

Domestic Government Borrowing And Public Debt Sustainability In Kenya: A Theoretical Review

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Abstract

Developing countries such as Kenya rely heavily on external and domestic borrowing to finance economic development and bridge budget deficits. Kenya's public debt remains at a high risk of distress, with most of the tax revenues generated in the country being used to make interest payments. The country has increased its domestic borrowing levels over the years in an effort to reduce external borrowing. The high levels of domestic public debt in Kenya are fast approaching unsustainable levels. Even though domestic debt reduces the exposure to foreign exchange risks and provides the government with a more stable source of funding, concerns have been raised about its potential impacts on the sustainability of national debt. The main objective of this study is to examine how the Kenyan government's use of internal debt raised through treasury bills and bonds impacts the sustainability of the country's public debt. Specifically, it seeks to examine the effect of domestic borrowing by the Kenyan government through treasury bonds and bills on the country's public debt sustainability, with the moderating effect of the country's macroeconomic conditions and the mediating role of debt servicing costs. To accomplish this objective, the study will be anchored by the Debt Sustainability Theory, the Keynesian Theory of Public Finance, and the Debt Overhang Theory. It will utilize a positivist research philosophy. An explanatory research design will be adopted to investigate the causal links between Kenya's public debt sustainability and domestic borrowing through Treasury securities. Quantitative data will be collected and analyzed using STATA to obtain insights into the relationship between domestic borrowing through government bonds and bills and the public debt sustainability. Additionally, the mediating and moderating effects of debt servicing costs and growth rate will be examined by the study.

Keywords: *Public Debt Sustainability, Treasury Bond, Treasury Bills, Public Debt, Debt Servicing Costs.*

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I. Introduction

The sustainability of public debt is a major concern for most developing economies. Developing countries such as Kenya rely heavily on external and domestic borrowing to finance economic development and bridge budget deficits (Kenya National Treasury, 2025). The World Bank Group (2025) report highlights that Kenya's public debt remains at a high risk of distress, with most of the tax revenues generated in the country being used to make interest payments. Similarly, the 2025 medium-term debt management strategy report prepared by the Public Debt Management Office, the National Treasury, and Economic Planning indicates that the country's public debt remains sustainable, but with a high risk of debt distress.

The government borrows domestically through the issuance of treasury bills and bonds. The Kenyan government has increased its domestic borrowing over the past few years with the aim of reducing the high dependency on external debt. The country's stock of domestic debt has increased substantially in the last two decades (CBK, 2025). As of the end of June 2024, Treasury bonds were approximately 85.5 percent of total domestic debt, while Treasury bills accounted for 11.4 percent of total domestic debt. The other domestic debt categories accounted for 3.1 percent (Kenya National Treasury, 2025). The high levels of domestic public debt in Kenya are fast approaching unsustainable levels (Musili, 2024). Even though domestic debt reduces the exposure to foreign exchange risks and provides the government with a more stable source of funding, concerns have been raised about its potential impacts on the sustainability of national debt. High levels of domestic debt can result in expensive debt payments, crowding out of private sector credit, and other budgetary pressures that may threaten the country's macroeconomic stability (Agusto and Co., 2024). To measure the sustainability of the country's national debt, indicators such as debt service-to-revenues ratio, the primary fiscal balance, and interest payments as a percentage of government expenditure are used.

Debt servicing cost is an important factor in public debt sustainability. This is because it plays a mediating role between government borrowing and the sustainability of public debt. It mediates the extent to which domestic borrowing by a country's government affects the sustainability of public debt. Mose *et al.* (2024) suggest that as the debt servicing cost goes up, the repayments of interest and principal amount of the loans use up a significant proportion of the national budget. Hence, high debt servicing costs eventually make the public debt of a country unsustainable.

Public Debt Sustainability

The sustainability of public debt refers to the ability of a country's national government to repay its existing debts without defaulting, resorting to debt restructuring, excessive borrowing, or hurting the economy. According to the IMF, public debt sustainability relates to the government's capability to service its debts without requiring unrealistic adjustments to its expenditures and incomes. This relates to both solvency and liquidity. Solvency pertains to the ability of the government to meet its long-term obligations, whereas liquidity relates to the ability to meet short-term obligations. To measure the sustainability of a country's public debt, several indicators may be used, including the debt-to-GDP ratio, the debt service-to-revenues ratio, the primary fiscal balance, and interest payments as a percentage of government expenditure. In Kenya, the rising domestic debt has raised alarms concerning the long-term sustainability of increasing internal debt.

