THE EFFECTS OF THE EAST AFRICAN MONETARY INTEGRATION ON COUNTY FINANCING IN KENYA: POLICY ADVICE FOR KENYA

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Abstract

The purpose of this thesis is to form a county financing structure in Kenya that enables county borrowing in the cheapest, most risk-averse manner with respect to the upcoming East African Monetary Union. The research question is therefore: Considerate of the East African Monetary Union, what fiscal policies can Kenya pursue at the East African Community to safeguard the optimal structure of county financing in Kenya? This thesis deduces through process of elimination and reference to other countries a method of county financing that minimizes costs and risk. This thesis then analyzes the East African Community with economic theory on regional integration. The limitations of economic theory are illuminated and alternatives are presented. Through analyzing what the European Union did when forming a monetary union, this thesis formulates a way of harmonizing county borrowing in Kenya with a proposed EAC fiscal policy that ensures economic stability within the region. This thesis appreciates the relative limitations that the East African Community may have on county financing but proposes a structure that instead ensures macroeconomic stability.

Acknowledgements

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List of Acronyms

EAC – East African Community

KCB – Kenya County Bank

EU – European Union

USD – United States Dollars

Ksh – Kenyan Shillings

EALC – East African Legislative Assembly

SWOT – Strengths, Weaknesses, Opportunities and Threats

INCA - Infrastructure Finance Corporation

TNDUF - Tamil Nadu Urban Development Fund

LGUGC - Local Government Unit Guarantee Corporation

Introduction

The East African Community is working towards a monetary union that will result in a common currency for Kenya, Uganda, Tanzania, Rwanda and Burundi. The monetary union is part of a larger plan to integrate along economic and socio-political lines, closely shadowing the European Union.

On the other hand, Kenya adopted a new governance structure with the promulgation of a new constitution in 2010. Under the new system of governance, the country has devolved and created 47 autonomous regions called counties. Counties are keen on developing independently and have the constitutional right to borrow money for county initiatives.

This thesis creates a link between these two issues. This thesis will fill a gap in past research as the two topics have been extensively studied independently, but never merged. This thesis explains the link between the East African Monetary Union and the issue of county borrowing in Kenya's devolved political structure.

As Kenya submits partial sovereignty to the EAC in line with integration, Kenya also delegates responsibilities to counties. The national government of Kenya has therefore surrendered powers to both the EAC and counties, both of which have the potential to be disruptive if broad macroeconomic plans are not harmonized.

This thesis formulates a structure of regulating counties' borrowing that enables counties to borrow funds at the cheapest rate possible while minimizing default risk. The structure formulated particularly avoids a disruptive situation whereby the counties have borrowed money to develop at the expense of the national government. Therefore, the aim of this thesis is to develop an optimal county financing structure for Kenya and propose fiscal policy that Kenya can advocate for at the EAC. This thesis will illustrate a way in which Kenya can abide by the proposed macroeconomic rules of the EAC while at the same time providing counties – out of a regulatory framework for borrowing – the freedom to develop.

In order to build a county borrowing structure that the Kenyan government can adopt, this thesis will assess the strengths and weaknesses of similar structures in other countries. This thesis analyses economic theory on regional integration and monetary unions, particularly referencing work by Paul De Grauwe and Robert Mundell and using economic reports on the EAC integration. This thesis will then propose a number of policies for the Kenyan government and for the EAC that ensure macroeconomic stability.

Chapter 1 of this thesis gives a background on political and economic developments in reference to the issues raised in this thesis. Chapter 2 discusses sub-sovereign financing and formulates a county financing structure for Kenya. Chapter 3 applies monetary union and public finance economic theory to Kenya in the context of East Africa, and chapter 4 merges the ideas presented in chapter 2 and chapter 3, offering a blueprint for county development in Kenya within the context of the EAC.

Chapter 1: The East African Community and Devolution in Kenya

1.1 Brief history of the East African Community

The East African Community (EAC) consists of five countries namely Kenya, Uganda, Rwanda, Burundi and Tanzania. The initial members of the community were Kenya, Uganda and Tanzania. The initial three signed the Treaty for Establishment of the EAC on 30th November 1999. On the 7th of July 2000, the treaty was ratified by the respective governments and entered into force. Burundi and Rwanda joined the EAC later when they signed the Treaty on 18th June 2007 and became full members on 1st July 2007 (East African Community 2014).

Figure 1.1 Map of EAC

(East Africa 2014)

The EAC strives towards a multi-faceted integration that is similar to the European Union (EU) albeit learning from their mistakes. The headquarters of the EAC is in Arusha, Tanzania where the East African Legislative Assembly (EALC) is located.

The mission and vision of the EAC is as follows: -

"*The **Vision** of EAC is a prosperous, competitive, secure, stable and politically united East Africa; and the **Mission** is to widen and deepen Economic, Political, Social and Culture integration in order to improve the quality of life of the people of East Africa through increased competitiveness, value added production, trade and investments.*" (EAC 2011)

1.2 The role Kenya plays in the East African Community

Kenya plays a dominant role in the EAC followed closely by Tanzania. The combined GDP PPP of the EAC is $235.74 Billion USD, made up of Kenya at $79.9 Billion USD, Tanzania at $79.29 Billion USD, Uganda at $54.4 Billion USD, Rwanda at $16.4 Billion USD and Burundi at $5.75 Billion USD (Central Inteligence Agency 2013). Kenya however leads the pack in other sectors of development. Better infrastructure and access to a port has given Kenya a competitive edge. Tanzania is the only other country in the region with a port.

1.3 The current state of affairs in Kenya since promulgation: Focus on Counties

In 2010, Kenya promulgated a new constitution that drastically changed its system of governance. The new constitution dictated that the country be divided into 47 regions called counties that have autonomous power to provide all services to inhabitants except for police and military services, which will continue to be the responsibility of the central government.

Under section 174[1] and 175, of the constitution of Kenya 2010, the objects of devolution and the principles of the devolved government are indicated respectively.

"*The objects of devolution are,*

a. *To promote democratic and accountable exercise of power;*
b. *To foster national unity by recognizing diversity;*
c. *To give power of self-governance to the people and enhance the participation of the people in the exercise of the power of the state and in making decision affecting them;*
d. *To recognize the right of communities to manage their own affairs and to further their development;*
e. *To protect and promote the interest and rights of minority interest and marginalized communities;*
f. *To promote social and economic development and the provision of proximate, easily accessible services throughout Kenya;*
g. *To ensure equitable sharing of national and local resources throughout Kenya;"* (The Consitution of Kenya 2010)

[1] The constitution of Kenya 2010, Chapter 11, article 174, pg. 108

In March 2013, Kenya held her first elections under the new constitution that saw the 47 autonomous counties elect governors, senators and county representatives. The county representatives sit in the county assembly with the governor acting as the county president. The purpose of the county assembly is to legislate on county issues. On the other hand, the senator represents the county on a national level in the Senate from the nation's capital - Nairobi. In addition a new president of the country was elected, as well as the members of parliament that sit in the national assembly.

Kenya therefore adopted a two tier parliamentary system with the new constitution. Kenya's governance structure has strong similarities to a federal system although counties are financially dependent on the national government. The system of governance Kenya adopted borrows heavily from the European Charter on Self-Government (European Union 1985). Kenya previously had a centralized structure whereby the country was divided into eight provinces. The eight provinces in turn were divided into districts. Provinces and districts however had no autonomy; they were administrative organs of the national government.

Kristiztina Beer-Toth clarifies varying levels of autonomy in a way that explains Kenyan counties well. To explain autonomy in counties, it is important to distinguish between expenditure responsibility and service delivery. Expenditure responsibility is defined as the obligation and ability of a county to manage the county's assets in the best interests of the constituents; deciding where the county's resources should be allocated on a policy level. Service delivery on the other hand is deciding how the agreed responsibilities are going to be accorded to the constituents. A county's autonomy can be understood by the degree of freedom on expenditure responsibility and service delivery that a county has. The authority with the expenditure responsibility is better known as the steering organization (Osborne and Gaebler 1993) – for its policy setting role in "steering" the county in a certain direction. The authority with service delivery responsibility is known as the rowing organization (Beer-Toth 2009). The diagram shown below illustrates the old and new structures in Kenya adequately.

Figure 1.2

Form of Decentralization	**Type of Expenditure Functions**	**Steering organization**	**Rowing Organization**
De-concentration	Mandatory Functions	National government	National government/ local agency of line ministry
Delegation	Mandatory Functions/ Demand Driven Mandatory functions	National Government, County government	County government
Devolution	Demand Driven mandatory functions/ Optional Functions	County government	County government[2]

Kenya was previously in the de-concentrated row as defined in the table above. Kenya made a huge leap and is now in the devolution row. The counties have full expenditure autonomy and service delivery ability. The Demand Driven mandatory functions seen in devolution and delegation serve to illustrate that services accorded in counties are demand driven. Services are deemed mandatory depending on the demands of a qualified number of constituents only.

Since the elections in March 2013, Kenya has started the process of devolution. Among the devolving rights that counties are entitled to include borrowing funds for development and levying taxes. The ability and right to borrow has been given constitutional status. Other county financing rights given constitutional status are that at least 15% of the national government revenues must be transferred to counties.

[2] Krisztina Beer-Toth

Article 212 of the constitution of Kenya says that:

"A county may borrow if

a. The national government guarantees the loan

b. The county assembly approves the loan"

Article 213 goes on to say that

"*An act of parliament shall prescribe terms and conditions under which the national government may guarantee loans*."

The Kenyan parliament then passed the Public Finance Management (PFM) act 2012 (Kenyan Parliament 2012) that sets out broad boundaries of county borrowing. Articles 141 - 144 lay out certain requirements and standards that County financing must adhere to when borrowing. Among the requirements are that the county must borrow at the cheapest rate possible. County entities are not supposed to borrow more than of 5% of the entity revenues where entity revenues refer to revenues from county corporations owned by the county government for delivering services to county citizens. The PFM act also indicates that the County executive committee for finance, upon approval by the county assembly can execute county borrowing.

In addition, section 204 of the Constitution of Kenya[3] dictates that there shall be an equalization fund that receives 0.5% of all revenue collected from the national government. The constitution of Kenya explains the use of the equalization fund:

[3] The Constitution of Kenya 2010 – article 204.

"The national government shall use the Equalization Fund only to provide basic services including water, roads, health facilities and electricity to marginalized areas to the extent necessary to bring the quality of those services in those areas to the level generally enjoyed by the rest of the nation, so far as possible."

The constitution goes on to say that the equalization fund could either be used directly or indirectly by disbursed to the county government that inhabits the marginalized areas in addition to government transfers.

The Constitution of Kenya 2010 therefore is evidently in support of strengthening counties with support from the national government. The senate is now tasked with passing legislation that builds on constitutional provisions that safeguard external financing for counties beyond the PFM act. Although the discussion is imminent, the senate has not begun the discussion yet.

Chapter 2: County Financing in Kenya

2.1 Introduction

County Financing (CF) otherwise known as local government financing or Sub-Sovereign financing is the way in which second tier governments in any country source finances. The most common sources of finance for local governments are:

1. Revenues raised through taxes (Land rates, business taxes)
2. Municipal fees – parking fees, advertising.

3. Issuing bonds
4. Central Government unconditional transfers (totaling to 15% of national revenues to be distributed among the 47 counties in Kenya)
5. Conditional central government grants to the poorest counties with economically marginalized communities. (Kenya)

The current constitutional provisions regarding county borrowing create certain strengths, weaknesses, threats and opportunities that are highlighted below.

