



# AN ANALYSIS ON THE LINK BETWEEN PUBLIC DEBT AND DOMESTIC REVENUE MOBILIZATION (DRM) WITHIN THE EAC

Policy Brief



SEATINIUganda

## Introduction

Countries in the East African Community (EAC) have continued to witness an escalating debt situation that has now been worsened by the COVID-19 driven crisis. Even before the pandemic, EAC countries had already accumulated public debts to a tune of 110 Billion USD<sup>1</sup>. As a result, of the shrinking domestic revenues arising from low economic activity, these countries have now resorted to borrowing as the only available alternative to finance their budgets. As a consequence, the region's public debt has now soared to 120 billion with individual country debt levels already threatening to breach the agreed upon thresholds of 50 percent of respective country GDPs. It remains key to note that the rising public debt remains a key threat to the region's Domestic Revenue Mobilization efforts and consequent fiscal sustainability.

This policy brief is therefore going to unveil the interlinkages between public debt and domestic revenue mobilization within the EAC region. The brief aims to uncover the vicious cycle between weak DRM efforts and the surging public debt. It unwraps the implications of the weak DRM efforts on the region's public debt on the one hand while on the other, the analysis uncovers how the surge in public debt has in turn impacted Domestic Revenue Mobilization. The policy brief then provides some concrete proposals on how EAC governments can ensure prudent debt management and also strengthen their Domestic Revenue Mobilization.

## A summary of the Public Debt and DRM Status within the EAC

### Background

Public debt remains an essential source of financing for public investments. When utilized appropriately, public debt can foster economic growth by bridging financing gaps and funding development agendas in a country.

Most countries across the world borrow funds to meet their financing needs and close budget deficits. Simply put, public debt or sovereign debt can be described as money a country borrows from both local and external lenders to augment revenue from taxation for purposes of financing public spending. Both domestic and external debt constitute government debt. Domestic debt includes funds raised through financial assets such as Treasury bills and bonds and money borrowed from other locally owned financial institutions. Similarly, external debt can be from bilateral, multilateral or commercial sources. Bilateral sources include government to government while multilateral sources include government to a conglomeration of countries or agencies that have created a pool of resources from which they lend. Multilateral debt can be sourced from financial institutions such as the IMF, African Development Bank and the World Bank among other Institutions (Polly, 2009).

### Public debt status within the EAC

The East African Community region is witnessing a rise in the public debt burden with member countries' appetite for borrowing not seeming to settle any sooner. As of October 2020, according to the World Economic Outlook database (WEO October, 2020)<sup>2</sup> the region was marred in debts to a tune of 120 billion USD. Kenya took the largest share of the region's debt standing at 66.2 billion USD followed by Tanzania with public debt stock to a tune of 24.6 billion USD; Uganda came in third place with a debt stock of \$17.3 billion and lastly was Rwanda (\$6.1 billion); South Sudan (\$4 billion) and Burundi (\$2 billion).

It is worth noting that the region's public debt indicators are now in the red with some countries already in breach of the maximum debt thresholds agreed upon under the region's macro-economic convergence criteria.

<sup>1</sup> <https://www.monitor.co.ug/uganda/news/national/covid-19-leaves-eac-states-in-2-3b-debt-hole-in-three-months-1890578>

<sup>2</sup> <https://www.imf.org/en/Publications/WEO/weo-database/2020/October/select-country-group>

EAC countries while signing the monetary union protocol in 2013 agreed to a debt thresholds of 50 percent of GDP. However, as of October 2020, Kenya's public debt to GDP ratio stood at 66 percent way above thresholds that were agreed upon with other EAC countries. The same is to be said for Burundi (65 %); and Rwanda (61 %) and Uganda whose debt levels are threatening to cross the 50 percent mark by the end of the financial 2020/21. Of all the EAC countries, Tanzania has the lowest debt to GDP ratio that stands at 38 percent.

The economic fallout arising from the COVID-19 crisis has worsened the region's debt sustainability with EAC countries now piling on larger debts in a move to fill up the fiscal gap within their budgets. Kenya has taken the lead once again acquiring loans to a tune of 1.5 billion<sup>3</sup> USD. Uganda has taken a similar route by borrowing to a tune of 889 million dollars<sup>4</sup> from the IMF, World Bank and the African development bank and other bilateral lender

A number of factors can be attributed to the rising unsustainable debts within the region. These include but are not limited to the changing debt landscape characterized by the declining concessional finance that was traditionally received from multilateral lenders such as the International Monetary Fund, World Bank and other bilateral lenders such as the Paris Club. EAC countries are now increasingly relying on new non-concessional forms of finance. These have taken the form of Eurobonds from large investment banks; Public Private Partnerships that are creating hidden liabilities off the Governments' balance sheets; domestic borrowing from the local financial markets; and collateralized loans owed largely to China to fund infrastructural projects. Such loans to China place these countries at risk of losing critical assets and resources in cases where they fail to raise the revenues needed to pay off these loans.