According to Were and Tiriongo (2013), domestic debt tends to reduce the vulnerability of the country's exchange rate, but the high-interest payments associated with the debt tend to increase fiscal stress in the country. In addition, the IMF performed a debt sustainability analysis of Kenya in 2021 and warned that if not well managed, the growing domestic debt, if not effectively managed, could result in a strain on the nation's fiscal resources as well as crowd out private sector investments (IMF, 2021). In similar research, the Central Bank has revealed that increasing the proportion of Treasury Bonds in the national debt's portfolio has resulted in higher interest rate expenses, thereby further raising concerns about the long-term sustainability of the strategy.

As of June 2023, Kenya's public debt to GDP ratio stood at 70.8%, then reduced significantly to 65% percent in June 2024. This ratio surpasses the 55% recommended threshold for developing nations by the World Bank and IMF. Consequently, such high debt levels raise concerns relating to public debt sustainability in Kenya. To reduce overreliance on external debt, the government resorted to increasing its domestic borrowing. This has helped ease the exchange rate risks at the expense of increased debt servicing costs owing to high local interest rates in the country. In 2024, the rates on treasury bonds were as high as 18% (Central Bank, 2025). Interest payments have drastically increased, thereby consuming a substantial portion of government revenue. The high debt-service-to-revenue ratio (64.9% as of June 2024) limits the funds available for developing projects, as money available goes towards servicing the debt securities. As a result, the nation continues to run on sustained budget deficits.

Government Domestic Borrowing

As of the end of June 2024, out of the total domestic debt, treasury bonds accounted for 85.5%, treasury bills 11.4%, while other sources accounted for 3.1% (National Treasury, 2025). Notably, the treasury bonds make up the largest share of domestic debt. This can be attributed to their significantly longer maturity periods and greater attractiveness to institutional investors. On the other hand, treasury bills provide more liquidity to investors since they are short-term securities (CBK, 2025).

The Kenyan government has increased its domestic borrowing over the past few years with the aim of reducing the high dependency on external debt. This strategy is also aimed at helping to reduce the foreign exchange risks. Consequently, the country's stock of domestic debt has increased substantially in the last two decades. Even though domestic debt reduces the exposure to foreign exchange risks and provides the government with a more stable source of funding, concerns have been raised about its potential impacts on the sustainability of national debt. High levels of domestic debt can result in expensive debt payments, crowding out of private sector credit, and other budgetary pressures that may threaten the country's macroeconomic stability. This study, therefore, seeks to examine the effect of domestic borrowing by the Kenyan government through treasury bonds and bills on the country's public debt sustainability with the moderating effect of the country's macroeconomic conditions and the mediating role of debt servicing costs in the country.

Debt Servicing Costs

The debt servicing costs incurred by the Kenyan government plays a fundamental mediating role in the relationship between the country's public debt sustainability and domestic borrowing. It is worth noting that the increased use of domestic debt to finance budget deficits has increased the overall interest repayment obligations. The treasury bonds, for instance, tend to be associated with higher interest rates due to their long-term nature. Thus, the accumulation of this interest payment obligation has led to a significant increase in the nation's debt servicing costs. Debt servicing costs have a direct influence on the sustainability of a country's public debt due

to the fact that it consumes a significant proportion of the government's revenue. This results in a constraint of fiscal space and reduces funds available for development expenditures and essential services. Kenya's debt service to revenue ratio has consistently gone above the recommended global thresholds, thereby indicating that there are an increasing fiscal strain and reduced capacity to manage public debt sustainably. By incorporating debt servicing costs in the study as a mediating variable, this research acknowledges that domestic borrowing increases interest obligations, thereby indirectly affecting the sustainability of public debt. Obtaining insights into this transmission mechanism is fundamental for Kenya, where increasing domestic coupon payments have brought about fiscal vulnerability. Thus, including this variable in the study's analytical framework offers better and more policy-relevant insights into how domestic debt affects sustainability, beyond just debt accumulation.

Statement of the Problem

Over the years, Kenya has become increasingly dependent on domestic debt to fund the national budget. Ordinarily, the use of domestic borrowing through the issuing of debt securities such as Treasury bonds and bills is regarded as less risky compared to external debt. However, recent trends have revealed an increasing reliance on these debt securities to fund the national budget. This trend is very alarming. A report by the IMF (2025) revealed that the nation's debt-to-GDP ratio has been consistently exceeding the 70% threshold recommended for developing nations.