2.2 SWOT Analysis of Kenya County Financing.

Strengths

Under the constitutional provisions in Kenya, counties are entitled to at least 15% of the national revenues. This unwavering obligation is a great strength for the counties and assurance that one source of finance will move in tandem with the country. Further, the constitution dictates that the central government must guarantee all borrowing by counties, affording the county's debt a credit rating similar to Kenyan sovereign bonds.

Weaknesses

Counties are hesitant to immediately levy taxes as they begin to compete for investment. Municipal taxes and fees are currently in place but increasing other fees are seen as investor unfriendly. In addition, increasing land rates could have negative political consequences. Already constraints to raising revenue arise. Politicians want to avoid a case where devolution is seen as double taxation (County tax and national tax) to citizens. Lastly, the taxes levied and fees charged would still not be enough to facilitate the development needed by counties (this will be evidenced later in this chapter).

Opportunities

The decentralization of service delivery in Kenya enables more efficient use of finances through increased sensitivity to local needs and practices (Greco 2003)[4]. Increased efficiency allows for better revenue collection that, previously, national government institutions had not maximized on. Fortunately for counties, the guarantee on county debt by the national government and the guaranteed transfers of 15% of national revenues serves as good collateral for commercial banks and lenders. The national government guarantee transcends all other credit indicators.

Threats

County financing in Kenya could however have unfavorable political and economic consequences. Economically, the fiscal burden placed on the national government fiscally threatens the credit rating of the country on bond markets.

The vertical fiscal imbalance (Singh and Plekhanov 2005) creates a moral hazard in that the constitutional obligation of transferring funds to the county governments creates attitudes susceptible to laziness and dependency in the counties. This has the potential to instigate fiscal indiscipline from county governments.

2.3 Things to consider when making a county financing structure

Studies have been done on the structure of sub-sovereign financing that other countries use. To effectively borrow structures from other countries, the structure developed for Kenya must

[4] William E. Oates pioneered the discussion on decentralization.

be contextualized. To do this, the relevant factors in forming a county financing structure for Kenya are presented below.

First and foremost, it is important to note that Kenya has only begun the process of devolution. This fact must be placed at the forefront of all considerations in devising a structure. It means that Kenya lacks the technical expertise, the capacity and may lack investor confidence when it comes to issuing county bonds.

Secondly, Kenya's fiscal position is unbalanced and heavily reliant on certain counties such as Nairobi County, Mombasa County and Kisumu County. Nairobi, Mombasa and Kisumu counties are home to the three biggest cities in the country in that order.

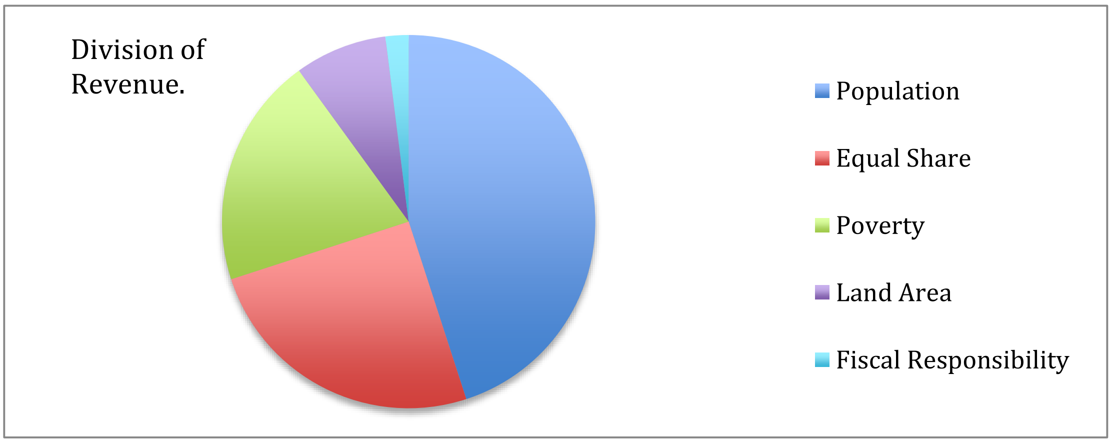
Thirdly, it is important to consider the mechanisms used to transfer funds. Government transfers are distributed among the 47 counties using certain parameters. The constitution of Kenya dictates that the commission on revenue allocation (CRA) shall be the body that determines how the 15% of the national revenue will be distributed to 47 counties. In the first year of devolution, the CRA formulated distribution according to the following parameters. The weighting of each parameter is indicated to the right of the table.

Figure 2.1

Commission of Revenue allocation	
Parameter	**Weight**
Population	45%
Equal Share to all counties	25%
Poverty	20%
Land Area	8%
Fiscal Responsibility	2%
Total	**100%**

(Commission of Revenue Allocation 2012)

Figure 2.2



(Commission of Revenue Allocation 2012)

For example, the figure for the allocation of funds to Nairobi County from population would be attained using the formula below.

<u>Nairobi County Population transfer</u>

(Nairobi population ÷ Total Population of Kenya) × (0.45 × Total National Transfer to Counties) = Nairobi County Transfer for Population.

In the grant allocation formula, CRA gives fiscal responsibility 2% in determining how to allocate county funds. The relatively small role that fiscal responsibility plays is indicative of the central government's commitment to adequately reallocate and equalize the level of development in each County. Poverty is another parameter given a higher weighting of 20%.

Population is accorded the largest weighting substantiated by the principle that every citizen in the country must have an equal allocation as much as is possible.

Fourth, as stated above, the constitutional requirement that county governments get transferred 15% of the national revenue, and that the national government must guarantee county borrowing is an important factor. It is important to note that this can only be amended through a referendum of the constitution[5] involving participation at the grass root level from the entire country. Politically this is tedious, expensive and arguably paralytic to an incumbent government. As a result of the difficulties in amending the constitution, the allocation to counties cannot be used as a partisan tool. Indeed, the allocations could be increased for partisan motives, but could never be less than 15%. This is advantageous to the county governments and supportive of devolution. Government transfers are very unlikely to be used as a political tool.

Fifth, the financial sophistication and size of the Kenyan bond market should also be taken into consideration. Liquidity in the secondary market is vital to investors in assuring them that their bonds are fungible. The Nairobi Stock Exchange has a market capitalization of approximately 1.3 trillion Kenya shillings (15 Billion dollars). The daily traded bonds are in the USD 60M ballpark (Kestrel Capital 2010).

Finally, this thesis proposes that principles that encourage acting in good faith and ensuring structural incentive alignment be an integral part of constructing a county financing structure. County financing must be structured in a way that discourages corruption over and above using prosecution in the courts. Structural alignment of institutional practices must be reliable

[5] Article 255-257, Chapter 16 – The Amendment of This Constitution, The Constitution of Kenya 2010

as if there is no court. In an attempt to align incentives, this thesis proposes the national government attempt to contain partial liability on county borrowing within the county. The government must seek interpretation to whether the constitution dictates that the entire county loan must be guaranteed, or whether a fraction of county borrowing can be guaranteed. This would help in aligning incentives of the national and county governments.

2.4 Why do Counties need to borrow money?

In the first financial year under the devolved system of governance of 2013/2014, Kenya's 47 counties had a total expenditure budget of 275.8 Billion Ksh (Office of The Controller of Budget 2014). 163.7 Billion Ksh reflecting 59.3% was budgeted for recurrent expenditure leaving 112.2 Billion Ksh for development. Of the 112.2 Billion Ksh, collecting 31 Billion Ksh is doubtful according to the World Bank. It is therefore safe to assume that counties have 81.2 Billion Ksh for development for the financial year 2013/2014. To put these figures in perspective, the World Bank policy research working paper (Shakaratan and Briceno-Garmendia 2011) on Kenya's infrastructure estimates that the infrastructure deficit in Kenya requires 346 Billion Ksh annually for the next ten years (Starting 2011). That is to say that in the financial year 2013/2014, the counties of Kenya will only meet 23.4% of the development needs. The national government is undoubtedly going to play a part in development but the transfer of responsibilities to counties places a large burden on counties. The infrastructure gap deteriorates and widens with every year that the infrastructure development need is not satiated.

Figure 2.3 Total County Profile (Office of The Controller of Budget 2014)

County Expenditure	Kshs (Billion)	Per cent
Recurrent Expenditure	163.7	59%
Development Expenditure	112.2	41%
Total	275.9	100%
County Revenue		
Government Transfer	190	69%
Local revenue	65.9	24%
Condition grant	20	7%
Total	**275.9**	**100%**

2.5 How to Finance Counties

In deriving a method of county financing, it is important that all methods are explored despite their simplistic nature. The foremost source of finance once savings and revenues have proved inadequate, is seeking financing from banks in form of traditional loans.

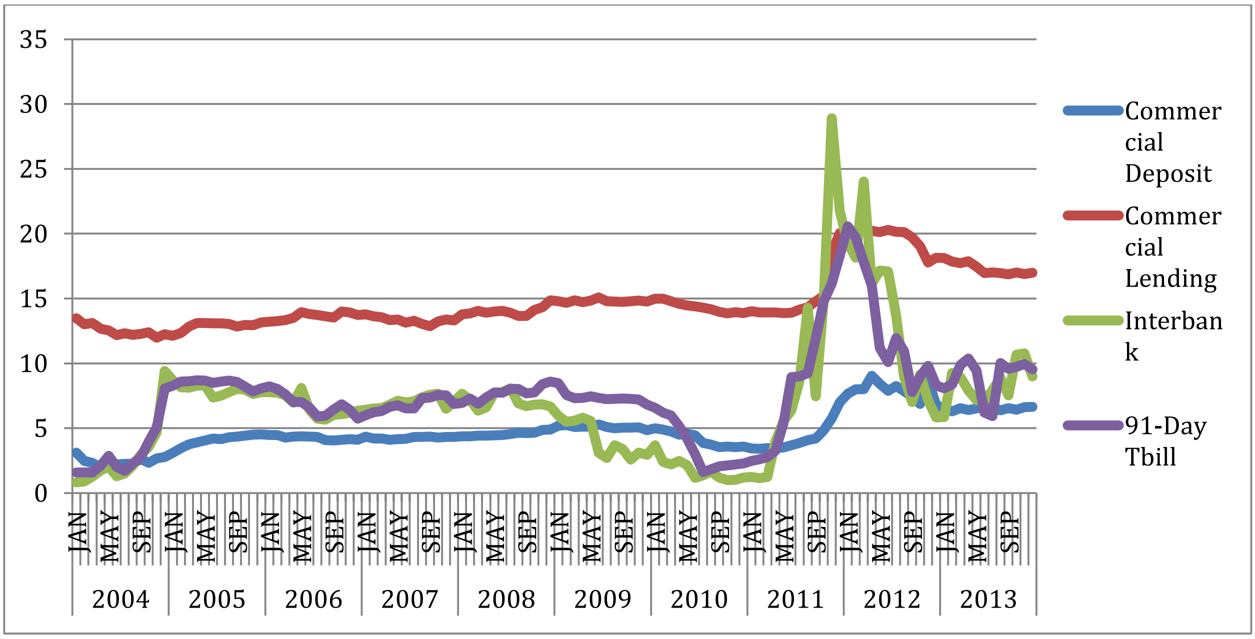
In the basic bank loan arrangement, a customer opens an account at a bank, presents a credit rating or establishes a credit rating with the bank and then asks for a loan. The bank in turn, will always want to see healthy credit worthiness of their customers. Credit worthiness in this case refers to stable revenues year on year, good security and good management of finances. In addition, the customer at the bank is looking for the lowest possible interest rate that he/she could get.

