s did not translate into poverty reduction and inequality seems to have increased. The economic

decline in the 1980s and 1990s and the declining GDP per capita has translated into rising poverty levels. It has become increasingly clear that growth does not necessarily trickle down and a poverty reduction strategy has to be mapped out to make growth friendly to the poor.

Table 1. Composition of Government Expenditure

	Wages	Interest	Other	Capital
91/92	31%	21%	29%	19%
92/93	26%	34%	22%	18%
93/94	24%	36%	22%	19%
94/95	32%	24%	23%	22%
95/96	30%	24%	26%	19%
96/97	29%	21%	34%	17%
97/98	32%	19%	31%	18%
98/99	32%	20%	31%	16%
99/00	38%	17%	35%	11%
00/01	32%	14%	39%	16%

*Source: Quarterly Budget Review, Ministry of Finance—various issues*

While the government grapples with short-term macroeconomic management, growth has stagnated and as a result poverty levels have been rising. O'Brien and Ryan (1999) observe that structural adjustment has failed to create conditions for a sustained economic recovery, poverty has been increasing and social indicators have shown negative trends in recent years.

Poverty eradication has been a goal for the Kenyan government since independence but the goal has been elusive. A welfare monitoring survey (WMS III) conducted in 1997 revealed that the overall incidence of poverty in Kenya stood at 52%. The number of the poor has increased from 3.7 million in 1973 to 15 million in the year 2000. One of the recent initiatives towards poverty reduction is the National Poverty Eradication Plan, NPEP, which is a long term plan to reduce poverty, in line with International Development Goals, by 50% by the year 2015.

There is now a consensus among the donors that poverty reduction should have three broad elements: expand the economic opportunities for the poor through better functioning of the markets; empowerment; and security to withstand economic shocks—pointing to the need to make growth more pro-poor. This led to a change of stance by both the World Bank and the IMF and from 1999 formulation of PRSPs became the key to access either debt relief or concessional finance under the Poverty Reduction Growth Facility.

This paper examines the debt problem in Kenya and the plausibility of implementing a poverty reduction strategy before the debt problem is addressed and sustainable growth achieved.

The rest of the paper is structured as follows: section two outlines the background; section three attempts to quantify Kenya's debt problem in various ratios; section four examines the plausibility of the PRSP process under the current macroeconomic conditions; and section five gives the concluding observations.

## **2. Background**

In Kenya, the early 1980s were characterized by high budget deficits, high inflation, and unsustainable current account deficits. These financial imbalances were triggered by, among other things, the erosion of fiscal discipline following an expansionary fiscal policy implemented after the coffee boom of 1977-78 and severe external shocks (oil shocks). During this period, the ratio of public expenditures to GDP increased from 24% in 1973-74 to over 31% in 1979/80 while the deficit increased from 3% to 10 % of GDP.

Kenya's problems are typical; when the economy was growing fast, it was possible for the government to fund new priorities while retaining the old ones but once growth stagnated and donor funding petered out, resource allocation became fixed and priorities failed to change in line with circumstances

The high deficits were financed by a combination of domestic and foreign borrowing, and by 1981 debt to GDP ratio stood at 13.2%, up from 4% in 1977. Clearly, this trend of expenditure was not sustainable, and in 1982 Kenya had to turn to the IMF for a Structural Adjustment Loan (SAL). However, the policy changes stipulated in the lending agreement were not backed by a true commitment to change, and lack of compliance led to failure. Kenya received nineteen structural adjustment loans during the reform period.

In Kenya twenty years of reforms have not achieved expected results, the macroeconomic environment has not created the conditions necessary to achieve sustained growth at the levels of the 1970s and 1980s. Though some reforms like market liberalisation have been successfully implemented, other critical structural and institutional reforms are yet to be finalised. The failure to achieve institutional reforms has resulted in a reduction of donor inflows to finance the government budget. This induces uncertainty in the economy and a reluctance to invest in the real sector, thus the declining trend in private investment observed in the economy in the last two years.

### *2.1 Past reform efforts*

This section focuses on the fiscal adjustment component of the structural adjustment programs—the restoration of fiscal discipline in the public sector and the impact this adjustment had on the debt profile.

Following the oil crisis and the rise in international interest rates in the 1980s Kenya, like other developing countries, was not in a position to service her debt and turned to Bretton Woods institutions to be bailed out. Assistance was conditional on implementing Structural Adjustment Programs (SAPs) –market liberalization, privatisation, currency devaluation and reduction of public expenditures—which through cutting back of social programs worsened poverty.

The implementation of SAPs saw a significant reduction in the huge deficits incurred in the early 1990s. After a period of chronic deficits reaching an unprecedented level of 9.65% of GDP in 1992/93, the fiscal deficit gradually declined to 0.25% of GDP in

1996/97. The reduction was achieved through cuts in public investment and the provision for operations and maintenance. Through the introduction of cost sharing in education and health, the government also reduced its involvement in the provision of basic services.