This status raises concerns regarding the sustainability of the country's public debt. Furthermore, the increasing domestic debt burden has forced the government to limit expenditure on development projects, potentially resulting in a slowdown in the country's economic growth (Lagoa, Leão, & Bhimjee, (2022)). Several scholars have undertaken studies to examine the sustainability of Kenya's public debt. The focus of these studies has mainly been on the overall debt profile of the nation, and has not specifically looked into the growing repercussions associated with the increasing borrowing through treasury securities. The IMF (2024) and the World Bank (2024) have also undertaken an analysis of the country's sustainability status. However, their research has focused on the risks linked to the use of external debt. Consequently, this implies that there is still a research gap on the consequences of the country's increased reliance on borrowing through bonds and bills. In addition, there are studies that claim that domestic borrowing is a more sustainable option in comparison to external debt. On the other hand, other studies claim that overreliance on domestic debt results in an increase in debt servicing costs that increases the fiscal risks of a country. The existence of these contradictory results from studies further reveals that there is a need for further research to be undertaken to critically examine the impact of internal borrowing on the sustainability of public debt. This study, therefore, aims to evaluate the effect of internal debt raised through treasury bills and bonds by the Kenyan government on the sustainability of the national debt, with the moderating effect of the macroeconomic conditions and the mediating role of debt servicing costs.

Research Objectives

The following objectives guided the study.

General Objective of the Study

The main objective of this study is to investigate how the Kenyan government's borrowing through treasury bills and bonds impacts the sustainability of the country's public debt.

Specific Objectives of the Study

The following specific objectives will guide the study.

- i. To determine the effect of domestic borrowing through treasury bonds on the public debt sustainability in Kenya.
- ii. To establish the effect of domestic borrowing through Treasury bills on the sustainability of public debt in Kenya.
- iii. To evaluate the relationship between domestic government borrowing and Kenya's debt service-to-revenue ratio.
- iv. To determine the role of debt servicing costs in mediating the relationship between domestic borrowing and public debt sustainability in Kenya.

Research Hypothesis

The study seeks to test the following null hypotheses:

H₀₁: Domestic borrowing through treasury bonds does not have a significant impact on the public debt sustainability in Kenya.

H₀₂: Domestic borrowing through Treasury bills has no significant influence on the sustainability of public debt in Kenya.

H₀₃: Debt servicing costs have no significant mediating role of in the relationship between public debt sustainability and domestic borrowing in Kenya

Significance of the Study

The significance of the study is grounded on the basis that it contributes positively to both academic literature and government policy. It addresses critical aspects and contemporary issues affecting the management of public debt in Kenya. The increasing dependence on domestic debt to fund public expenditure has raised concerns regarding the sustainability of the country's public debt. Thus, by critically examining domestic public debt from Kenya's point of view, the study contributes to debates on the trade-offs between government financing needs and the workings of the domestic financial market.

From a policy perspective, the study provides relevant information for Kenya's monetary and fiscal authorities, including the CBK and the National Treasury. Specifically, findings on the implications of domestic borrowing on private sector credit, interest rates, and debt servicing costs can influence debt management strategies aimed at reducing refinancing risks and preserving fiscal space. Given the current conditions in the country, with the nation facing increased debt distress risks and limited access to additional external debt financing, evidence-based insights on domestic borrowing will be instrumental for developing sustainable consolidation measures and effective liability management systems.

The findings of the study are also instrumental to the financial sector as well as private investors. Domestic debt has a direct impact on the allocation of financial resources within the economy. Therefore, by shedding light on the crowding out effect of public domestic borrowing, the study offers important information to businesses, financial institutions, and investors regarding interest rate dynamics and the availability of credit. This information is pertinent for promoting private sector-led growth, especially for SMEs in the country that are vulnerable to credit constraints.

The study also contributes to existing literature by synthesizing recent empirical and policy-oriented research on domestic public debt in Kenya using an integrative approach. Although several studies have examined public debt and economic growth in general, there is limited literature on the effect of internal debt raised through treasury bills and bonds by the Kenyan government on the sustainability of the national debt, with the moderating effect of the macroeconomic conditions and the mediating role of debt servicing costs. The findings of this study will therefore inform the literature on this niche area.

II. Literature Review

This research is anchored on the debt sustainability theory, Keynesian theory, and the debt overhang theory.