The County Budget Implementation review report released by the Office of the Controller of Budget reveals that expenditure budget for counties for the 2013/2014 financial year totaled to 275.8 Billion Ksh. Of this, the counties estimated that they would collect 67.8 Billion Ksh internally through taxes and fees. This reflects 24.8% of the planned expenditure. Unfortunately actual collection has deviated greatly from planned collection. Only 11.4% of internal revenue collections have been made by half year.

Certain factors deter counties from borrowing from banks in Kenya. Banks in Kenya are infamously known for high interest rates and in conformity with the PFM Act; counties must source the cheapest possible source of finances. The high interest rates create an unfortunate scenario because the banks accord institutions with government guarantees the best credit rating. The government guarantee transcends all other credit indicators for banks in Kenya.

The interest rate spread that banks in Kenya gives banks assured profits. As the figure 2.4 below shows, the spread between Commercial Lending and commercial deposits is large. The spike in Interbank and 91-day T Bill seen below was due to an unusual depreciation of the currency partially due to banking irregular behavior. This however is an outlier event.

Figure 2.4



(Central Bank of Kenya 2013)

An added deterrent of sourcing financing from banks from a macroeconomic perspective is the crowding out effect whereby the counties increase demand for capital from the same banking sector that gives out loans and mortgages to businesses and families in Kenya. This increases the demand for money leading to high interest rates. It is difficult to estimate how much the counties will affect the increase in interest rates if they use bank financing but because their financing needs are large, this factor should not be underestimated.

For the banks, the government guarantee generally makes the counties a stable customer. This is despite having poor revenue collections at half year. In the unlikely event of default or delayed payment, the judicial system is entrusted with awarding damages to the banks. Although it is a tedious and expensive process, banks enjoy government-backed assets on their balance sheets. Still, the unstable revenues are susceptible to exploitation by banks through fees and charges for delayed payments.

Therefore, amidst high interest rates, the crowd out effect and unstable revenue collections, the issue of issuing bonds then arises. As stated before, the bond market has an estimated capitalization of 1.3 trillion Kenya shillings. For issuance of bonds, each county would require a credit rating determined by their financial strength in their ability to service the loan. For this thesis, the assumption made is that counties will streamline all their borrowing needs to one county loan/bond per county.

2.6 Kenya County Bank

In the discussion paper on Local Financing for Sub-sovereign infrastructure in Developing Countries: Case studies of innovative domestic credit enhancement techniques by Robert Kehel, Tomoko Matsukawa and John Petersen (2005), issues on local government financing structures in South Africa, India and the Philippines are discussed in depth. The following analysis borrows largely from their case studies.

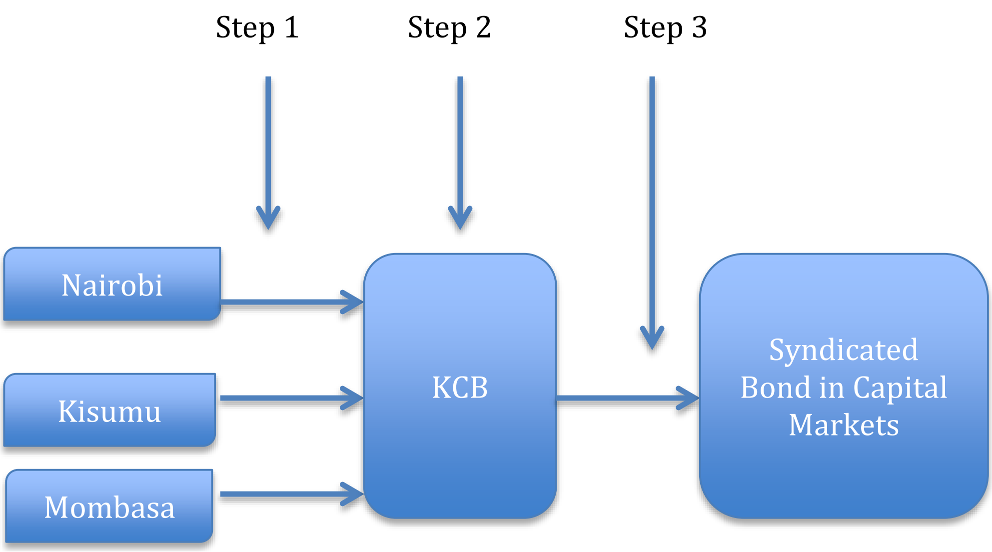
For counties to borrow in the cheapest way possible, credit enhancement is imperative. As mentioned before, the government guarantee accords any borrower a rating similar to national debt. However, the credit on bonds also depends on the ability of the issuer to make stable interest payments. One way of enhancing credit ratings borrowing from South Africa's Infrastructure Finance Corporation (INCA) and India's Tamil Nadu Urban Development Fund (TNUDF) is to form an institution that bundles all financing needs and then issues a syndicated bond. This then hedges the risk of one county's default against the others.

When all 47 counties are put together, they attain a credit rating that reflects the national credit rating. Grouping all financing needs of the counties enables a the middle institution to schedule disbursements as necessitated by the counties to avoid idle deposits and achieve maximum economies of scale (Kehew, Matsukawa and Petersen 2005). Despite being guaranteed by the national government, there is a premium on the notes because of interruption in payments, legal processes and administrative procedures that must first take place before the guarantee is paid.

The need for syndication is not only for counties, but for national governments' internal risk controls as well. Although investors have the government guarantee to rely on, it is in the interest of the national government that use of the guarantee is minimized. In addition, limiting counties' borrowing based on current financial profiles would promote the development disparities between counties. Therefore, syndication affords access of funds to all counties on the strength of all counties and achieves maximum equity.

This thesis proposes that Kenya adopt a structure similar to South Africa and India in this regard. This would assist in coherency between county and national borrowing to achieve maximum economies of scale. This thesis proposes that the institution be a subsidiary of the National Treasury of Kenya or parliament extend the mandate of CRA. This would enable sharing of technical expertise and exploitation of the country's capacity in regards to bond markets. For purposes of this thesis, the Kenyan institution proposed by this thesis will be referred to as Kenya County Bank (KCB).

Figure 2.5 Flow chart below shows how borrowing will work



Step 1 – The 47 Counties approach KCB individually. KCB processes all their borrowing needs and schedules interest payments. The above diagram gives the example of Nairobi, Kisumu and Mombasa counties approaching KCB for borrowing.
Step 2 – KCB receives borrowing requests from counties and securitizes the financing needs.
Step 3 – KCB issues a bond incorporating all borrowing needs from all Counties.

The TNUDF has financed India's 3,682 urban local bodies (ULB) in consolidating borrowing needs and issuing various bonds. South Africa's 246 municipalities require the banking sector be involved for the administrative part of processing loans. INCA does not have the back office and regional spread to accommodate all 246 municipalities. The municipalities apply for loans from the banking sector. INCA purchases those loans to avoid the crowd out effect. INCA then sources a range of secondary investors who are accorded senior lien. To enhance the credit of municipalities, INCA, a big investor herself, takes junior lien. This is also a way of ensuring that there is no moral hazard. The municipalities were as many as 1300 in the early 90's but have been amalgamated, hence the need for commercial banks to process loans. (Kehew, Matsukawa and Petersen 2005). Fortunately, Kenya's 47 counties are less of a back office burden allowing counties to go directly to KCB. Elimination of this process will reduce transaction costs. It is also important to note that South Africa's local governments generate more than 90% of their own revenues. This is unusual for the developing world. As mentioned earlier, Kenya's counties' optimistic predictions are at 24.8%. In South Africa, INCA currently has 2 outstanding notes (Infrastructure Finance Corporations of South Africa 2014). Moody's gave the INCA's outstanding notes a rating of Baa2, one notch down from South Africa's sovereign rating of Baa1 (Trading Economics 2014). The healthy credit rating reflects South African municipalities' strong independence and strong revenue base, a luxury Kenyan counties do not have.

2.6.1 Internal Credit Assessment

As mentioned before, the national government has the constitutional obligation to guarantee all county borrowing. Government would therefore need to empower KCB to assess and approve loans on its behalf. Although the syndicated bond sold to investors obtains a national government credit rating, internal risk controls necessitate that KCB gauges counties independently. This practice is merely to deny counties borrowing needs, but to assist in financial management. It is in the interest of the national government that KCB ensures loans are given to financially healthy counties. To avoid malfeasance in the event that KCB issues loans to maximize their commissions and fees insensitive to the credit worthiness, the law must make provisions that hold the directors of KCB liable.

Economic literature provides analyses on debt affordability of local governments. A simple structure advises that counties be gauged by ratio calculations, comparisons and forecasts (Miller and Hildreth 2007). A study done by the National Association of State Budget Officers (NASABO) shows how U.S states assessed affordability using ratio calculations. Common ratios used are:

- *Debt service as a % of total revenues*
- *Direct debt as a % of personal income*
- *Direct debt as % of assessed value of taxable property*

States in the U.S however differ in limit levels allowed. This thesis proposes that KCB develop affordability ratios specific to each county. Setting similar limits among counties will maintain the economic inequalities. Thankfully, KCB, through advanced processes of securitization could ensure that economically weaker counties are accorded maximum possible borrowing abilities. This thesis proposes that KCB accommodate the principle of equal opportunity and attempts to defy the current inequalities as much as is possible through giving loans. This must be done within reasonable levels however to ensure safety.

2.6.2 Limits on county borrowing

The national government of Kenya, through KCB, reserves the right to regulate borrowing to ensure that counties are moving in tandem with the country's macroeconomic policies, avoiding defaults at all times. This is legally enforceable through the constitutional provision that dictates all county borrowing must be approved by the national government. This thesis proposes that the national government empower KCB with this responsibility.

There are four main ways that sub-national governments are constrained in their borrowing (Singh and Plekhanov 2005). Relevant to Kenya, are the rule-based controls in countries such as Austria, Spain, Norway, Brazil, Japan and Korea. *Singh and Plekhanov* show that these countries either use restraints on overall budget deficits, indicators of debt servicing capacity, levels of accumulated sub-national debt or operating budget deficits – all of which are fiscal controls.

Singh and Plekhanov proceed to describe national government imposed administrative controls as another form of controlling county borrowing. The Kenyan constitution rules on county borrowing identify with administrative controls. Important for Kenya is that the administrative control county borrowing links counties to national macroeconomic policies but give counties flexibility in fiscal expansion.

As we will see in later chapters, the rules regarding debt affordability will have to be dynamic as Kenya moves towards the monetary union. The macroeconomic position and aims of the country must be imposed albeit to a degree on the counties through KCB. The exact details of debt affordability and county credit analysis are however, beyond the scope of this thesis.

2.6.3 Liquidity

The concerns of the KCB system however are not limited to their long-term repayment of principal loans but the short-term servicing of debt as well. Liquidity refers to the ability of KCB to make scheduled coupon payments to bond holders. Despite being pooled collectively, 47 counties is still a small number and untimely servicing of loans by counties could strain KCB on a short-term basis. With this in mind, investors could be wary of buying county bonds issued fearing unstable coupon payments.

TNDUF enhances credit through allowing a trust, which is mandated to make interest payments to investors, to access ULB bank accounts where municipal fees and taxes are deposited. In South Africa, INCA pays insurance with a private insurance company. In addition, the INCA is a funded institution with reserves. In the Philippines, the Local Government Unit Guarantee Corporation (LGUGC) provides guarantees to all sovereign debts to ensure investors of stable payments. The LGUGC would request an upfront fee from all municipalities on bond issue. The national government would then redirect the transfer payment meant for the municipality to the LGUGC in the event that the municipalities did not make their interest payment. (Kehew, Matsukawa and Petersen 2005)

The Philippines and India method of enhancing credit has the potential to be unconstitutional in Kenya with the 15% national government revenue transfer required. In the event that the government transfer was only 15% and a county delayed interest payments on certain months, a redirection of the fees or accessing a county bank account like Philippines and India do respectively, would effect a lower than the constitutionally prescribed 15%. Once again, this would need constitutional interpretation from the Attorney General's office.

