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Thinking Policy Together

Public Debt Ceiling: The Experience for Kenya and Lessons from Other Countries

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Key Highlights

Public debt ceilings are rules or limits on public debt which determine how much a country can borrow. This Policy Brief focuses on the public debt ceiling in Kenya and provides policy options. The key highlights include:

(i) The requirement for debt ceiling varies from country to country, with some having the ceiling stated in the legislation – such as in Europe, Poland, Denmark, and Ghana – while it is open in others, for example, in the United Kingdom. Whichever framework is in place, the need to enforce the debt ceiling is vital.

(ii) Kenya has shifted from a nominal debt ceiling that was initially provided for in the Public Finance Management Act, 2012, to a debt anchor of 55 per cent of GDP as provided for in the debt anchor law of October 2023.

(iii) Debt brinkmanship is sometimes inevitable, where the debt ceiling is raised when reached. Despite this being an optimal policy rule, if not well utilized, it can be misused and hence defeat the purpose of setting the ceiling in the first place. This means fiscal discipline is required in conducting debt brinkmanship. An ever-rising debt ceiling can have undesirable consequences to the economy.

Introduction

Debt ceilings or limits are a set of rules that provide the maximum amount of debt that a government can undertake. Often, they are imposed by governments as part of measures to ensure fiscal discipline and promote debt sustainability. Once a debt ceiling has been established, the government may then decide to set its debt target either below or just at the debt ceiling. In some instances, debt targets are set below debt ceilings to create a buffer between the actual debt levels and the specified ceiling. Governments may impose debt ceilings in nominal terms (specified in absolute numbers of specific currency) or relative terms (expressed as a percentage of GDP). Countries such as Denmark, the United States of America, and Kenya use nominal debt limits. Kenya, in October 2023, replaced the nominal debt ceiling with a debt anchor ceiling, set at 55 per cent of GDP.

Kenya has been using the nominal debt ceiling between 2006 to 2022, with the debt ceiling requiring approval by the National Assembly. The debt ceiling has, therefore, been shifting to accommodate rising budgetary requirements in the country. The debt ceiling was Ksh 6 trillion before 2012 and was raised to Ksh 9 trillion in October 2019, and later revised further upwards in July 2022 to Ksh 10 trillion. Kenya has thus had some form of debt brinkmanship where the ceiling is raised to accommodate more debt.

This policy brief, therefore, discusses the debt ceiling experience for Kenya, the motivation for imposing public debt ceilings and the debt brinkmanship problem, an assessment of changing debt ceilings, the pros and cons of debt-anchor versus nominal debt ceilings, and lessons Kenya can learn from other countries experiences.

Experiences and Lessons Learnt on Debt Ceilings

i) Experiences on debt limits from other parts of the World

In most countries, the law restricts the amounts to be borrowed either by a borrowing limit expressed in net or gross terms or restriction by a clause in respect of the purpose of borrowing. The most common structure in Europe is where Parliament sets an annual limit in connection with the approval of the fiscal budget, which then functions as a means for it to control the budget. The clause that restricts purpose usually ensures that the borrowing mandate is on specified purposes, with the main purpose being borrowing to finance the budget deficit and refinance existing obligations.

Debt ceilings may be established in various ways (see Box 1 adapted from IMF 2015 report). For example, a debt ceiling may be established through political commitments, supranational ceilings, ministerial action, constitutional or statutory ceilings, and annual ceilings set by Parliament. Currently, Kenya has in place the Debt Anchor Bill, 2023 which is a statutory ceiling set at 55 per cent of GDP. Various countries have adopted different ways of establishing their debt ceilings.

In Poland, for example, there is a clause in the constitution that requires that total government debt, augmented by the amount of anticipated disbursements on guarantees, should not exceed 60 per cent of GDP; similar sentiments are expressed in the Maastricht Treaty. The US and Denmark also have legislative limits on the stock of debt outstanding. In Ghana, the government through the passage of PFM Regulations and the Fiscal Responsibility Law made the inclusion of debt ceilings in the economic tool kit setting the debt limit at 65 per cent of GDP. In the UK, the mandate on borrowing is open. The National Loans Act of 1968 permits the Treasury to raise any money that it considers expedient for promoting sound monetary conditions.

In Suriname, the law on Government debt invalidates any debt that is more than the debt ceiling and prohibits any payment of a debt or guaranteed obligation that exceeds the limit (Rivetti, 2021). The example of Suriname shows that the law spells out the debt ceiling and that enforcement is key to ensuring that the debt level is contained within the debt ceiling.

Box 1: Ways of establishing debt ceilings

Approaches towards establishing debt ceilings include:

Political commitments: Debt ceilings in some countries (Canada and Cape Verde) are established as part of a fiscal responsibility framework based on policy commitments rather than explicit legal instruments.