Theoretical Review

The Debt Sustainability Theory was initially proposed by Henning Bohn in 1995, who then later made additional developments to it in 1998. It is a foundational theory in finance that provides an approach for evaluating the sustainability of a country's public debt. It helps determine whether a country has the capacity to comfortably pay off its obligations without needing to obtain debt relief, default on payments, or accumulate arrears. The theory suggests that a country's debt is sustainable when the government can offset the debts now and in the future without putting the economy's stability at risk. The theory further suggests that sustainability is achieved when the present value of a country's future budget surpluses is at least equal to its current public debt level. However, when the latter is higher than the former, the nation's risk of sinking into a debt trap increases exponentially. This theory is paramount for developing nations such as Kenya, where the level of domestic borrowing by the government has been increasing exponentially over the last few years. Particularly, it provides insights into whether the government's strategy to shift from external debt to domestic debt is sustainable in the long run. Overall, this theory was selected as the principal theory for the study because it sheds light on the dependent variable of the study- public debt sustainability. It provides a theoretical and numerical foundation for evaluating how domestic borrowing practices affect the nation's capacity to control the amount of public debt over time.

The Keynesian Theory of Public Finance by John Maynard Keynes (1936) is a theory that supports economic intervention by government, especially during periods of economic downturn. In this theory, Keynes (1936) suggests that governments can stabilize their economies by implementing fiscal policies. The theory further suggests that borrowing through the issuance of treasury bonds and bills can act as an effective tool for controlling economic fluctuations in the country, while at the same time resolving economic shortfalls during downturns. As such, raising money through domestic debt securities allows the government to inject money and improve the liquidity of the economy. Although such a strategy may be beneficial, it may be associated with drawbacks such as high debt servicing costs and increased inflation. Thus, the government must balance the use of borrowing as a stimulus in order to avoid the risk of excessive debt accumulation over the long term. Notably, the theory was selected as an anchoring theory for the study because it aligns with the key variables of the study

and addresses the potential trade-offs between the stimulation of the economy through public borrowing and its long-term repercussions for the economy's public debt sustainability.

The Debt Overhang Theory is a theory that is commonly attributed to Paul Krugman (1988) as the pioneer, and Jeffrey Sachs (1989), who made further developments to it. This theory was originally developed to explain the unending and vicious debt cycle burden that engulfs most developing nations. The theory proposes that the excessive use of debt often creates a burden in the economy that eventually weakens its ability to grow and develop. This mainly happens because the debt servicing costs are excessively high, and a large proportion of the national income is directed towards the repayment of the debt instead of investing in development projects (Krugman, 1988). Based on the theory, excessive government borrowing undermines long-term sustainability. In this proposed study, debt servicing costs will be examined as a mediator in the relationship between domestic borrowing through treasury bills and bonds and public debt sustainability. The debt overhang theory will play a fundamental role in helping to conceptualize the effect of the increasing domestic borrowing through Treasury bonds and bills can constrain the government's capability to repay its maturing debt obligations as and when they are due.

Empirical Literature Review

This section critically analyses the studies that have been undertaken by other scholars on the subject of public debt sustainability, government borrowing through securities, and the mediating and moderating role of debt servicing costs and the country's GDP growth.