As a result, public infrastructure has been decaying and has witnessed little expansion. Both health and education standards have been declining, consistent with high poverty levels, and the positive trends achieved in the first decade have reversed. The structural adjustment program was characterised by high demand management and seems to have compromised investment and growth and it would appear that the fiscal contraction was too tight too fast.

Ryan and O'Brien observe that the implementation of SAPs proved to be beyond the capacity of most governments, Kenya's included, though it was acknowledged that the reforms were needed. (At the same time, it is clear that even well formulated reform programs can be thrown overboard by adverse shocks.)

The allocation of resources, both by economic category and by sector, contributes to the poor performance of public expenditure. During the period 1991/92 to 1999/2000, interest payments and wages and salaries averaged 54% of total expenditure and 66% of recurrent expenditure. Indeed, Easterly (1998) cites Kenya as a typical case where fiscal adjustment was an illusion. The success in deficit reduction was a result of reduced spending in operations and maintenance, resulting in a rapid depreciation of public capital stock, and of crowding out new public investment.

Fiscal indiscipline, typified by rapid expansion of the public sector and large deficits, left most developing countries with huge debt obligations; inadequate evaluation of expenditure implies that the budget carries the burden of past policy, budgetary and legislative decisions, leaving little room for manoeuvre. The overwhelming majority of resources must be allocated to existing programmes and projects leaving little or no scope for funding new policies and priorities.

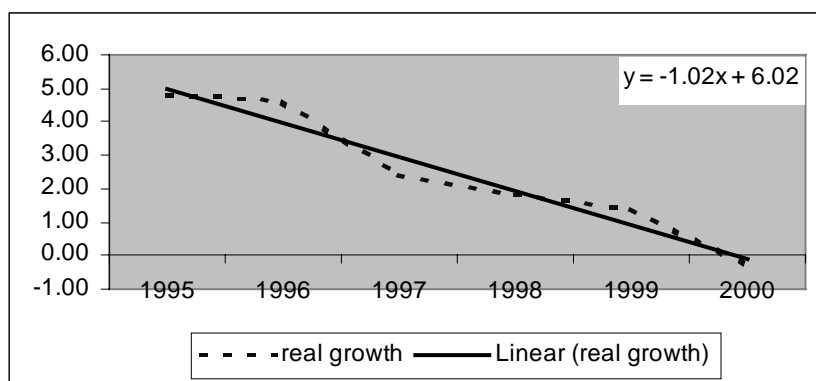
Schick (1999) avers, "when government is inefficient, public sector wages tend to be low, much public expenditure is absorbed by dead weight administrative costs and the government is robbed of resources needed for critical social development". This limits the range of executive and legislative discretion in any one year. Short of a crisis, it is only possible to deal with the margins of the budget. This has been the case in Kenya.

The overall conclusion is that the resource allocation process and implementation is flawed. There are several weaknesses in the planning and budget process which have contributed to Kenya's poor performance.

## 2.2 Current Situation

The chart below captures Kenya's growth performance between 1995 and the year 2000. It is easy to understand how the economy got into the current situation.

Chart 1. Kenya's Growth Performance 1995- 2000



The linear (real growth) line is a trend line for real growth. A simple interpretation would indicate that the economy has been declining by an average of  $-1.2$  percentage points during the last six years. This paints a rather gloomy picture. The factors that have led to the situation depicted above are effectively summarised in the recent report on "Opportunities for Fostering Pro-Poor Growth in Kenya" as follows:

- i. Frequent policy reversals have undermined government credibility.

- ii. The productivity of investment has fallen sharply, estimated at 50%, over the last three decades.
- iii. Both public investment and savings have been well below the levels required to generate growth and have an impact on poverty.
- iv. Kenya has achieved a successful record on investment in education and health but these gains are threatened by the lack of private investment through which the social investments would achieve growth and equality dividend.
- v. The main constraints on poverty reducing growth rate relate to weak governance, corruption, poorly coordinated and prioritised government actions.
- vi. The poor record of fiscal management and the inefficiency of much of public expenditure has curtailed the scope for effective government investment. Public finance strategies have been characterised by an expansion of short-term domestic debt, which has crowded out the private sector and increased the proportion of debt service obligations in the government budget, shrinking the proportion that is available for social expenditure.

The report notes that Kenya's problems and structural weakness have been well analysed and documented in various policy documents dating as far back as the 1990s but the development strategy has not addressed them. Trying to improve from the past, the PRSP macroeconomic strategy aims at reducing domestic the debt burden through revenues from privatisation, concessional foreign borrowing and a medium term reduction of government share in GDP. Debt clearly emerges as a major preoccupation in growth and poverty reduction in the medium term.

### **3. Kenya's Debt Problem**

In Kenya domestic borrowing has had two negative impacts: (1) crowding out the private sector; and (2) bidding up interest rates, a disincentive to investment. Between 1996 and May 1997, real interest rates on the 91 day treasury bills<sup>1</sup> and overdrafts by commercial

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<sup>1</sup> Source: CBK Monthly Economic Reviews

banks averaged 13.5% and 21.2% respectively--making the cost of capital relatively high. It was hoped that these rates would decline with the improvement of the government's fiscal position.