The same can be said for the increased securitized loans from the Eurobond and domestic debt markets. These come at very high rates such as 15 percent for Uganda's case.

### **The policy frameworks on debt in the EAC**

Medium-term debt management strategies have been established across all the EAC countries to manage the levels and composition of public debt with South Sudan being the exception. However, they remain ineffective due to poor implementation and lack of political goodwill<sup>5</sup>. EAC countries have also set forth provisions on public debt management within their respective Public Financial Management Acts. These Acts have set out guiding terms on the process of borrowing; borrowing limits; approval by national parliaments; terms on foreign borrowing; debt service; reporting on loans and grants among others. Such policy frameworks have played a critical role in enhancing public debt management within the region but have still fallen short in curbing the surging public debts within member states. A key illustration has been the continuous amendments made to these laws to allow for countries to push their borrowing limits much further. Kenya as an example raised her borrowing limits to KShs.6 trillion in 2019 breaking the peg off her GDP levels. Just 14 months later, the Treasury has again fronted new proposals to have this ceiling raised further to KShs.9 trillion<sup>6</sup> to allow for more headroom to borrow billions to finance the coming budget for FY 2021/22.

At the regional level, EAC countries have also signed the monetary union protocol that sets forth key convergence criteria on a number of macroeconomic variables including debt and government revenues. Under this protocol EAC countries have agreed to maintain their debt levels below a ceiling of 50 percent of their GDPs.

<sup>3</sup> <https://www.monitor.co.ug/uganda/news/national/covid-19-leaves-eac-states-in-2-3b-debt-hole-in-three-months-1890578>

<sup>4</sup> AFRODAD report on: COVID-19 Debt Sustainability Impacts and Economic Rescue Packages in the EAC

<sup>5</sup> Study by the East African Tax and Governance Network and the Africa Centre for People Institutions and Society: Framing the Linkages between Public Debt and Tax Justice

<sup>6</sup> <https://www.reuters.com/article/kenya-debt-idAFL1N2K10K8>

## Current DRM status within the EAC

Domestic revenue are collected to finance government budget and support government led initiatives aimed at providing public utilities to its citizens. The concept of Domestic Revenue Mobilization includes all types of taxes and fees levied and collected by a government (through its institutions, both local and national) to finance its operations and development programmes. DRM plays a vital role in society in every country, redistributing wealth from corporations and rich individuals, funding vital public services and tackling poverty. According to a study by the East African Tax and Governance Network (EATGN) in partnership with the Africa Centre for People Institutions and Society (ACEPIS)<sup>7</sup>, COVID-19 has contracted revenue collection within the region as most workers have been laid off, purchases have reduced, and exports and import have either been delayed or stopped. For instance, Covid-19 led to the introduction measures meant to prevent the spread of the virus, including testing and waiting for the test results for truck drivers hence raising the non-tariff barriers<sup>8</sup>. In essence, this made transportation of goods difficult across the region. The effect of this was reduced national revenues in the short term as the effects of the virus continues. Furthermore, some governments such as Kenya did reduce tax rates during the COVID-19 period and this has had huge consequences on individual country budgets whose huge portion is supplemented with the country's revenue collection. To counter this, countries have had to find other innovative ways of increasing tax base and also created additional taxes to increase the amount of revenue collected.

According to the EATGN study, it therefore remains worth noting that in the last half decade, tax rates

across the EAC have remained largely the same for top revenue earners except for Kenya that has

temporarily reduced Income, Corporation and Value Added tax during the COVID-19 period. Generally, tax rates in Kenya are lower in comparison to its peers in the EAC before and during the COVID-19 period. This may have created incentives for investors who have opted for Kenya as a good destination for investment as opposed to its peers hence boosting revenue collection.