Supranational ceilings: Refers to instances where debt ceilings are established as part of fiscal rules under regional treaties that bind members of monetary unions. For example, debt ceiling imposed on EU member states, EAC (debt-to-GDP ratio of 50 per cent), SADC (debt-to-GDP ratio of 60 per cent), WAEMU (debt-to-GDP ratio of 70 per cent) and the CEMAC (debt-to-GDP ratio of 70 per cent).

Constitutional ceilings: Refers to the establishment of the debt ceiling under the constitution. This applies to a limited number of countries such as Hungary and Poland. The prescription of the ceiling in the constitution makes the debt ceiling rule more permanent and not subject to arbitrary changes, given that the procedures for constitutional amendments are often more stringent than for ordinary laws. However, in instances of economic challenges, the rigidities may lead to unintended consequences, which should be carefully considered.

Statutory ceiling: Refers to the establishment of the debt ceiling under statutes such as the public debt law, fiscal responsibility law, or budget/public finance management law. The level of flexibility provided in the case of a statutory debt ceiling may be slightly higher than under the constitution, given that Parliament may typically amend such statutory ceilings.

Annual ceilings set by Parliament: In some countries (Argentina, Brazil, Canada, Japan, New Zealand, and Spain) the Parliament is empowered to establish debt ceilings under the annual Budget/Appropriations Act. The US, before the coming into force of the 1974 Congressional Budget Act, required the House of Representatives to pass a resolution to approve the annual debt limit, with the budget.

Ministerial action: Some jurisdictions provide much more flexibility by empowering the Minister of Finance to periodically set the debt ceiling by secondary legislation. This may, however, leave too much discretion in the hands of the Minister, especially where there is no requirement for Parliament to affirm such regulations.

Adapted from IMF Working Paper (2015)

(ii) Kenya's experience with debt ceilings

Before October 2023, Kenya's debt ceiling was set by Parliament in line with the Legal Notice No. 34 of 2015. During that period, Kenya has had three debt ceilings as follows: Ksh 6 trillion before the PFM Act (2012), Ksh 9 trillion in 2019, and Ksh 10 trillion in July 2022. However, in October 2023, the Debt Anchor Bill was passed into law and, therefore, sets the thresholds for Kenya's borrowing. At the regional level, however, the East African Community (EAC) Monetary Union Protocol established a debt ceiling of 50 per cent of GDP. Anchoring debt to GDP means that a country's borrowing is dependent on the performance of its gross domestic product. Table 1 presents the debt ceiling for Kenya with the rising debt ceiling over the years.

Table 1: Level of total public debt versus the debt ceiling

As at June	Total public debt (Ksh trillion)	Debt ceiling (Ksh trillion)	Present value of debt to GDP ratio and (targets)
2015	2.8	6.0	48.5 (74)
2016	3.4	6.0	48.1 (74)
2017	4.4	6.0	55.4 (55)
2018	5.0	6.0	60.6 (55)
2019	5.8	9.0	61.4 (55)
2020	6.7	9.0	60.3 (55)
2021	7.7	9.0	61.6 (55)
2022	8.6	10.0	61.7 (55)
2023	10.2	10.0	NA

Data source: National Treasury, Annual Debt Report (October 2022), BPS reports (Various), and CBK and IMF Reports (Various)

(iii) An assessment of the likely implications of debt ceilings

Ideally, a country's debt level needs to lie below the ceiling or cap to allow for some space to absorb shocks that are likely to hit the economy, which would increase the fiscal borrowing requirement and hence the fiscal deficit and debt level (Saxegaard, 2014). Aguiar et al. (2015) observe that one role of a debt ceiling is to reduce the risk of default. Another potential benefit of a debt ceiling is that it reduces debt, which leads to higher consumption and increased welfare (Andersen, 2019).

However, a breach of the debt ceiling set by a country could result in harmful consequences. For instance, a debt ceiling constrains fiscal policy choice (Heinemann et al., 2015). Worse of them is the increased likelihood of the country defaulting on its debt[1]; other than this, and based on experiences in the US and other parts of the world, a breach of the debt ceiling is detrimental and is likely to cause negative externalities, which include: the inability of a government to offer financial assistance to those in need, including government failure to fulfil social security payments; the inability of a government to offer basic services; markets and businesses would be hurt due to the arising uncertainties; consumers would be hurt – lack of pay to workers, hence financial ruin, and reduced consumer confidence.

In addition, there are likely to be substantial declines in the stock markets; higher borrowing costs; higher likelihood of a self-inflicted economic recession and a financial crisis. In a worst-case scenario, if prolonged, a default on debt arising for example from a breach of the debt ceiling can lead to a decline in GDP and loss of many jobs. There is also a higher likelihood of a government shutdown and the need to take extraordinary measures to keep the government open. Additionally, debt ceilings could result in increased tax burdens in the short run (Uchida and Ono, 2021).