About 72% of Kenya's debt is external and the balance is domestic debt of short maturity. However, domestic interest payments constitute over 70% of total interest payable, an indicator that the government is financing current spending at a very high cost

### *3.1 Sustainability*

Several criteria have been developed to assess debt sustainability and this section uses some of the standard measures to assess the Kenyan situation.

#### *a) Government Balance Sheet*

Drawing a parallel from the private sector, the government balance sheet should be a good indicator, reflecting all current and future assets and ensuring that they are sufficient to cover all the liabilities. However, as in most developing countries, developing a government balance sheet for Kenya has not been possible and this indicator cannot be used to assess the Kenyan position.

#### *b) Debt to GDP Ratio*

Debt to GDP ratio is one of the common measures used to monitor and measure the sustainability of debt. This ratio can increase in two ways:

- a) If the real interest rate exceeds the real growth rate—in this scenario, rising interest payments will cause the debt ratio to rise
- b) Running a primary (non interest) deficit. If the primary deficit is zero, then to maintain a stable debt/GDP ratio, the requirement is that the nominal GDP growth rate be greater than the nominal interest rate.

The primary deficit--non-interest deficit—is measured as total revenue plus grants less expenditure excluding interest payments and can be expressed as:

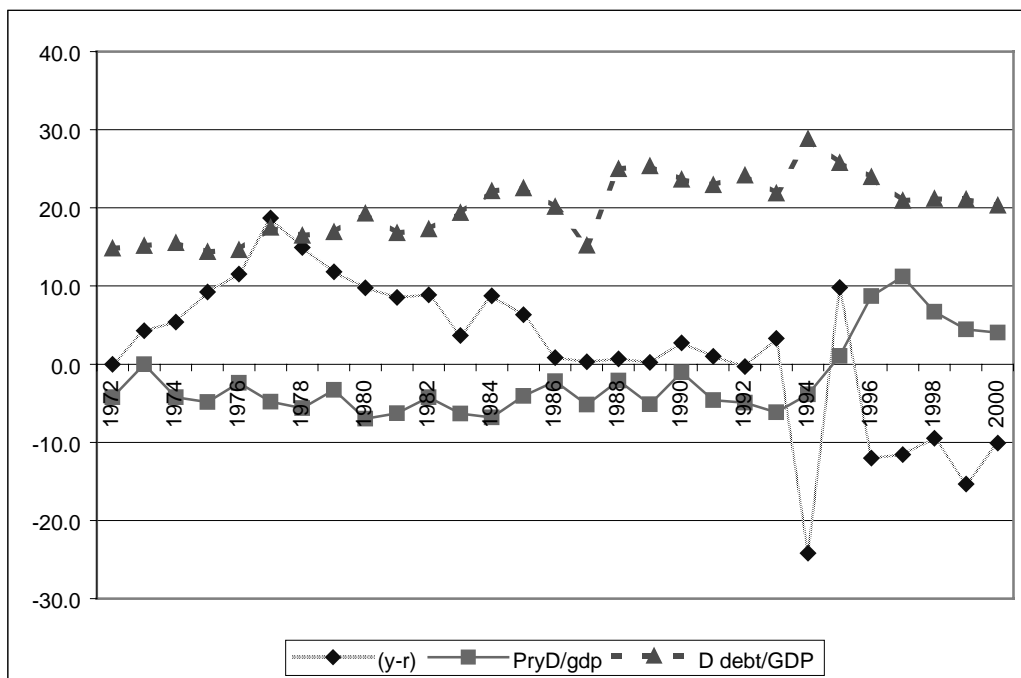
$$PD = (R_g + G_e) - (E_g - I_g)$$

This is a good policy measure used to assess the current fiscal stance and policy contribution to the growth in the stock of debt i.e. the growth of debt attributable to non-interest deficit.

For any economy, it is possible to run a primary deficit and not increase the debt to GDP ratio only if the real rate of growth of the economy exceeds the real interest rate. When the growth rate is higher than the prevailing interest rate, existing debt can be serviced by sale of new debt. Turning the coin the other side, implies that if the real interest rate exceeds the growth rate, then, to contain the debt ratio the government has to use its own resources to service debt and it is therefore necessary to run a primary surplus.

The Kenyan situation is depicted in the chart below. During the early 1970s and prior to liberalisation of the financial sector, the real growth rate was higher than the real interest rate, i.e (g-r) was positive. During this period, the government was running a deficit and expanding both investment and recurrent programs. However, this positive trend was not sustained and the growth started declining in 1978 but was not matched by a reduction in the deficit, as prudent fiscal management would dictate.

Chart 2. Government Fiscal Stance 1972-2000



Source: *Economic Survey and Statistical Abstract, Various Issues*

Following liberalisation in 1993, interest rates were freed thus sky rocketing to unprecedented levels. The situation reversed 'overnight', real growth was below real interest rates, (g-r) turned negative. This should have been a signal for a tight fiscal stance.