Further, it is imperative that cost minimization be a constant theme in the construction of a County financing structure. Constructing and funding a county insurance institution like the LGUGC is expensive. Paying insurance like the INCA does would be an added cost as well.

To ensure smooth coupon payments to investors despite irregular servicing of debt by counties, this thesis proposes that KCB accesses the interbank market [6]like other commercial banks effectuating a guarantee by the central bank. The ability to source funds in the interbank market however is limited to short term payments for managing liquidity. KCB would then investigate which county in particular is causing the interruptions of payments. Interbank funds are relatively cheap as shown in Figure 2.4.

Liquidity on the interbank market in Kenya has been improving gradually according to a presentation made by Central Bank of Kenya officials (Marete 2013). Reasons from improved liquidity are diversification of products in terms of tenure. Banks are now able to access the horizontal repo facility. In the repo market, a commercial bank needing short-term liquidity would sell a bond it holds to another commercial bank with excess liquidity with the promise

[6] Banks access the interbank market to borrow short-term (one day-one week) loans when they are temporarily illiquid. Bonds held by banks can be used for collateral

of buying it back the next day (or in a short period of time). The emergence of the horizontal repo market on the Nairobi stock exchange for the interbank market has improved liquidity tremendously.

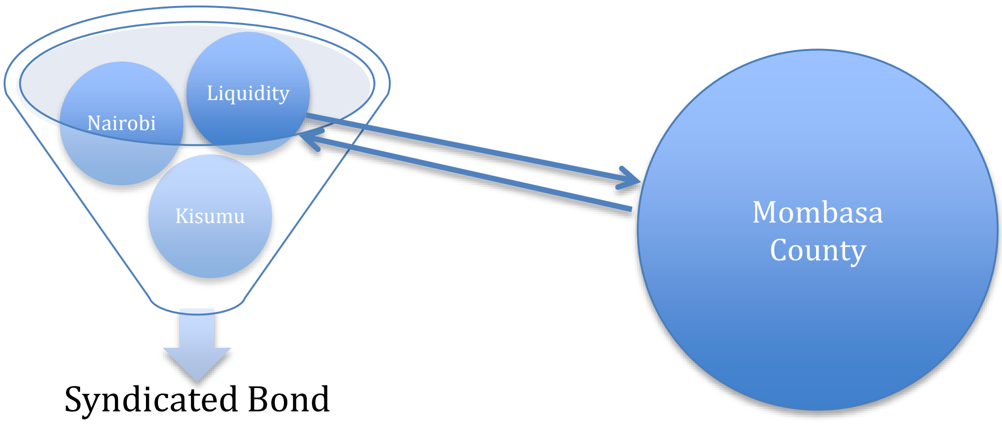
The proposed KCB can take advantage of the horizontal repot market. In the event that a county has not made payment that is stressing KCB on making coupon payments, KCB can source liquidity on the interbank market through selling the loan owed by the delaying county to a local commercial bank on the repo market. When the liquidity position improves, KCB would buy back the loan from the local commercial bank.

2.6.2 Ensuring Liquidity: Horizontal Repo Facility

Below, the example of Mombasa County being unable to finance its short-term obligations is shown. The loan owed to KCB by Mombasa County was temporarily exchanged in the interbank market for short-term liquidity. The buyer on the interbank market is currently holder of the Mombasa county loan.

Figure 2.6

Interbank Market



Controlling County Borrowing

2.7 The County Financing Structure in Summation

The County Financing structure proposed by this thesis takes an interesting structure whereby KCB issues sub-sovereign bonds that attract a sovereign rating however, has the ability to enter the competitive interbank market. The issue of bringing the crowd out effect to the bond market and interbank market is a disadvantage. Sub sovereign bonds will then compete with banks for liquidity in the short term. Interesting to note however is that banks in Kenya rarely get liquidity form CBK in the interbank market. Banks prefer to go to each other. Nonetheless, the CBK is an alternative albeit a last alternative. Involving the regulator is always frowned upon, but this however does not mean it is not an option.

Interbank access to ensure short-term uninterrupted coupon payments and government guarantee to ensure long-term payments has the added advantage of giving county bonds a reputable start. The syndicated bond draws strong similarities to a Kenyan government sovereign bond. Global investors are familiar with Kenyan bonds; KCB under the national treasury attaches credibility. This is superior to having different bonds for every county.

Following the aim of the CRA to ensure that the disparities between the economic standing of counties is limited, county bundled borrowing seeks to help those that are unable to raise strong revenues enjoy the strength of other counties in regards to sourcing financing and financial assistance from KCB. As much as counties are devolving and embarking on their own developmental projects, they must see each other as partners in development and understand that it is the best interest that everyone develops and manages finances well. This results in a more unified country albeit a devolved one.

Ensuring that counties have fiscal discipline has been given commendable regulating ability to the national government through the constitutional requirement that all borrowing must be approved and guaranteed by the national government. How the national government determines whether counties can borrow however is determined by assessing the macroeconomic climate. KCB must be sensitive to the macroeconomic climate of the country and follow direction by the national government through the National Treasury. This could include arresting county borrowing as a whole.

Fiscal rules are used to determine limitations on borrowing. Fiscal rules include budget deficits, overall budget deficits, debt-serving capacity and levels of accumulated subnational debt. The rule chosen is dependent on a number of factors including the degree of decentralization and the purpose of borrowing. As the EAC proceeds to form a monetary union, a fiscal agreement must be concomitant. In the next chapter, this thesis discusses the macroeconomic factors that dominate in the EAC, and moving forward with integration, the fiscal rules that should be implemented.

Chapter 3: Moving Towards Integration of the East African Community

As integration proceeds in the EAC, issues concerning elimination of trade and tourism barriers have taken center stage. Already tourists need only a single entry visa to travel within the region. Citizens of East Africa can travel freely with only national identification cards. Transport costs and bureaucracy have been cited numerous times as obstacles to free flow of goods and services. The EAC is making impressive strides towards the elimination of these obstacles.

Still however, levying taxes on imports is a huge source of revenues for Rwanda and Burundi. For this reason, the two bottom countries enjoy one-way collection of taxes for goods being imported however their manufacturers enjoy zero rated goods within the region.

In regards to the monetary integration, IMF chair, Christine Lagarde advised that East Africa moves “hastily slowly[7]” to ensure that we do not make the mistakes others have made.

Section 1, Chapter 14, Article 83 of the Treaty Establishing the EAC on Monetary and Fiscal Harmonization states that:

1. *“The Partner States under take to adopt policy measures in accordance with an agreed macro-economic policy framework.”*

Section 2(c) and 2(e) of the same article says,

2. *“For the purposes of paragraph 1 of this Article, the Partner States undertake to:*
   (c) Adjust their fiscal policies and net domestic credit to the government to ensure monetary stability and the achievement of sustained economic growth
   (e) Harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the Community.” (East African Community 2010)

[7] Christine Lagarde quote from a book she read.

Attaining a common currency for the EAC involves complex analyses of monetary and fiscal policy. The debate on integration of economies is infinite in its aim to fully understand all relevant factors, avoid economic disasters and assessing the tradeoffs among policies. Below we begin to discuss the primary economic justifications for regional integration and a monetary union.

3.1 Economic Justification of Regional Integration

The justifications for moving towards a union that liberalizes movement of capital, services, goods and labor are ubiquitous in economic literature. The initial economic benefit is that countries can maximize on comparative advantages through increased specialization in production. Comparative advantage[8] is when countries specialize in the production of one good to achieve maximum efficiency and trade for what it does not produce. This is said to be preferable to producing all goods. For example, assume France and Germany both consume bananas and apples. Instead of each country producing both bananas and apples, France would specialize in producing apples and Germany would specialize in producing bananas, and the two countries would trade. This way both countries achieve economies of scale in production.

Paul De Grauwe's book, The Economics of Monetary Integration, discusses the benefits of a monetary integration in particular. Economic theory and practice show that with the coming of a monetary union, each member country surrenders the power to regulate their money supply through monetary tools: adjusting interest rates to increase or decrease money supply.

[8] Comparative advantage theory – Conceived by Adam Smith in The Wealth of Nations, but further advanced by David Ricardo.

The powers of national central banks in regards to monetary policy are significantly diluted to administration and implementation of the union's monetary policy.

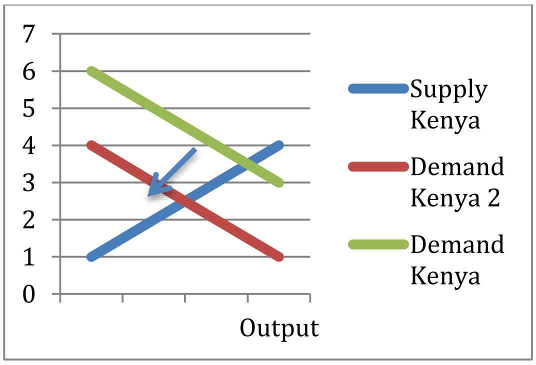
With the union monetary goals taking priority in a monetary union, the only tool left for contraction and expansion specific to the country is the fiscal tool. Unlike the central bank, taxes are a great political tool. As Kenya heads towards devolution with expected high recurrent expenditure in the short and medium term, the maneuvering ability forgone with the formation of the EAC monetary union may present challenges for Kenya.

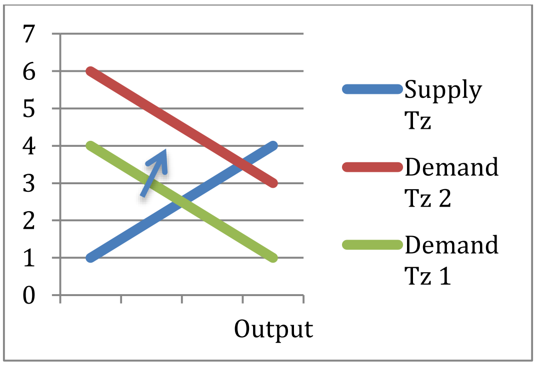
De Grauwe explains that with a monetary union of a common currency, there would have to be an East African Central Bank that sets the monetary policy for all countries. The East African Central Bank would be the sole issuer of currency within the region. As Krugman (1990) explains, empowering all 5 countries to issue a currency that is perfectly substitutable in 5 countries would create a situation whereby the countries would print money with a lack of discipline resulting in grossly destabilizing effects on the other countries.

De Grauwes book and lessons from the EU crisis highlights the importance of having an empowered union (through a central bank) that can make social transfers such as unemployment benefits when one economy is gaining at the expense of another in a swift manner. This stems from the theory of Optimum Currency Areas (Mundell 1961) (P. D. Grauwe 1992)[9]. The theory is shown below.

Figure 3.1

[9] Robert Mundell however is credited as the pioneer in this theory.





Price – Y axis, Output – X axis

In the above graphs, we see the effects of asymmetric shocks in Kenya and Tanzania in the case of a monetary union. With increased integration and free movement of goods, services and labor, suppose that from a state of equilibrium there is increased demand for Tanzanian goods and services over Kenyan goods that causes an increase in output for Tanzania. The shift from equilibrium could be caused by a change in consumer tastes. The increase in output is shown from the demand curve shifting from *Demand Tz1* to *Demand Tz 2* in figure 3.1. With this increase, Tanzania raises more tax revenues that may even result in a budget surplus and reduced national debt.