For policy makers to overcome the negative effects highlighted, the best option is to temporarily suspend the debt ceiling once it is hit or to raise it. This will help avoid economic devastation[2]. The country can also avoid defaulting on debt, which has adverse economic implications and avoid an economic catastrophe. Furthermore, as the debt level approaches the limit, that should be an alert for the fiscal authority to implement a fiscal policy adjustment mechanism to avoid a great increase in the premium risk, a possible restriction on credit access, or a debt default.

The experience of the United States has demonstrated the implication of failure to further raise the debt ceiling when a country is at its debt ceiling brink. The US hit the debt limit and entered debt limit crises in 2011 and 2013, but the country was able to ultimately avoid a debt default. The debt limit crises cost the country billions of dollars in lost economic activity. The crises also resulted in the first-ever downgrade of the US Credit rating (JEC Debt Limit Brief, Undated). The short-term effects of debt ceiling brinkmanship[3] include[4]: government shutdowns and extraordinary measures to keep the government open, becoming common; volatility in financial markets; a country's credit rating suffers; and the government being less resilient in case of a disaster or unforeseen events.

1 Whitehouse.gov/cea/written-materials/2021/10/06/life-after-default/.
2 JEC Debt Limit Brief.
3 Brinkmanship is defined as the art or practice of pursuing a dangerous policy to the limits (brink) of safety, before stopping.
4 Itsuptous.org/blog/what-debt-ceiling-and-its-effects.

Arguments in Favour and against Nominal Debt Anchor versus Debt-to-GDP Ratio

Kenya has shifted from a nominal debt anchor to a debt ceiling anchored on GDP. A nominal debt ceiling is fixed on a subjective target, which makes it likely to be abused and is more vulnerable to debt brinkmanship, which means regularly shifting the ceiling when it is approached. The benefit of a nominal ceiling is that a country can borrow as much as it wants irrespective of its economic performance. However, this also presents a problem of making public debts unsustainable.

A debt ceiling anchored on GDP has the benefit of pegging debt on GDP and hence increases the likelihood of debt sustainability, since borrowing cannot exceed the threshold and is based on economic performance. Furthermore, a debt-anchored ceiling is a moving target in line with GDP, which can motivate governments to enhance growth to increase their debt ceilings. A debt-anchor ceiling also offers a better approach to managing debt compared to nominal or arbitrary ceilings. However, debt anchored on GDP may fail to yield a debt-to-GDP threshold that maximizes public investment and growth (Arbelaez, Benitez, Steiner and Valencier, 2021). Finally, countries sometimes borrow to take care of unforeseen emergencies such as war, pandemics, and other unexpected shocks. Thus, whereas a debt anchor is likely to promote debt sustainability, it largely remains silent on what to do in such extreme events that call for additional borrowing requirements.

Policy Recommendations on Debt Ceilings

Policy interventions towards observing debt ceiling provisions include:

(i) Link debt ceilings to the country's debt-carrying capacity and growth

The debt ceiling is a good policy measure to ensure that the government has a limit in terms of debt levels it can accumulate. Kenya has now anchored the debt ceiling in the Law at 55 per cent of GDP. Thus, Kenya has made progress in this aspect by shifting from an ad-hoc nominal debt ceiling to a debt ceiling that relates to the gross domestic product of the country. Adherence to the law will, therefore, be critical to achieving a more sustainable debt.

(ii) Adhere to debt ceilings to avoid the debt brinkmanship problem

For many governments with debt ceilings, there is a tendency to raise the debt ceiling when the debt levels are about to surpass the ceiling. Whereas this is a good policy option, to either raise the ceiling or temporarily suspend it when it is almost hit, there is a need to adhere to ceilings and avoid the brinkmanship problem that is usually associated with debt limits. Thus, the regulations as passed by Parliament or as established in statutory law can be improved in a way that ensures debt brinkmanship (if embraced) is done in an optimal way that promotes fiscal discipline.

(iii) Enhancing debt utilization towards growth and development of the country

Given that the debt anchor law has been passed, which anchors debt to GDP, the country can, therefore, borrow more only in line with its GDP. This can thus be achieved by ensuring that debt money is used on development projects and other growth-enhancing economic activities. This will also help to improve debt transparency.

(iv) Institute appropriate fiscal policy adjustment mechanisms as the debt level approaches the debt limit

It should be an alert to the fiscal authority to implement fiscal policy adjustment mechanisms as the debt level approaches the limit. This will help avoid a great increase in the premium risk, a possible restriction on credit access, or debt default (Campos and Csyne, 2021). This is where both fiscal and monetary policy actors can collaborate to ensure coherent policies as relates to debt and institute appropriate policy measures that will ensure the country does not unnecessarily take up debt brinkmanship, which is vulnerable to misuse as experiences from other jurisdictions have shown.

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