Taking cognisance of the unsustainable fiscal position, fiscal discipline was tightened, reflected in a primary surplus from 1996. However, as observed in other sections of this paper, the fiscal surplus was achieved through unsustainable strategies. The period of running the surplus coincided with the stand-off between Kenya and the Bretton Woods institutions during which period all aid to Kenya was frozen and the government had to result to domestic borrowing as the only option for deficit financing.

For the Kenyan scenario, it was possible to run a primary deficit during the periods when real GDP growth exceeded the real interest rate, periods prior to 1988. However, between 1988 and 1994, the growth and interest rate differential was minimal and the fiscal policy should have been tightened.

After 1995 the primary deficit turned into a surplus as a result of tight fiscal policy. This picture, however, is deceptive since the surplus was achieved through a combination of reduction of essential expenditure and enhanced revenue measures, both of which are undesirable and unsustainable in the long-term. The surplus was achieved at the expense of public investment and to the extent that the projects were not purely consumption then the surplus is unsustainable.

Some of the problems highlighted during Kenya's Public Expenditure Review exercises stem mainly from the composition and the inefficiency of public expenditure.

The concluding chapter of the Public Expenditure Review 1997 indicated the need to establish revenue and expenditure forecasts over the medium-term. "A key element of this [medium-term expenditure] strategy is the reduction in the share of public expenditure. This must be done in ways which: concentrate Government activities on a more narrowly focused range of functions; protect and better target the delivery of essential social services; and provide essential infrastructure which supports private sector growth. This, in turn, requires far reaching reforms of public sector management in order to improve productivity while reducing the size of Government" (PER, page xi).

Table 2. Debt Ratios

	Debt/GDP	Ext. Debt serv/Exptrs	Debt serv/Revenue	DebtServ/GDP	Exp/GDP	Interest/GDP	Dev Ex/GDP
1997/98	73%	17%	93%	22%	30%	6%	5%
1998/99	78%	16%	57%	13%	27%	6%	4%
1999/00	72%	20%	79%	14%	23%	4%	2%
2000/01	71%	8%	49%	10%	28%	3%	4%
2001/02	68%	13%	55%	10%	25%	4%	3%
2002/03	63%	10%	46%	9%	24%	3%	3%
2003/04	58%	9%	42%	8%	22%	3%	3%

*Source: MTEF Fiscal Strategy Paper 2001/2002 – 2003/2004*

#### *c) Debt Service to Revenue*

In the absence of debt relief, all debt must be repaid. Debt service to revenue measures the capacity of the economy to service the current debt. For Kenya, this ratio currently stands at a high 79%. This indicates that, in the absence of fresh donor inflows, 79% of government revenues would be used for debt service, leaving little room for funding of other government programs. Though measurements of debt sustainability differ, some NGO's argue that measured by debt service to revenue ratio, the sustainable level should be reduced to 20 –25%, (this ratio does not take into account domestic debt which is also major problem in highly indebted poor countries). Taking both domestic and external debt service, the ratio for Kenya is currently at 49% and is projected to fall to 42% by the year 2003/4 in the current fiscal strategy which is still well above the sustainable level.

#### *d) Other indicators*

Other indicators used to measure sustainability include external debt service to exports, which measures the ability of the economy to generate foreign currency needed to service foreign debt and interest payments to GDP. Both of these indicators seem to be stable for Kenya. Under the new HIPC initiative it is expected that debt to exports ratio in present

value terms will be reduced to a sustainable level of not more than 150 percent of exports reduced from 250% under the original initiative.

However, from Table 2 above it can be observed that in the past the proportion of interest to GDP has been higher than development expenditure as a proportion of GDP. During the PRSP/MTEF planning period, interest/GDP is projected to decline by one percentage point while Dev/GDP remains at 3% of GDP. It is clear that the main focus of the three-year projections is debt reduction. Debt service to revenue is projected to fall from 49% to 42% while debt to GDP ratio is projected to decline from 71% to 58%. Development expenditure is expected to remain constant in real terms—an indicator that there is no room to fund emerging priorities before debt is contained.

### *3.2 Impact on the Economy*

In Kenya fiscal policy is constrained by the need to service and pay public debt. Both external and domestic debt have direct implications for fiscal policy and fiscal sustainability. These effects pose a great threat to fiscal adjustment, which has been found to be the most fragile component of SAPs. In Kenya, as in many other countries in the region, domestic debt (as with external debt) has been shown to induce uncertainty and affects private investments via high interest rates. The interest rate is an important determinant in investment decisions, so high interest rates reduce profit margins and deter investment especially since retained earnings are an important source of finance.

The second impact is through taxation. Debt has to be paid and the economy has to generate the revenues to service debt through taxation. A high debt burden sends signals on the magnitude of government liability and thus the taxation expectations for debt service. High taxes are a disincentive to investment.

These factors have contributed to low investment levels, a shrinking formal sector and, by extension, a fast growing informal sector which is generally characterized by low levels of productivity.