The theory of optimum currency areas explains the asymmetric shocks concept that predicts Kenya will experience the opposite effect. Decreased demand for goods and services in Kenya will decrease national output therefore decreasing tax revenues in Kenya. This is illustrated by a shift in the demand curve from *Demand Kenya* to *Demand Kenya 2* in figure 3.1.To sustain the economy, Kenya may have to inject some new money. To kick-start the economy once again, where Kenya could have decreased the interest rates, now it could only decrease taxes and increase government spending. This causes a budget deficit and increases national debt. (Mundell 1961)

De Grauwe explains Mundell's economic theory (P. d. Grauwe 1992) (Mundell 1961) and predicts that labor will migrate from Kenya to Tanzania to satisfy increased demand. The increase in output caused an increase in demand for labor in Tanzania that elevated wages. Kenya on the other hand will initially experience downward pressure on their wages owing to a decrease in output. The exodus of labor from Kenya will reduce supply of labor in Kenya and eventually restore the wages to equilibrium. The Kenyan labor in Tanzania will satisfy the increased demand and restore wages back to equilibrium as well. The mobility of labor is an integral component of regional integration.

Considering all the intelligent predictions by economic theory, the next section applies this theory to East Africa in an attempt to gauge the benefits the EAC will gain from integration.

3.1.1 Applying Regional Integration Theory to the EAC

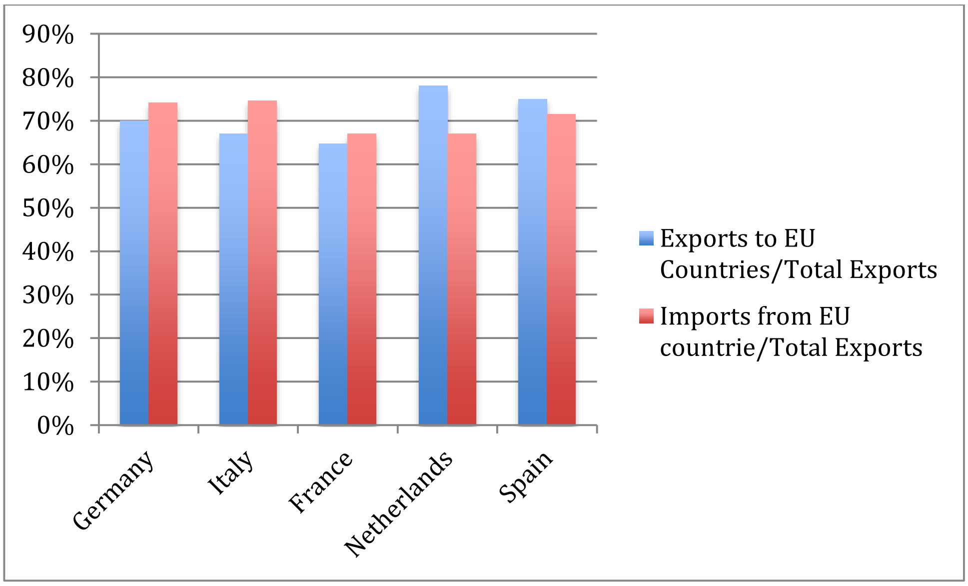
In the case of East Africa, three important things should be noted that are very different from the European Union.

Firstly, the economies of East Africa exhibit relationships indicative of symmetry that debilitates Mundell's analysis for application to the EAC. This is because of the trade patterns shown. Vegetable products form the largest export for Kenya, Uganda and Burundi while the 2nd largest for Tanzania and Rwanda. Tanzania exports gold and Rwanda exports mineral products. What is important to note is that the largest trade partners (import and export) for all East African countries are Asia and Europe. EAC countries have similar goods produced, and similar trade partners outside the region that form the largest market for all EAC countries. (The Observatory of Economic Complexity 2010)

An increase in demand in vegetable products (From Europe or Asia) would see an increase in output in the entire region. Kenya cannot grow at the expense of Tanzania like the theory dictates. This suggests strong symmetry within EAC markets. Trade is rightfully used as an indicator of symmetry because of the dominating role that trade plays in East African economies. In 2010, the EAC countries' trade as a percentage of GDP figures stood at 57% for Uganda, 49% for Tanzania, 53% for Kenya, 36% for Burundi and 36% (2009) for Rwanda. (East African Community 2011)

In comparison, De Grauwes theory was applicable to the EU because of the contrasting asymmetry that EU markets showed. EU markets trade more with each other than they do with 3rd party states even before the euro. The EU countries are far more interdependent and practice the theory of comparative advantage. The graph below shows the trade statistics of Germany, Italy, France, Netherlands and Spain in 1995 (A period relatively more similar to EAC today)

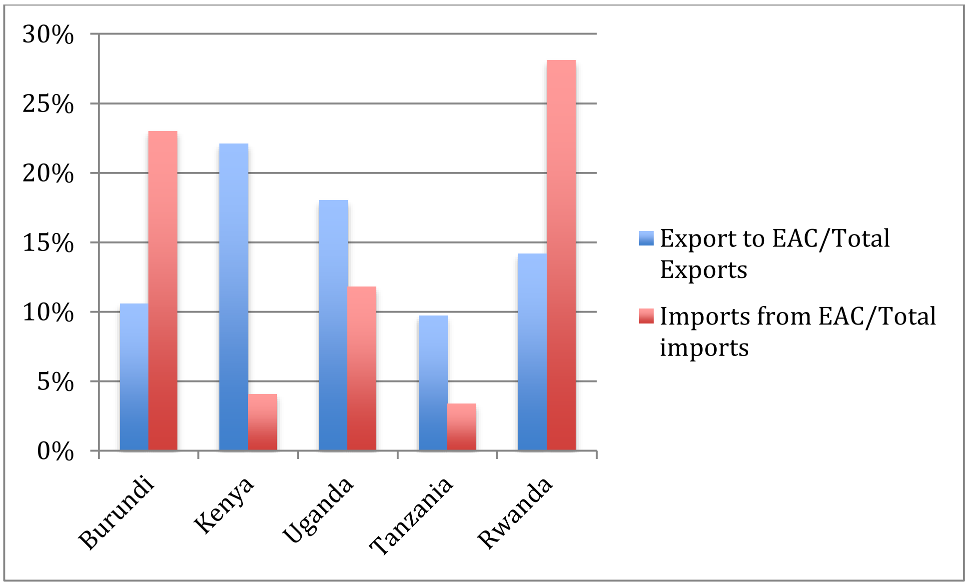
Figure 3.2



(The Observatory of Economic Complexity 2010)

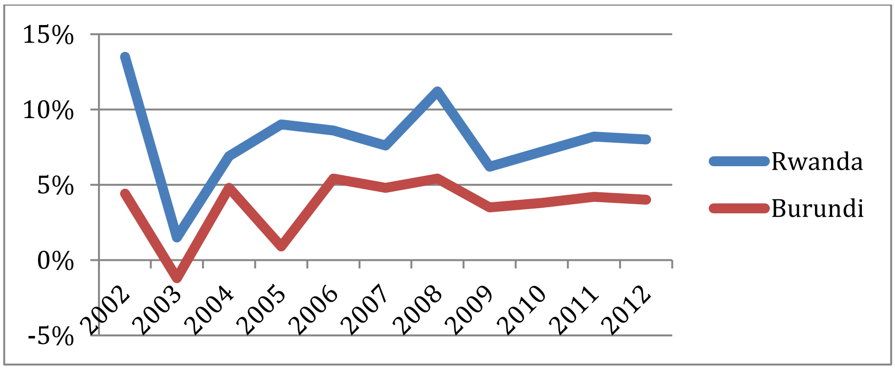
In Contrast, the graph below shows the trade between EAC countries as a percentage of total trade in 2011.

Figure 3.3



(The Observatory of Economic Complexity 2010)

East African states form markets for each other much less than they do for 3rd party states. The two East African states that show strong symmetry are Rwanda and Burundi. Below is the GDP growth from the two countries from 2002-2012. The graph below depicts similar trends between the two countries over the last ten years. Figure 3.4



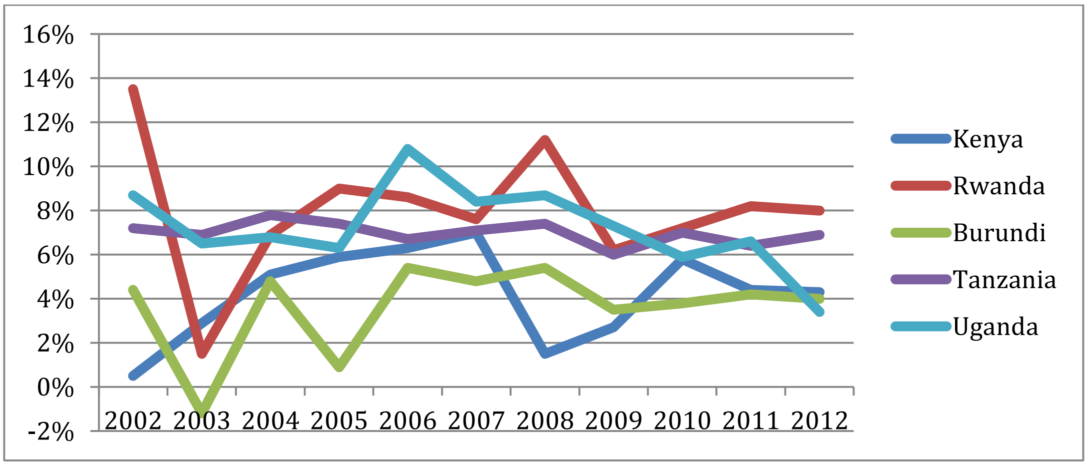
(www.google.com 2012) [10]

The other East African countries do not show strong signs of symmetry or asymmetry that further debilitates De Grauwes theory on asymmetric shocks. There is no correlation seen among the growth of the countries. This can be attributable to country specific volatile

[10] Www.google.com – sources include world bank data

political climates that local industries and foreign direct investment are very sensitive to. Below is a graph showing GDP growth of EAC countries from 2002-2012.

Figure 3.5



(google 2012) [11]

Secondly, Mundell's theory suffers further debilitation from the EAC labor market. Unfortunately unemployment is very high in all countries. There is by far a large supply and very little demand. Moreover, labor mobility is low. Domestic urbanization is taking place but mobility across borders is insignificant in the labor market. In Kenya 99.5% of industrial sector employees are Kenyan (Kenya National Bureau of Statistics 2013). The demand necessitated to cause a labor shortage in Kenya that attracts labor from other EAC countries is unrealistic in the short to medium term. Demand market fluctuations are unlikely to have effects on the labor market that either increases or decreases the cost of labor owing to the large supply of labor. Further, EAC labor is highly concentrated in the agricultural sector (Kenya 75%, Rwanda 90%, Tanzania 80%, Uganda 82% and Burundi 93.6%) (Central Intelligence Agency) – mostly on family owned land that has strong cultural ties. The socio-economic form of labor in East Africa exhibits a sticky-ness around inherited land. This

[11] www.google.com "Rwanda GDP growth" – source includes world bank data

inherited land is usually the main source of income for the family. Moving to another country, where acquiring land is almost impossible is arguable an unreasonable proposition.