Revenue collection across the region has improved significantly in the past decade with high increase being seen in income and VAT. Data from the study reveals that between 2009 and 2017 individual country revenue collection across the EAC increased by over 180%. Highest increase during this period was recorded by Tanzania having increased by 233%. Kenya revenue collection increased by 188% while Rwanda and Uganda have increased by 210% and 232%. According to Organization for Economic Cooperation and Development (OECD), the bulk of the total revenue collected are from income taxes, VAT and custom duty in all the five EAC countries under review. VAT and income taxes form at least 50% of the total revenue collected each year. It is important to note that general increase in tax revenue has also been contributed by other taxes such rental income tax, import and export duty and other excise taxes that have also increased during the period under review. The increase in tax revenue collection has been attributed to tougher tax legislation across the EAC, increased tax base and increased awareness of the importance of taxation amongst the public. However even with the improvement, all the EAC countries have consistently missed the revenue targets in the last half decade putting increased scrutiny on the revenue collection agencies and the tax policies being advanced in the region.

<sup>7</sup> Study by the East African Tax and Governance Network and the Africa Centre for People Institutions and Society: Framing the Linkages between Public Debt and Tax Justice

<sup>8</sup> <https://www.monitor.co.ug/uganda/oped/commentary/covid-19-hits-eac-trade-hard-1922416>

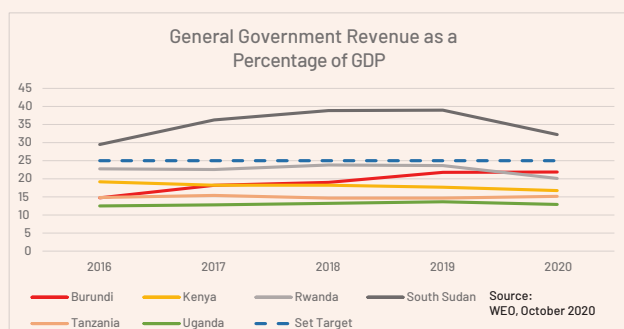
## The Links Between public debt and Domestic Revenue Mobilization within the EAC

This section unveils the linkages between public debt and Domestic Revenue Mobilization within the EAC. Focus has been placed on the implications of the weak DRM efforts on the region's public debt on the one hand while on the other, the analysis uncovers how the surge in public debt has in turn impacted Domestic Revenue Mobilization.

### Weak domestic revenue mobilization, a reason for the increased borrowing

In 2013, EAC countries while signing the monetary union protocol agreed on certain targets to be met with regard to their respective tax revenue to GDP ratios if these countries were to achieve a monetary union by 2024. The set targets for the tax revenue to GDP ratio was 25 percent. However, over the period, these countries have still failed to meet the agreed on targets. As can be shown in the chart below, none of the EAC countries has met the set revenue targets in any of the years considered with South Sudan being the only exception given its large oil revenues. Worse more, Government expenditures and the corresponding national budgets have kept widening over the same period with domestic revenues failing to match up to these huge budgets.

Figure 4: General Government Revenue as a Percentage of GDP



Source: World Economic Outlook Database, October 2020

The weak revenue mobilization has been due to several reasons. These countries face the dual challenge of a lack of modern infrastructure, such as IT systems and property registers, and weak capacity in tax authorities due to shortage of skilled staff. Other reasons have included the continued non-tax compliance, large informal sectors, and weak economies. Public borrowing has therefore remained the only way out of this predicament with Governments now seeking loans to finance large supplementary budgets in a bid to fill up the deficit in financing

### IFFs and Harmful tax practices, a key cause for the rising debt

As has remained evident in many cases, EAC countries have effectively signed away their rights to tax multinational companies operating within their jurisdictions through several bilateral tax agreements. Aggregate estimates of the scale of the problem are not available but some country assessments are indicative of the problem. In the same vein, these countries have also registered major tax losses from aggressive tax planning and avoidance by large multinationals. Such enterprises have eroded the region's tax base through unfair tactics such as transfer mis-pricing. According to a study by SEATINI on double taxation treaties, it is generally estimated that countries across Africa are losing \$50-60 billion every year to illicit financial flows, with two-thirds of this being lost to manipulation of commercial transactions.<sup>9</sup>

Some EAC countries have also remained notoriously unwilling to cut down on tax exemptions to foreign multinationals. This has been the case despite concerns raised that such measures are not key determinants of Foreign Direct Investments with a study conducted by Tax Justice Network Africa (TJNA) and Action Aid in 2012 indicating that Kenya, Uganda, Tanzania and Rwanda were losing up to

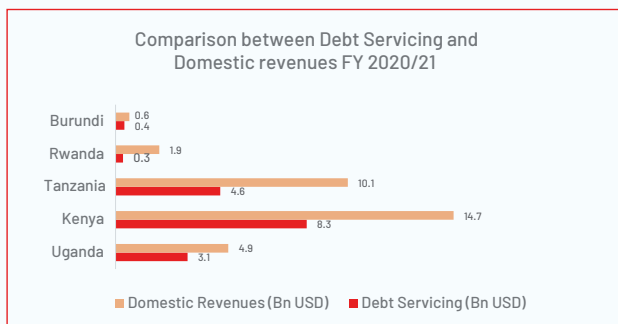
9 <https://seatiniuganda.org/download/double-taxation-treaties-in-uganda-impact-and-policy-implications/>

US\$2.8 billion a year in total from tax incentives and exemptions<sup>10</sup>. All such practices have created huge outflows of resources that are much needed back home and have thus pushed the Government to pursue external loans.