Domestic debt acts as a distortion in the economy and has various effects which are aptly summarized in Ndung'u (forthcoming),:

- Excessive domestic debt affects interest rates and interest rate structure. Use of Government or Bank's commercial paper and which is made more attractive relative to other financial assets. Thus the term structure of interest rate cannot be used to predict economic activity or the stance of monetary policy. The yield curve is distorted. The information content of the term structure is impaired.
- Interest rates are driven by the availability of this commercial paper. This is what has happened to Kenya since April 1998. Interest rates were forced down by selling less Treasury bills at the auction.
- In most cases interest rates have to rise to make this commercial paper attractive, it compounds the capital flows problem which responds to interest rate differential (since the capital account is open). This affects the exchange rate and makes the exchange to be driven by the volatility of the capital flows.
- Affects banking sector operations and financial sector development and growth. This is because of the short-term nature of commercial paper. The financial sector is turned into a short term deposit taking and lending short term.
- If fiscal deficits persist, there is accumulation of borrowing to service the domestic debt, a Ponzi game may be played, which will reinforce rather than break the vicious circle. Borrowing domestically to service debt further deteriorates the quality of debt.
- Domestic debt cannot be defaulted, unlike external debt. This is because domestic debt is mostly held by the banking sector and default may trigger a banking crisis.

- The usual crowding-out arguments are prevalent. Perhaps this explains why private investments in Kenya have drastically slowed down.

#### **4. The PRSP Process**

##### *4.1 Poverty Reduction Strategy*

A key objective of the Government is to reduce poverty and to achieve sustainable economic growth. The poverty reduction strategy was introduced following the recognition that growth is necessary but not sufficient for poverty reduction. Therefore the need to put in place measures targeted to poverty reduction. The Interim PRSP had no pro-poor growth strategy and that this proved to be a major weakness. In order to address this weakness, the government commissioned work on Pro-Poor Growth Strategy.

. Section three outlines the macroeconomic conditions under which the PRSSP was introduced.

As a complementary activity the Government commissioned a study to map out pro-poor growth choices for the economy. The table below is reprinted from the draft report of the pro-poor growth study.

The table below shows a simulation on the level of growth required to eliminate poverty in the next 15 Years. The simulation uses different elasticity of poverty reduction with respect to growth.

Table 3

		Elasticity of Poverty Reduction with respect to Growth <sup>2</sup>						
		<b>0.3</b>	<b>0.5</b>	<b>0.7</b>	<b>0.9</b>	<b>1.1</b>	<b>1.3</b>	<b>1.5</b>
Annual Growth Rate (%)	<b>1%</b>	4%	7%	10%	13%	15%	18%	20%
	<b>2%</b>	9%	14%	19%	24%	28%	33%	37%
	<b>3%</b>	13%	20%	27%	34%	40%	45%	<b>50%</b>
	<b>4%</b>	17%	26%	35%	42%	49%	<b>55%</b>	
	<b>5%</b>	20%	32%	41%	<b>50%</b>	<b>57%</b>		
	<b>6%</b>	24%	37%	47%				
	<b>7%</b>	27%	41%	<b>53%</b>				
	<b>8%</b>	31%	46%					

Hanmer and Naschold (2000) as quoted in Ndung'u et al (forthcoming) conclude that elasticity of poverty reduction with respect to growth is around 0.3 in highly unequal economies like Kenya.

The National Poverty Eradication Plan (NPEP) outlines the goal as poverty reduction by 50% by the year 2015. When one examines the strategy to achieve the higher growth from which the dividend would be paid one comes across the old chorus without a clear strategy. Using this elasticity in the table above, it indicates that the economy needs to grow at 8% if the NPEP goal is to be achieved in the next fifteen years.

In Kenya during the periods 1990-1995 and 1995-2000, growth averaged 2.5%. If this trend continues, then poverty can only be reduced by 9-13% in the next 15 years. Clearly, unless efforts are put in place to achieve higher levels of growth, there will not be any significant reduction in poverty.

## 4.2 Funding Options

Most of the countries where the PRSP conditionality has been imposed are still struggling to provide a stable macroeconomic environment, they have witnessed a shrinking development budget portfolio, which to some extent has contributed to the rising poverty levels. The macroeconomic situation has not changed, the debt burden is high and debt service payments have tended to crowd out government investment. Levin and Ndung'u (2000) point out that, since causes of poverty are diverse, the resource requirements might be prohibitively high and may also have the moral hazard spillover of dependency. For a country with a shrinking resource basket, the PRSP/MTEF approach will not necessarily be panacea.

To the extent that poverty reduction strategies have to be mapped after a consultative process, it is an acknowledgement that, the priorities and needs of the poor have not been addressed by previous budgetary provisions, which necessarily classifies them as emerging priorities. This takes the discussion to the available funding options for the emerging priorities.