Thirdly, social transfers that buffer economic slumps are not common practice within East African governments. Social transfers are concomitant to the theory of asymmetry that has doubtful application to EAC. Kenya has in recent times made social transfers to the elderly but those are very small. Moreover, cross border social transfers need a strong political appreciation of interdependency between member states, a concept that only extremely advanced unions may be capable of. Nonetheless, the government of Kenya has obligations that may be stressed if the country experiences a decrease in taxes from reduced output.

Moving forward, this thesis believes in the relative symmetry that trade patterns the EAC figures suggest. Although labor movements and social protection in the EAC are not suitable to apply De Grauwes analysis of Mundell's theory, this thesis however does not completely disregard De Grauwe and Mundell. EAC countries have other factors such as governance that have no correlation to each other. Overall, regional integration is still beneficial to the EAC. The EAC has identified that forming a common market for 3rd party states for tourism, trade and foreign direct investment as a goal. The threshold of conducting business in a larger market broadens the scope and depth of foreign direct investment. However, increased trade and easier flow of goods and services could create asymmetric effects. For purposes of this thesis, this thesis will hold that the EAC is conveniently at a point where planning to bank on symmetry is reasonable.

3.2 Theory on Public Expenditure

In the discussion paper titled Fiscal Adjustment and Composition of Public Expenditures, public expenditures are divided into productive and non-productive. The argument made by the authors is that the effect of fiscal policy depends equally as much on the composition of public expenditure in using fiscal policy as a tool for growth as it does on the budget balance and the fiscal policy pursued. The productive and unproductive sectors in the European context are defined as follows (Ferreiro, Garcis-del-Valle and Gomez 2008),

"Productive expenditures: Defense, public order and safety, economic affairs (includes sectorial R&D and transport and communication), environmental protection, housing and community amenities, health and education.

Unproductive expenditure: general public services (includes public debt interest payments), recreation, culture and religion, social protection". (Ferreiro, Garcis-del-Valle and Gomez 2008)

3.2.1 Applying Theory on Public Expenditure to the EAC

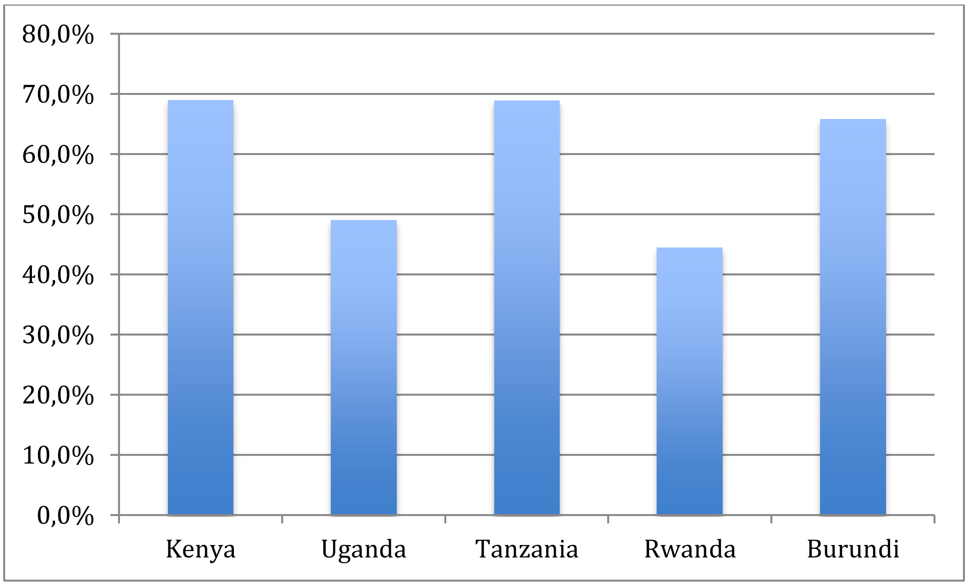
In the case of Kenya, productive and unproductive parameters are defined better between recurrent and development expenditure. The public sector still needs to advance to bring services closer to the people. The scheduled growth in Kenya therefore has growth both in recurrent and developmental expenditures ahead.

What is considered business as usual in the EU has not yet been attained in Kenya meaning that the improvement of service delivery to the people is developmental.

Recurrent expenditure in East African countries is particularly high. Even worse is that in the case of Burundi for example is that the budget is highly financed by donor countries and not through capital markets. It is important to note that the budgets of Rwanda, Uganda and Burundi are highly dependent on foreign aid. Without foreign aid, the economics of Uganda and Burundi would spend 61.2% and 78% on recurrent expenditure respectively.

Non-Developmental Recurrent Expenditure as a Percentage of Total Expenditure[12]

Figure 3.6



(Wolrd Bank 2008) (citizens budget 2014) (Ministry of Finance Uganda 2014) (Kenya National Bureau of Statistics 2013)

The high recurrent expenditure leaves little for development. Therefore in the event that the tax revenues are strained, the budgets could go from bad to worse. In the case of Kenya, devolution is set to increase recurrent expenditure through the wage bill.

[12] Budget 2013/2014: The onset of Devolved Government and the Hurdles Ahead

Although figures from the European Union on recurrent expenditure are comforting, the difference is in contextualization. The governments of the EAC do not accord their citizens the same services that EU countries do. For a government in the EU, having a high recurrent expenditure is substantiated through the provision of services that are being maintained after approaching saturated development. However, in East Africa, the high recurrent expenditure reflect a government that is “overdeveloped in size, but underdeveloped in functionality” (Chabal and Daloz 1999)

With other standards however, the state of finances in East Africa is manageable. A table below shows the major indicators of public finance.

Figure 3.7

2012/2013	Kenya	Uganda	Tanzania	Rwanda	Burundi
Tax Revenues/GDP	20.0%	12.5%	15.0%	13.0%	14.0%
Total Revenues/GDP	25.0%	17.0%	20.0%	26.0%	37.0%
Recurrent Expenditure/Budget	69.0%	49.0%	68.9%	44.5%	65.8%
Budget Deficit/ GDP	4.2%	7.3%	6.0%	1.9%	4.0%
Deficit (Excluding Grants)	5.3%	9.5%	10.6%	13.7%	24.7%
Government Debt/GDP	43.0%	29.2%	44.4%	23.4%	35.3%
External Debt/GDP	23.0%	25.0%	40.0%	15.2%	21.2%

Source: (Wolrd Bank 2008) (citizens budget 2014) (Ministry of Finance Uganda 2014) (Kenya National Bureau of Statistics 2013)

We can gather the following from above in regards to a monetary union.

a. All countries have manageable debt albeit too much of it being external in the case of Tanzania and Uganda.
b. Recurrent expenditure levels are high *vis-a-vis* the public services provided to citizens.
c. Tax revenue collection is too low. Ideally it should be between 30%-50% of GDP.
d. The budget deficits are too reliant on external support.

From the data above, this thesis suggests that a large obstacle to progress for Kenya and the other EAC countries is the high recurrent expenditure. With such a small percentage of the budget being allocated to development, their growth is limited. The development budgets are below the level required to fill the development gap. With this in mind, their ability to raise finances through public borrowing could also be limited because of the minimal investment in the future.

3.3 Public Debt Management

Keynesian economic theory on public debt management dictates that: -

- A country should only borrow at a rate below the economy growth rate such that debt rollover is possible and sustainable in the long term.
- The rate at which the interest rate on borrowing grows should be below the year on year rate at which the country is experiencing economic growth.

Debt rollover is when the country has the ability to borrow enough to pay back the principal on existing debt plus the interest in a sustainable manner. Using the above guiding principles, a country could maintain their debt level and even reduce in the event that the growth rate of the country surpasses the interest being paid. The growth of the country therefore, depends on the government investment into infrastructure and other investor friendly policies that government implements.

Most crucial to this thesis however is the accounting standards used in public accounting. Public debt managerial accounting involves various international standards that detail how to calculate national debt and other public figures. Relevant to this thesis however is the global debate on whether the national government should inculcate contingent liabilities (Investopedia 2014)[13] in national debt. The legal debate on how liable a government is for its "contingent liabilities", is an extremely complicated issue and beyond the scope of this thesis. This application to this thesis will be explained further in Chapter 4.

3.3.1 Applying Theory on Public Debt Management to the EAC

Countries in the EAC may face a situation where they must undergo fiscal expansion to raise finances for development in the hope that a strengthened union will facilitate the necessary growth to repay these obligations. This happens through reducing taxes and borrowing which increases the deficit.

Even though there are no transfers made in the EAC, the more integrated economies should still hold each other accountable to ensure good financial management. Default of member states' obligations could have serious repercussions for the other states as we have seen in the EU. Fiscal contraction because of debt management would drive the economy output and demand down for a member states' goods.

The amount of taxes raised therefore needs to be monitored as a % of GDP. Already there are large differences in the tax raising ability of each country in the EAC. None is doing perfectly. This thesis proposes that every country should have a minimum goal of tax

[13] A contingent liability is the obligation that results in a guarantee, whereby if the guaranteed party does not fulfill an obligation, the guarantor would be liable. (Investopedia 2014)

revenues raised as a percentage of GDP to reduce budget deficit and mitigate a decrease in output through public spending in the event that the monetary policy is unfavorable.

Setting a high standard for low budget deficit allows for national sustainable development and shock absorbers without requiring every member state to donate to a suffering member state.

3.4 What the European Union did

The EU devised a way to coordinate fiscal policies through the Stability and Growth Pact (SGP). (European Union 2013) The SGP is defined as:

"The Stability and Growth Pact (SGP) is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all Member States."

SGP has both corrective and preventive mechanisms. In the preventive mechanism, the medium term goals of each individual country are defined. Every country had to show that they are moving towards their medium term goals, while keeping safely within the limits of the EU in regards to debt and deficit. The EU set limits of 60% national government debt to GDP and a 3% budget deficit as a pre-requisite to joining the union. In the corrective mechanism, measures to achieve debt and deficit levels are prescribed by the SGP and the EU gives oversight to ensuring that the countries that have exceeded these limits attain them. The summarized SGP formula is as follows:

Budget Balance = Cyclical adjusted Budget Balance + α**(Output Gap*)

(Gonzalez and Fernandez 2008)

α represents the automatic stabilizers that determine how aggressive output is encouraged or discouraged to achieve the desired budget balance.

The SGP however comes under criticism for being insufficient in the measures it takes. The SGP largely underestimated the role of fiscal policy in stabilization of a monetary union. Economists have shown that monetary policy for an area as large as the EU with asymmetric economies can in some cases be destructive. The monetary policy in the case of the EU consists of countries with differing long-term inflation rates, output rates and an average monetary policy is too high for some, and too low for others. When the ECB sets a union wide low interest rate, countries with low interest rate trying to expand their economies experience proportionally less effects. This is because, as earlier mentioned, the interest rate set by the union serves as the nominal rate which countries apply and adjust taking their inflation into consideration. Critics of the SGP say that SGP should not only have the output gap, but other indicators in determining how to adjust the budget balance. The SGP identifies a budget balance target (usually 0) as a focal point and adjusts the automatic stabilizers when output has deviated. Using the output gap as an indicator, the fiscal policy identifies how aggressive to use the budget to achieve the desired outcome. (Gonzalez and Fernandez 2008)

3.5 How the Approach of the EU relates to possible steps for the EAC

A strong basis for analysis on the EU is the asymmetry of EU member states. The European south and the north are known to differ greatly in business cycles and industrial makeup. Labor moves from less developed EU countries to Germany and the UK to cool down labor wages. In the case of East Africa, similar economies largely compromised of similar industries albeit being differently developed minimizes asymmetric shock effects. In attempt to form an SGP for the EAC, considerations such as the symmetry of economies, the degree of spillover effects, and the labor mobility or immobility must be considered.