### Huge debt servicing taking up a large chunk of mobilized domestic revenues

As a result of the high costs of the debt acquired, EAC countries have continued to witness a large share of their mobilized domestic revenues being paid off to domestic and external creditors. Uganda and Burundi have taken the lead with 64 percent of their generated revenues for the FY 2020/21 being spent to clear debt obligations. Kenya has followed suit spending 57 percent of her domestic revenues while Tanzania incurred 45 percent. Of the 5 economies, Rwanda has been the only country with a lower debt servicing ratio standing at 17 percent of domestic revenues. It is worth mentioning that this huge debt repayment expenditure takes up a large chunk of the domestic revenues necessary to provide infrastructure and other crucial services to citizens. The huge cost curtails further Governments' ability to mobilize future domestic revenues as Government expenditures are diverted from productive sectors that would have boosted revenue collections. Below is a chart that elaborates further on the proportion of domestic revenues going towards debt servicing.

Figure 1: Comparison between Debt Servicing and Domestic Revenues FY 2020/21



10 <https://uganda.actionaid.org/publications/2012/tax-competition-east-africa-race-bottom>

11 Economic sustainability in East Africa; Framing the linkages between public debt and tax justice. By East African Tax Governance Network (EATGN) and Africa Centre for People Institutions and Society (Acepis)

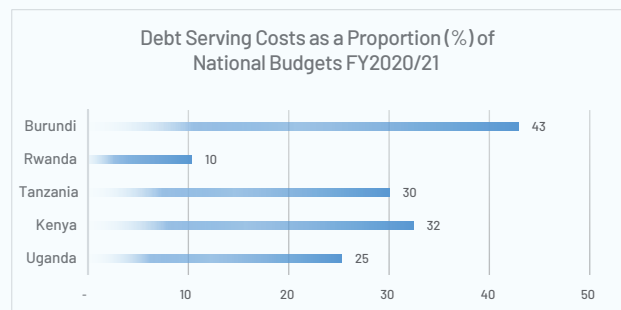
12 <https://african.business/2019/04/economy/african-governments-must-widen-the-tax-base/>

Source: Respective national budgets for the EAC countries for FY 2020/21

### Rising debt costs, a cause for the decreased concern on the effect of regressive taxes

As earlier indicated, EAC countries have continued to witness rising public debts over the decade. This has been accompanied by a subsequent rise in the costs of servicing these debts with an average of 28 percent of the region's national budgets being spent on debt servicing.

Figure 2: Debt Servicing Costs as a Proportion (%) of National Budgets FY2020/21



Source: Respective national budgets for the EAC countries for FY 2020/21

With Governments struggling to pay off debts owed to their creditors, rather than broadening the tax base by providing enticements for formalization of businesses, EAC governments have resorted to digging deeper into the pockets of the average citizens by levying more consumption based taxes. Such taxes have included VAT and excise duty. A case in point, Uganda's tax system has been considered largely regressive given its high reliance on the above mentioned taxes as they now constitute about two thirds<sup>11</sup> of the country's total revenue. For example, in July 2018, the country introduced a social media tax and a 1% levy on all mobile money transactions, which affected about 5M people<sup>12</sup>. This led to a substantial decline in internet subscriptions and the value of mobile money transactions fell by \$1.2m in the three

months following the imposition of the tax.

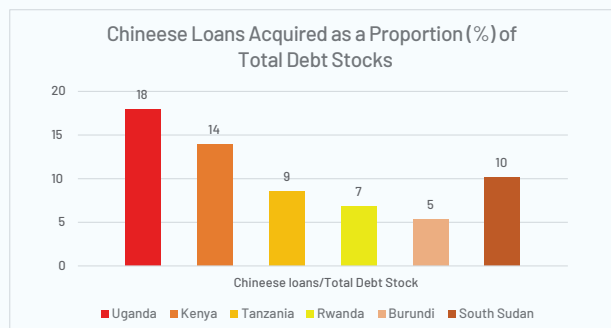
Whilst many countries have resorted to imposing new regressive taxes and raising the tax rates in order to pay off their debt obligations, it is the citizens especially the most vulnerable and the marginalized who have remained affected the most by these government decisions. The tax policy paths taken in response to rising debt obligations have proven to work against the poor citizens who are already leaving on less than \$1.9 US dollars a day. This points to the unfairness in the debt repayment strategy for many East African countries.