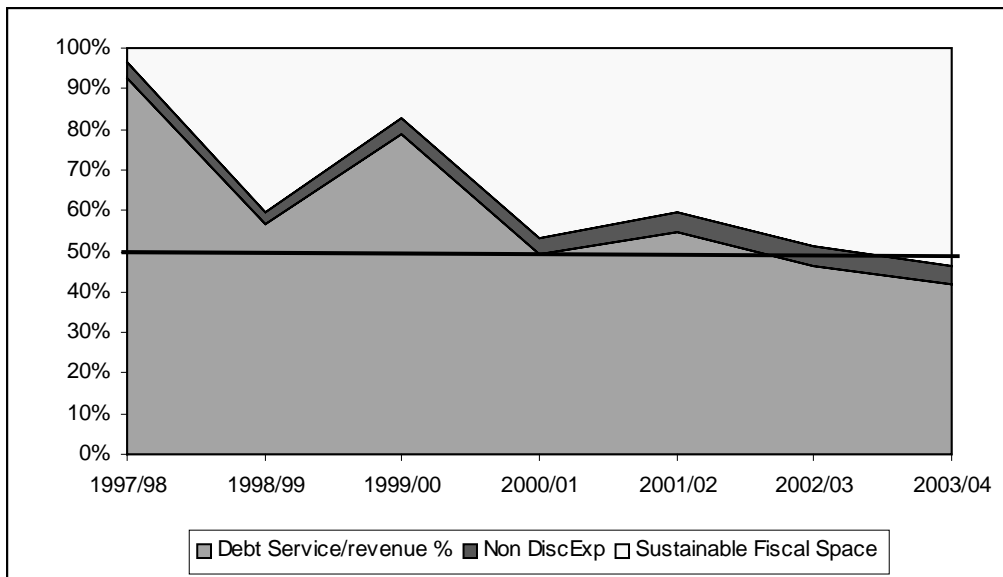
The chart below shows the debt service to revenue ratio and the balance, which I refer to as sustainable fiscal space. This is the revenue margin available after debt service to finance other government expenditure, the resources that can be generated within the economy without recourse to additional debt. This is based on projections from the Fiscal Strategy Paper.

This chart shows that unless debt service is reduced significantly, the governments' capacity to fund emerging priorities is limited, unless there is heavy donor involvement. Furthermore, the projections appear to be rather optimistic if the past is anything to go by.

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<sup>2</sup> Reprinted from Macroeconomic Policy Choices for Pro-poor Growth, Ndung'u et al (forthcoming)

Chart 3. Debt Service/Revenue



*Source: Figures derived from the Fiscal Strategy Paper 2001 -2004*

The section below evaluates the options available for funding emerging priorities identified during the PRSP process, under the current fiscal strategy.

#### *a) Grants*

Grants are the best option for funding the priorities identified in the PRSP. The experience with this type of financing has been disappointing. In most cases only 40% of the grants committed in the budget are realised.

#### *b) External Financing*

This is a good financing option for a country like Kenya where there is a huge savings gap, especially if the debt is on concessionary terms with a grace period and high grant element.

However, these resources are not always within the country's reach and given the poor performance in reforms, external flows to Kenya have been dwindling. Kenya has factored donor funds in the budget but, as a result of failure to meet conditionality, the aid does not get disbursed. External financing has therefore contributed to uncertainty in the resource allocation process.

*c) Higher Taxes*

Alesina and Peroti (1996) as quoted in Easterly (1997)<sup>3</sup> argue that whether a government can sustain fiscal adjustment depends on the composition of that adjustment, adjustments that rely upon tax increases and cuts in public investment are unlikely to last.

Kenya's tax/GDP ratio is high by developing country standards, there is no scope for higher taxation, the country has reached the internationally recommended tax/GDP ratio—about 22% of GDP-- and any further increases would be a disincentive to much needed investment therefore detrimental to growth. Furthermore, tax reforms point to lower broad based taxes. For Kenya, the dismal performance in growth has resulted in a shrinking formal sector, and an erosion of the tax base, as the informal sector expands. The only options available in domestic resource mobilisation are through enhanced administration and compliance measures and this too can be elusive when there is no commensurate provision of public services.

*d) Domestic Debt*

A second option is to issue domestic debt. To the extent that domestic debt crowds out the private sector, distorts the financial markets, hampering deepening the sector, puts upward pressure on interest rates and reduces efficiency of the financial sector then it

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<sup>3</sup> Background paper for the Public Expenditure Review 1997

exacerbates poverty, issuing more domestic debt would therefore be countering the poverty reduction strategy.

Domestic debt in Kenya has reached unsustainable levels and for that the reason, the government has been looking for solutions to reduce the domestic debt, which has impacted negatively on growth. Furthermore domestic debt is of short maturity and cannot be used to finance long-term investment. The only option would have to be alternative long-term instruments, which currently are not available in the Kenyan market, and only after the current level of debt has been reduced.

#### *4.3) Improving the Quality and Composition of Government Expenditure*

It is important to note that in evaluating the contribution of government expenditure to growth, it is the composition of expenditure—not even the recurrent and capital classification—rather than the level that matters. As noted in the PER exercises, the current mix is by no means optimal.