The theoretical application to the EAC has displayed various limitations. Lessons from the EU however have served as strong guiding principles in the formation of reactionary tools within the EAC monetary union. In the next section, a fiscal reactionary policy is formed and applied to Kenya to identify effects on county financing.

Chapter 4: Kenya and Fiscal Harmonization

In Chapter 2, this thesis formed a county financing structure and proposed the KCB. In Chapter 3, this thesis illuminated the misfits in economic theory on regional integration to the EAC, given the economic situation of the EAC. This chapter will now take lessons learnt from Chapter 2 and Chapter 3, and propose how KCB, Kenya and the EAC can coordinate policy to achieve maximum efficiency, minimal risk, and sustainable growth.

It is difficult to predict the borrowing needs of the counties. Devolution has still not completely taken shape and the current government has only been in power 1 year. Regardless, Kenya must ensure that moving forward with the EAC monetary union integration, Kenya's devolution plans are safeguarded.

The critics of the SGP offered the alternative of using a More Active Fiscal Rule (MAFR) (Gonzalez and Fernandez 2008). MAFR stems from an appreciation of the strong influence of fiscal policy on contraction and expansion of the economy. The MAFR advocates for strong use of fiscal tools. Supporters of the MAFR say that the application of the Taylor rule[14] in monetary policy can be mirrored in Fiscal Policy. The largest difference between the SGP and MAFR is that MAFR uses both output and the inflation levels when deciding how aggressive to approach fiscal policy. Inclusion of inflation assists in tailoring an effect more conducive to the country after the broad EAC monetary policy has been set. The MAFR does not put limits on the budget deficit explaining that the long-term targets of the budget are sufficient. The MAFR formula is shown below:

[14] "*A guideline for interest rate manipulation. Stanford economist John Taylor in order to set and adjust prudent rates that will stabilize the economy in the short-term and still maintain long-term growth introduced Taylor's rule. This rule is based on three factors*" (Investopedia 2014)

$$\textit{Budget Balance} = \textit{Cyclical Adjusted Budget Balance} + (\alpha 1+\alpha 2)*\textit{Output gap} + \alpha 3*(\textit{Current Inflation} - \textit{Long term inflation})$$

The parameters α1 represents automatic stabilizers, α2 represents discretional reaction by officials, and α3 considers the weighting of inflation deviation.

To further support the argument made by MAFR, a study done on the Nigerian economy (Olaiya, et al. 2012) based on advanced econometric analysis using data form 1970-2010 found that there is unidirectional relationship between government spending and inflation. There is also unidirectional relationship between economic growth and inflation. Government spending and economic growth however have a bi-directional relationship. Nigeria, although much larger than Kenya has similarities in macroeconomic financial management.

The MAFR is based on the Keynesian school of thought that believes fiscal contraction or expansion has steering ability on the economy. The Keynesian theory argues that in the presence of fixed prices and fixed wages, increasing government spending will have expansionary effects on the economy and decreasing government spending will have contractionary effects on the economy. The contractions/expansions are not limited to spending, but also include increasing taxes levied for contractionary effects and decreasing taxes levied for expansionary effects. This thesis endorses Keynesian theory and stresses that in a monetary union a more aggressive fiscal union should be used to produce desirable country specific results. This thesis agrees with the Keynesian argument but believes that increased (decreased) spending must be targeted at the correct sectors of the economy for expansionary (contractionary) effects.

The deductions from the analyses on MAFR and on the composition of public expenditure in Chapter 2 support the economic argument that recurrent non-developmental expenditure has inflationary effects but no growth in output. Also, developmental expenditure has growth effects that raise taxes that the government reflects in later periods through spending. Development expenditure also has inflationary effects.

The SGP has been criticized for failing to incorporate inflation in determining the budget balance. Only the output has been used. Kenya, however, is about to increase public spending in ways non-developmental (recurrent) to the country as theoretical economics would categorize. County governments still need to build strong public service institutions. Public service falls under recurrent expenditure and not investment. These have high inflationary pressures but low output effects.

A scenario in which the fiscal policy creates high inflation, but maintains low output necessitates that inflation be considered in the budget balancing formula – a factor SGP does not consider. Critics to MAFR would argue that considering inflation would restrain the effect of the output coefficient in budget balancing. In response, this thesis argues that the MAFR merely includes inflation to restrain the output, but including inflation enables better targeted spending on the output enhancing sectors of the economy while avoiding the inflationary segments as much as is possible. In other words, if inflation was high and output was low, where critics would argue that the MAFR would experience an increase in output coefficient and decrease in inflation coefficient that neutralizes the budget and does not support output, this thesis contends that the budget would be balanced in a manner that targets output growing industries, but tames inflation and attempts to achieve an equilibrium in doing both.

The fiscal policy however only needs to take into consideration government induced inflation. The underlying assumption that the above is making is that inflation caused by private consumption is controlled by the monetary policy while inflation caused by the government can be arrested by fiscal policy through the budget balance.

This thesis proposes that because Kenyan combined levels of government are a large part of the Kenyan economy, it is imperative that their effects on inflation, output and all other major indicators of the economy be included in the computation of the one tool that the government has sovereign power to use.

4.1 The More Active Fiscal Rule –East African Community

The MAFR however does not put limits on budget deficits. In the EAC convergence road map, the EAC agreed to set targets on budget deficits as they approach the East African monetary union. In the first stage (2007-2010), overall deficit excluding grants was to be reduced to 6% of GDP and 3% of GDP including grants for all member states. In the 2nd stage (2011-2014), member states were to reduce deficits to 5% of GDP excluding grants and 2% including grants (Gupta and McHugh 2012). Debt-to-GDP levels are yet to be prescribed. This thesis proposes that the EAC adopts a fiscal reactionary policy similar to MAFR that includes putting limits on the budget deficit. The cautionary measure of enforcing limits on budget deficits is substantiated by the susceptibility of EAC country tax bases to macroeconomic volatility. Whether the exact limits on budget deficits to GDP agreed by the EAC are appropriate and enforceable, however, is beyond the scope of this thesis. For purposes of this thesis, the MAFR with deficit and debt limits shall be termed MAFR– EAC.

This thesis therefore proposes that the EAC issues a directive concomitant to the implementation of the currency union that EAC member states implement MAFR – EAC. The directive allows for national transposing through use of α2 and α3.

It is in Kenya's best interest to endorse the MAFR – EAC structure of ensuring fiscal harmonization. MAFR –EAC acts as a fiscal stabilizer and enables the economy to control inflation using fiscal policy. This thesis also proposes that there be coordination between the EAC monetary policy and use of the MAFR-EAC.

Keynesian economics believes that the multiplier effect of government is strong. In Kenya, the combined efforts of the national government and the counties form a large consumer with strong demand abilities. When Keynesian theory is applied to the EAC monetary union (Rostaing-Paris 2008), the expansion (contraction) experienced in one country has spillover effects. The symmetry between economies illustrated in chapter 3 dictates when a member state of the EAC is undergoing fiscal expansion, other member states are pursuing the same macroeconomic goals. Symmetry among member states affords the ability to chase desired budget balances less aggressively owing to the spill-over effects.

4.2 What This Means for Kenya County financing

County financing is guaranteed by the national government. The EAC has set limits on deficits that must be adhered to by the time the EAC currency is in circulation. Economic good practice dictates that borrowing of governments should be limited to developmental matters and recurrent expenditure should be paid through revenues. Should the deficit levels therefore be applied to counties as well? The legitimacy of this question is explained in the paragraph below.

The discussion on debt to GDP levels is imminent. Because the national government has guaranteed county borrowing, the claim that exposure to risk of default on county borrowing should be incorporated in calculating national debt is legitimate. The discussion on contingent liabilities resurfaces. Should the EAC demand that member states consider sub-sovereign debt, and the risk attached when calculating national debt? After all, it is the national government that will be liable in the event that counties are unable to repay debt. The exposure of the national government to default by the counties can be calculated by:

*(Average risk of default for counties * total counties debt) + Sovereign debt = Kenya's total debt*

The average risk in the formula above pertains to the internal risk rating that KCB has accorded counties. Although investors receive Kenya's national bond rating for the syndicated county bond, KCB assesses default probability for internal risk controls. Outsiders are unable to identify the actual creditworthiness of counties. When Kenya approaches the EAC to decide on debt levels within the union, it is in Kenya's interest that the issue of national governments' exposure to county debt be addressed. Total county debt is likely to be a considerable amount that will markedly limit the national government in issuing bonds if it is considered part of national debt. The difference between inculcating the exposure to county default and not doing so also sets limits on the ability of counties to borrow. This proposition is further legitimized because counties enjoy the national government credit rating because of the government guarantee.

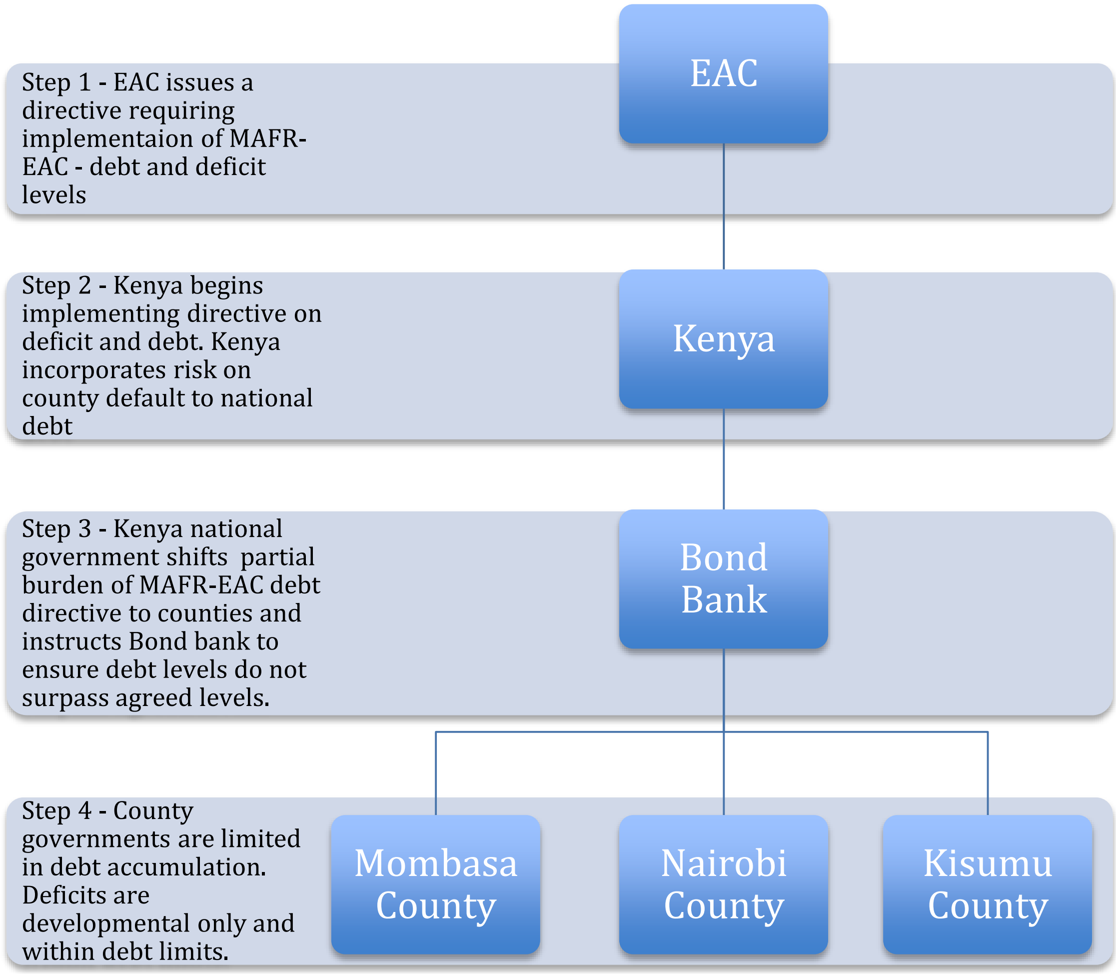
Therefore, this thesis proposes that in the best interests of the EAC and Kenya, the national government of Kenya inculcate exposure to the risk of default on county debt when calculating national debt. This thesis proposes that the EAC enforce MAFR-EAC by issuing directives on accounting standards that in effect consider the risk of default on contingent liabilities (Mink and Rodriguez-Vives 2009); whereby the risk is calculated using international accounting standards in good faith.