### **Ability to borrow easy money creates false comfort and kills innovativeness in improving tax regimes and policies.**

With the rise in private lenders such as China and other BRICS institutions; the Eurobond markets; and the growth in domestic debt markets, Governments now have much easier access to loan markets without having to bear with new conditions as were normally imposed by traditional lenders. For the case of Uganda, the Government has now shifted much of her budget financing efforts to domestic debt markets with the country having borrowed to a sum of about 6.3 billion USD as of December 2020 from the local financial markets and commercial banks according to reports<sup>13</sup> from the Ministry of Finance. In the same fashion, the country has joined Kenya and other regional partners to acquire easy loans from China by borrowing to a tune of about \$3.1 billion USD to finance her large infrastructural projects. Data from the China Africa Research Initiative<sup>14</sup> indicates that as of 2019, Kenya's debt owed to China stood at \$9.2 billion accounting for the largest loan share from China within the region.

Uganda came in second and was followed by Tanzania (\$2.1 billion), Rwanda (\$415 million); South Sudan(\$407 million)and lastly Burundi(\$107million).

**Figure 3: Chinese Loans Acquired as a Proportion (%) of Total Debt Stocks**



Source: Data from the China Africa Research Initiative

In the same vain, Kenya and Rwanda have taken a step further down uncertain route to acquire loans from large investment banks under the Eurobond markets to tunes of about 6.4 billion<sup>15</sup> USD and 400 million<sup>16</sup> USD respectively. Worth noting that the East African giant (Kenya) plans to borrow an additional 2 billion dollars from the Eurobonds market over the next 18 months starting the FY 2021/22. Such quick loans pose major future debt sustainability challenges to these countries. Worse more, they have now led to false comfort within

Government institutions and consequently killed their innovativeness in improving tax regimes and policies. Governments have now witnessed a weaker urge to widen their tax base and formalize economies. The effect is that a large proportion of the region's economy has remained under the informal sector. Such easy loans have also left Governments reluctant to cut down on tax exemptions except for Tanzania which has made major strides over the previous years to cut down and even terminate many of the tax exemptions earlier offered to large multinationals.

<sup>13</sup><https://www.finance.go.ug/publication/report-public-debt-guarantees-other-financial-liabilities-and-grants-financial-year-0>

<sup>14</sup> <https://chinaafricaloandata.bu.edu/>

<sup>15</sup> <https://www.businessdailyafrica.com/bd/economy/kenya-plans-another-sh780-billion-in-fresh-eurobonds-3353240>

<sup>16</sup> <https://www.fitchratings.com/research/sovereigns/fitch-affirms-rwanda-at-b-outlook-stable-25-08-2020>

## Conclusion and Recommendations.

### Conclusion

From the above linkages, it therefore remains critical to note that a rising public debt burden has several negative implications on the region's DRM efforts. In the same vein, the region's failure to curb domestic revenue leakages such as IFFs and tax exemptions has remained a key driver for her increased borrowing and consequent unsustainable debts. It therefore remains critical for tax payers to check that their Governments engage in prudent debt management and undertake further measures to curb all revenue leakages.

### Recommendations

- Governments need to rely more on concessional loans and grants rather than on expensive private loans from the Eurobond and domestic debt markets. National parliaments should maintain caution on the rates of return they are accepting to pay while approving loans from private lenders.
- The World Bank and IMF need to adopt a human-rights based approach for assessing individual countries' debt sustainability within the region with more consideration to the human rights impacts of the rising debt servicing costs. DP
- Need for increased scrutiny by legislators and civil society actors on the region's increased borrowing from China and other BRICS institutions so as to address transparency concerns and other likely implications.
- Taxbodies within the EAC should take necessary measures to strengthen their domestic tax systems and address all resources leakages including illicit financial flows, tax evasion, double tax agreements and unnecessary tax exemptions.
- The EAC and EALA secretariat need to play a stronger oversight role on member states 'conformity to the agreed upon convergence criteria within the monetary union protocol on debt and revenue thresholds.
- Governments should direct more of their loan resources towards the real economy such as irrigation schemes or local manufacturing plants as these have the capacity to drive household incomes while at the same time generate the needed tax revenues to service debts.
- Civil society organizations and media institutions should play a closer role in tracking utilization of public loans within the region by conducting debt audit campaigns and strengthened investigative journalism.



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