However, changing the composition of government expenditure by shifting resources from defence, general administration wage bill and transfers to areas that would have an impact on poverty reduction such as primary health care, education, infrastructure and water supplies this can only be achieved if the core functions of government are well defined. Unless the economy is growing there is little room for manoeuvre at the margin.

Compounding the composition problem is inefficiency, as noted in PER 1997, even the amounts appropriately allocated to development spending do not translate into capital formation. Easterly (1997) observes that “it is clear that each shilling of investment spending has not translated into a shilling worth of productive capital due to inefficiencies and because several projects are left incomplete”. Increasing the efficiency of public expenditure is an option that needs to be aggressively pursued before increasing spending levels.

## Box 1. Excerpt from PRSP Fact Sheet 2

1. The consultative process will involve more Kenyans in the planning of activities that affect them. It is a paradigm shift from top-down planning to bottom-up planning. The focus will be in the districts taking advantage of such established development structures at the district level in line with community participation.
2. The consultative process will help ensure that development of the PRSP steer the effort against poverty away from the path of failed projects implemented in the name of assisting the poor, which even though well intentioned still fall short

The consultative process necessarily enhances awareness and increases expectations of the stakeholders. Though it is a good thing, it might be an exercise in futility in a country like Kenya that has a tight budget constraint and, unless the debt burden is eliminated, the country is not likely to have the additional resources necessary to fund emerging priorities. In any case SAPs were introduced to restore fiscal discipline and contain expenditure within manageable levels. Cost sharing was introduced in the social sector—in health and education—which has compounded poverty problems.

The priorities of the PRSP are to be funded through the Medium Term Expenditure Framework, (MTEF), budget. The strategy behind the MTEF budget is outlined in the Fiscal Strategy Paper, FSP 2001/2002 – 2003/2004. Box 2 below outlines specific objectives in the FSP, which shows that there is no scope for funding expanded government programmes, except through additional concessional external finance (*the main factor driving the PRSP process*), until domestic debt is reduced. The main focus is to reduce domestic debt by running a primary surplus and reduce the relative share of public expenditure to GDP. These objectives are familiar and echo policy agenda for the last decade.

Levin and Ndung'u (2000) using GCE models to analyze the impact of external aid found that too much aid in the initial stages in the reform process might be harmful but when the reform process has stabilised aid would be supportive. This points to a danger if too much aid is sourced yet it is the only source of financing. On the other hand, failure by the government to meet the stakeholders expectations will create disenchantment with the whole process and it therefore becomes essential to get the basics right.

#### Box 2. Objectives of the Fiscal Strategy 2001/2002 – 2003/2004

1. Allow the share of aggregate expenditure relative to GDP to decline over time.
2. Ensure the gradual reduction in the amount of debt by running a current surplus & attracting additional concessionary external finance, since this, by relieving pressure on the capital market, will reduce average interest rates.
3. Ensure expenditure is properly targeted at national development objectives and that those objectives are achieved in an efficient manner.
4. Ensure adherence to a prudent fiscal policy which will achieve a low and stable domestic price level.

In Kenya when the process was started, all systems stopped and all focus was on the consultative process. Rather little attention was paid to the measures that need to be put in place to ensure that growth can be achieved. Though there were some donors who took initiatives and undertook studies in this area, they do not seem to have been embraced by the key policy makers<sup>4</sup> for implementation.

Fishlow<sup>5</sup> argues that that the right level of indebtedness is embedded in the right development strategy. External financing closes the domestic savings gap, finances public sector deficits and the foreign exchange gap. However, debt increases the vulnerability of an economy and in the long-term, more sustainable options should be pursued. Measures that would increase domestic savings through efficient internal capital

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<sup>4</sup> DFID funded a Pro—Poor Growth Study for Kenya, SIDA also funded a similar study but is not clear if they will translate to policy initiatives.

and financial markets; lower interest rates; increased export supply capacity through competitiveness to resume growth of agricultural production and domestic industries.

#### *4.4 Plausibility of the PRSP Process*

In finalising the PRSP 2001, the problems cited as the bottlenecks to the implementation of the Interim PRSP include:

- The severe drought which affected electricity and water supplies which negatively impacted on all sectors of the economy
- The delays in disbursement of donor funds affected the implementation progress of donor funded projects and programs
- The reduction of the resource envelope for some spending categories by about 50% half way through the year.

The problems cited above are typical—external shocks, fluctuations in external flows and variability in domestic resources—and will continue to haunt policy makers until the economy can achieve and sustain high levels of growth.

The PRSP observes that though one year is too short to evaluate performance, nevertheless the growth enhancement objectives were not met while the outcome of poverty reduction efforts has been less than satisfactory.

Another shortcoming in the introduction of the process in Kenya is that some useful stages were left out of the budget process; the Project Investment Appraisal, (PIP), for instance has been omitted from the budget process. The PIP was useful in prioritisation of capital projects for inclusion in the budget. The interfacing of the development plan and the PRSP/MTEF is also not clear. The PER, which is useful in identifying implementation constraints, has not been undertaken for three years.