This thesis also proposes that the EAC enforce the MAFR-EAC through a directive. A directive is binding in its result, but not in its method of implementation therefore enabling the member states to use MAFR-EAC parameters as necessitated to achieve EAC wide agreed targets. This thesis proposes that the Kenyan government, in transposition and implementation of the proposed MAFR-EAC directive, enforce rule based and administrative controls (Plekhanov and Singh 2005),[15] effectuated by KCB, which apportions debt limits to county budgets in accordance with EAC debt limits. This thesis further proposes that in accordance with the proposed MAFR-EAC, the Kenyan government limit the deficits in county budgets to developmental projects insofar as the counties prescribed county debt limits will allow. This thesis therefore proposes that the deficit levels outlined in the EAC be applicable to the national government budget only.

[15] As described in Chapter 1 of this thesis under the sub-section, *Limits on borrowing*

Below is a figure showing the structure of the proposed structure.

Figure 4.1



Because recurrent expenditure takes senior lien in budgeting, it is difficult to arrest the recurrent expenditure induced inflation through the budget without reducing the development appropriation. Therefore, to reduce spending across the board in the event counties have caused inflation, borrowing must be reduced in line with target inflation rates. Borrowing should be limited to developmental projects only. This would ensure that even when borrowing abilities are tightened or frozen to reduce inflation, recurrent expenditures are still paid.

High inflation within the EAC is countered by setting high interest rates by the East African Central Bank. The country specific inflation rate could be countered by national authorities adjusting MAFR –EAC parameters specific to the country. KCB would be the tool used by the national government of Kenya in addition to the marginal efforts of the Central Bank of Kenya in a monetary union.

The symmetry of the EAC will be amplified when the union adopts one currency. The price of vegetable products in the EAC will be even more undistinguishable to foreign markets. This further harmonizes the inflation of the region and makes it easier for the East African Central Bank. Therefore, as earlier mentioned, the countries of the EAC are afforded relatively less aggressiveness to achieve desired results through the MAFR-EAC because of symmetry.

When pursuing contractionary fiscal policy, the national government reduces county transfers to the 15% minimum prescribed in the constitution. When pursuing expansionary fiscal policy, the national government increases county transfers to more than 15%. This tool however is limited in its use because recurrent expenditure must be covered. Decreasing national transfers below the amount necessary to cover recurrent expenditure would be detrimental to the economy of the country. Ideally however, counties should be self-sustainable in the long term and cover recurrent expenditure from taxes levied.

The EAC must emphasize that the MAFR-EAC must be applied in good faith among the member states of the EAC. They must want to coordinate their fiscal policies with the EAC wide monetary policy to avoid clashes. It is imperative that the political will be evidenced in coordinating monetary and fiscal policies. Over and beyond the EAC directive this thesis proposes be used to set fiscal policy, countries must identify that with their monetary tools gone, using the MAFR-EAC is beneficial to all member states.

4.3 SWOT analysis of MAFR-EAC on County Financing

Strengths

Using the MAFR-EAC, Kenya can tailor a detailed reactionary predictable policy that safeguards the country and the EAC against macroeconomic fluctuations. Surrendering the monetary policy is a large step and can be destabilizing as 47 independent development plans are undertaken. The MAFR-EAC will see a strong fiscal policy tailored to Kenyan conditions but in reaction and coordination with EAC monetary policy.

Kenya sustains a healthy level of public debt that is almost evenly split between external and domestic creditors. An International Monetary Fund Report on the debt sustainability analysis shows that Kenya has a net public debt to GDP ratio of 43% of which 23% is external and 20% is internal. The external debt reflected by 23% is $9.1B USD. (International Monetary Fund and World Bank 2013)

From the World Bank report on Kenya's Infrastructure that stated Kenya needed $4B USD a year, with $2.1B USD in additional funding (Garmendia and Shkaratan 2011). Assuming that the ratio between internal and external creditors is maintained, an attempt to fill the infrastructure gap through the counties by issuing a county bond would increase Kenya's external debt by 11% reflecting the $2.1B USD. In total, the debt would increase the debt to

GDP ratio form 43% to 48%. This according to world standards is still a manageable debt level and likely to be below the prescribed MAFR-EAC prescribed debt limit.

Weaknesses

MAFR-EAC restricts the counties to EAC set monetary policy indirectly. It is unlikely that all 47 counties will have the same developmental agendas as the EAC. In cases where KCB has frozen borrowing, counties are likely to be displeased with adhering to a remote EAC. In addition, the proposed directive on accounting standards that inculcate contingent liabilities is difficult to monitor and implement.

There are non-pecuniary weaknesses as well. Counties may find it difficult to understand the restrictions on development they are limited to because of the EAC. This is because the EAC is still a remote idea on the grass root level throughout East Africa. Counties find it difficult to identify with the EAC making it harder to abide by rules by the EAC.

Opportunities

MAFR-EAC provides for a predictable fiscal reaction from member states of the EAC. Planning on a regionally wide basis becomes easy for businesses. Investors are drawn to stable economic conditions and non-volatile economic climates. The EAC could experience increased Foreign Direct Investment. The region as a whole achieves a more stable status that results in possible higher credit ratings on sovereign bonds, reducing the cost of financing development.

Threats

The deficit levels would rise to 10% doubling the current deficit in an attempt to finance the counties through bonds. County governments are already criticizing the central government for not supplying adequate financing. Limiting their borrowing to this end will come under political criticism.

In addition, the only way to limit the deficit is to levy more taxes from the national government. The county government could levy more taxes to reduce their borrowing needs although going by current figures this is set to be small.

Deficit levels of 10% endanger the region when repayment is due because of the decreased public spending by government that hinders demand for goods and services within the region. Kenya, being the leading economic powerhouse of the region will have spillover effects on Uganda and Rwanda if the economy slumps.

With devolution coming up for Kenya, it is imperative that the country budget's their spending needs over the period that devolution is supposed to take place and ensures that the EAC does not prescribe debt levels below the ones Kenya has identified as necessary for future development through county and national governments. The implementation of the MAFR-EAC could be very restrictive on Kenya with upcoming larger budget deficits and large spending. Lastly, MAFR-EAC is a risk-averse structure that limits borrowing. Counties could consider this as a threat to development that raises strong political opposition to the EAC.

Conclusion

5.1 Summary of Proposals

Figure 5.1

1. Chapter 2 Proposals: KCB	A. The national government of Kenya, through an act of parliament forms a Kenya County Bank as a subsidiary of the National Treasury that will be wholly responsible for county borrowing. Or Extend the mandate of the Commission on Revenue allocation through an act of parliament to include county financing and the outlined duties of KCB as described in Chapter 2. B. Streamline all county borrowing through KCB to attach credibility to county bonds; C. Ensure KCB develops affordability ratios and credit assessment techniques that espouse the principle of equity. D. Give KCB access to the interbank market for ensuring short-term liquidity. E. The Kenyan government request interpretation of the constitution in regards to the obligation of the national government to guarantee county borrowing. Must 100% of county borrowing be guaranteed or is partial guarantee of county borrowing lawful?
Chapter 3 Proposals: Economic analysis	A. The Kenyan government conducts further research on the symmetry of East African economies. B. Governments of the EAC undergo restructuring to make government leaner, and reduce recurrent expenditure. C. Kenya proposes that EAC countries set target on tax revenues to a % of GDP while forming a monetary integration. D. The targets on tax revenues as a % of GDP

	unique to every country understanding the macroeconomic situation in the country.
Chapter 4 Proposals: MAFR-EAC	A. Kenya propose the MAFR-EAC be adopted by the EAC by issuing a directive instructing countries to apply deficit/GDP limits that if dangerously approached or already surpassed, use the MAFR-EAC for reactionary fiscal policy begin. B. Kenya encourages political cooperation and commitment to the EAC among member states. Good will is necessitated for a successful EAC. C. Kenya in transposition of the directive on MAFR-EAC set a mixture of administrative and rule based policies that regulate county borrowing. Kenya forms a dynamic model that determines the burden of macroeconomic aims to be executed by counties through regulating county borrowing. D. The EAC issue a directive that includes exposure to risk of default on contingent liabilities in national debt calculation. Kenya restricts county deficits and debts to developmental projects only. Kenya however does not restrict deficit levels prescribed in the EAC to county budgets.

5.2 Closing Remarks

This thesis formulates a county financing structure for Kenya through analysis of sub-sovereign structures in other countries, in particular, India, The Philippines and South Africa. This thesis shed light on the factors that differentiate sub-sovereign financing in Kenya and proposed a structure that minimizes costs and risk, while sensitive to the EAC. This thesis structures a fiscal policy that the EAC could adopt that ensures macroeconomic stability within the region. The chief accomplishment of this thesis is the proposal of a fiscal policy that the EAC could enforce on member states that outlines regulations regarding sub-sovereign financing whilst ensuring that member states have the fiscal ability to implement country specific regulation – in particular, a directive that is beneficial to Kenya. This thesis has referenced foreign examples and evaluated local circumstances providing for a thesis that suggests enforceable actions for Kenya and the EAC.

The chief concern that the EAC faces is enforcement of rules. Ensuring that all member states abide by the rules has proved a problem in the European Union, and legally outlined repercussions are hard to enforce fearing political tension and further deteriorations. A union's functionality is limited to the willingness to cooperate.

However, the limits set not only serve as economic targets, but in the event that an economic crisis results due to non-compliance, the legal liability is easily appropriated by identifying which member state passed the limits and to what extent. This thesis finds it more productive and efficient to tackle issues of non-compliance from understanding the reasons of non-compliance and finding enforceable alternatives instead of threatening with various sanctions. In the greater context of things, the limits set at the beginning of the EAC are more strong guiding principles. History has shown that even the most carefully drafted laws and regulations can be just that. The EAC has embarked on an arduous journey to unite five countries that will undergo trial and error, and revision of regulations and directives before arriving at workable limits.

Forming fiscal policy sensitive to sub-sovereign financing in all EAC countries is a difficult task. This thesis only focuses on Kenya sub-sovereign financing, but other countries could have objections to the structure proposed. With further research that details the proposals and regulations proposed this thesis could serve as a framework that steers the EAC in ensuring sustainable risk-averse economic development. This thesis appreciates the influence of the EAC on internal Kenyan affairs, a concept that Kenyan counties have not begun to consider owing to the remoteness of the EAC. This thesis calls for a greater appreciation of the EAC, stemming from an identification of the potential benefits if member states intensify integration and create a greater intimacy with the EAC.

In conclusion, becoming more aware of the EAC in East Africa and the potential benefits is instrumental to continued integration and realization of potential. If the suggestions proposed in this thesis are pursued with the political will of member states, Kenya can optimally facilitate county development in a manner that is considerate of the EAC.

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