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<sup>5</sup> Chapter 9 in Dornbush and Helmers: EDI series in Economic Development

Kenya has proved to be more efficient at articulating policy reforms than implementing them.<sup>6</sup> The formulation of the PRSP will provide another opportunity for the production of a articulate policy document while all odds are against its implementation, i.e unless the basics or sequencing are taken into consideration.

Some of the benefits of the PRSP are cited as ownership and monitoring by stakeholders at the grass-root level. Following this assertion some of the questions that arise include: what will the stakeholders monitor in the absence of quantifiable targets? As it is, the current budget documents can only be understood by those who formulate the budget; it is also not possible , in the current format, to track the priorities they identified in the budget documents in measurable outputs, though they maybe specified in the PRSP documents. In the absence of a well-defined system to deal with corruption cases, then what will happen to corrupt managers?

One of the criticisms levelled at the PRSP approach is that though it is very clear on the goals of poverty reduction, (promoting opportunity , facilitating empowerment and enhancing security), the strategy is silent on the policy options available. There is also a recognition that in the short-term, the focus should be on reversing the trend depicted above, while poverty reduction strategy should be of a more long term nature.

Investigating the growth-poverty relationship, Dollar and Kraay (2000) found standard macro-pro growth policies—reducing government consumption, stabilizing inflation, macro stability, openness to trade and secure property rights—to be good for the poor. They conclude that such policies raise mean incomes without significant adverse effect on the distribution of income.

I will therefore propose here what I perceive as the appropriate order of introducing a PRSP process, if it is to achieve intended results:

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<sup>6</sup> See Ryan and O'Brien page 34

- Resolve the debt problems, both domestic and external. Domestic debt reflects the high involvement of the government in the credit market, the government resorts to domestic deficit financing when external financing cannot be sourced. Once the debt problem is resolved, this frees up resources to finance government investment in a sustainable manner.
- Develop a long-term growth strategy, this may be in the form of a development plan that takes into account resource constraints.
- Put in place measures to increase the efficiency of government expenditure. This can be done through the development of performance indicators. This is necessarily a long process but if the grass-root monitoring is to be achieved, there must be measurable or quantifiable performance indicators. Institutional strengthening should be done in tandem with the development of indicators. This is critical before the movement to managerial autonomy; give managers autonomy and make them accountable. This would necessarily involve changing the budget documents to a format that can be understood by those who are expected to monitor performance. There is consensus that those countries that qualify for debt relief will have some fiscal space to increase social expenditures and poverty reduction initiatives, however for the initiative to truly have an impact on poverty, the resources have to be utilized efficiently and effectively. The efficiency of government expenditure is therefore a necessary condition for PRSP to be an effective strategy. Bullet 2 in box 1 above is an acknowledgement that, in the past, programs and projects have been funded but failed.
- Create an efficient system to deal with corruption cases. This is the only way that monitoring can achieve expected benefits. Action must be taken against managers who do not deliver or divert resource from the intended purpose.
- Clearly define the core functions of government—this would help draw the line between what the government should do and how it should do it. In addition, disengagement of the government from non essential services would free up resources for reallocation to social spending.
- Embark on a full consultative process. It is expected that with debt problems solved, freeing resources for government investment, with some positive growth

achieved, then the time is appropriate to consult the stakeholders and make them part of the process

The rationale behind the proposed sequencing is that growth is a necessary—though not sufficient—condition for poverty reduction. The reduced involvement of the government in the domestic credit market would free resources for private sector and a combination of higher government investment and higher efficiency would have a crowding in effect on private investment that is necessary to get growth going. An increase in private investment would create a vibrant formal sector, improve employment opportunities in the sector where profitability is higher.

In a country where government investment (or lack of it) has not crowded in private investment, then the government has to play a lead role in stimulating growth before the private sector can respond to government initiatives. Yet as can be observed in the debt service to revenue ratio, the government has no fiscal space to increase expenditure to infrastructure unless there is a heavy donor commitment.

## **5. Concluding Remarks**

Though Kenya does not qualify for debt relief, one of the options that can be pursued is the sale of domestic debt to donors. Over 70% of interest payments are for domestic debt though the stock of domestic debt is only 35% of total debt.

From the foregoing, it would appear that though the country embarked on a country-wide consultative process, the macroeconomic environment, and specifically the fiscal position of the government does not have the scope to fund programs identified as priorities in the PRSP. Debt service payments--especially domestic interest payments-- take up a lot of fiscal space that would otherwise be used to fund emerging poverty reduction programs.

In addition, inefficient use of resources needs to be aggressively pursued if poverty reduction initiatives through public expenditures are to achieve desired results.

Finally and perhaps most important, positive real growth has to be achieved and sustained for a reasonable period of time if the PRSP initiatives are to make a dent on poverty reduction.

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Annex 1. Tracing Kenya's Growth Path 1980 - 2000