Government Borrowing and Public Debt Sustainability

The sustainability of the country's public debt under different policy scenarios and macroeconomic conditions has been examined by Nyaga (2020). The study employed a debt sustainability analysis (DSA) framework. From the study, it was noted that the country's debt was manageable over the medium and short-term period, but not over the long-term. This can be attributed to the fact that the examined debt indicators revealed that the country is on the verge of exceeding several critical indicators, something that reveals increased risk of debt distress (Nyaga, 2020). The study's main fear is that an upsurge in the level of domestic debt raised could further deepen fiscal pressures. Mose *et al.* (2024) focused on the key determinants of the nation's debt sustainability given the sustained budget deficits and high servicing costs associated with public debt. The study utilized a single equation regression analysis. Their findings revealed that the country's debt is not sustainable. This problem has been brought about by the ever-increasing budget deficits, high interest charges, a depreciating currency, and high inflation levels. Nandelenga (2024) aimed to analyze the sustainability of Kenya's public debt and establish the optimal level of debt that would help achieve the targeted growth rate of 10% as per the country's Vision 2030. The study adopted a co-integration testing method to gain a better overview of the long-term relationship between government debt and economic performance. According to the study, Kenya's public debt as of 2014 had been sustainable over time. At the time, the sustainability was attributed to the country's prudent fiscal policies adopted by the Kenyan government. The simulation results of the study further indicated that an optimal debt-to-equity ratio of 32.5% is required for the nation to achieve the ambitious 10% growth target by 2030. This suggests that it is crucial for the government to keep its debt below this level. In addition, Hassan, Onger, and Ndolo (2023) examine the effect of national public debt on the level of economic growth in Kenya with a focus on external and domestic debt from 1990 to 2019. The majority of development projects in Kenya are financed by borrowing, which is concerning, according to the paper. Hassan, Onger, and Ndolo (2023) express concerns on whether or not the country's debts can be sustained. Using the OLS regression model, the results reveal that external debt has a slight positive effect on the country's economy, while domestic debt has a negative one. The scholars emphasize the need for the government to develop sound policies for debt management. Too much internal debt could negatively impact Kenya's creditworthiness and even drive out private investments. A study by Kenyanya, Jagongo and Gitari (2018) examines Kenya's debt dynamics and the sustainability of the country's debt. The study utilized a correlation design analysis with dynamic panel regression models and secondary data from the National Treasury, World Bank and the IMF covering the period between 2000-2007. The study examined the relationship between external debt and the country's portfolio composition and financial repayment risk (Kenyanya, Jogongo and Gitari, 2018). The results reveal that Kenya showed an alarming trend in its public debt trajectory. There was a significant disparity between the nation's economic growth and debt accumulation. It was noted that between 2013 and 2017, the nation's total debt burden rose by 21.3% while the economy grew by only 5.5% during the same period. The study revealed that the nation's debt service burden was evidence of the nation's sustainability challenges. The debt service ratio was at 34%, substantially higher than the World Bank's Country Policy and Institutional Assessment (CPIA) threshold of 22% risk (Kenyanya, Jogongo, and Gitari, 2018). The study also noted that the internal borrowing dynamics were no better, as the government has increasingly borrowed from the domestic banking sector. It was concluded that the government must develop an optimal debt portfolio management system that balances debt to manageable levels and ensures low financial risks and long-term sustainability.

Public Debt Sustainability, and Domestic Borrowing

Okoth (2023) examines the impact of Kenya's government debt on economic expansion. The study showed that the republic's growth has exponentially grown over the years, something that has generated concerns among Kenyan stakeholders. Using data from 2002 to 2020, the study analyzed the data using the multivariate regression model and the OLS method. It was noted that external debt had a small positive impact on the level of inflation, but impacts negatively on the GDP growth rates. Similarly, domestic debt showed insignificant positive effects on GDP changes, with a negative but insignificant effect on inflation (Okoth, 2023). The underdeveloped capital markets in Kenya were suggested as a contributing factor to the insignificant effects of domestic debt (Okoth, 2023). Desmond, Ihuoma, and Udochukwu (2023) offer a thorough analysis based on ARDL of the ways in which Nigerian debt securities, such as Treasury bills and bonds, contribute to GDP growth. The study's instrument-level methodology is consistent with Kenya's strategy to breaking down domestic borrowing. Zhou, Liu, and Xu (2024) present a regime-switching analysis of China's public debt growth, showing how financial factors such as asset market dynamics and credit have varying effects on debt under different economic regimes. Although their primary focus was on debt expansion rather than sustainability, their findings highlight the need of looking at how macroeconomic factors, such as GDP growth regimes, influence debt outcomes. Importantly, their application of threshold or regime-aware models to evaluate the impact of domestic borrowing instruments on debt sustainability in Kenya is inspired by their use of dynamic modeling methodologies.

Domestic Borrowing, and Debt Service-to-Revenue Ratio.

Using time-series data and a Vector Error Correction Model, Kongo *et al.* (2023) demonstrated that while exchange rate depreciation increases fiscal vulnerability, higher debt service-to-revenue ratios significantly reduce the sustainability of public debt. Kenya's debt-to-GDP ratio is also expected to stay above safe thresholds through 2030, with domestic debt service ratios surpassing advised levels, according to the IMF's Debt Sustainability Analysis from 2024. Islam, Ahmed, and Faraz (2023) present important DSA and FRF data showing that, under optimistic growth assumptions (10% real GDP growth) and low real interest rates, Pakistan's public debt can become sustainable. Ochieng *et al.* (2023) investigated Kenya's domestic debt management practices and their effects on debt sustainability from 2010 to 2023. In comparison to Treasury bills and other instruments, the study shows a structural change in the government's borrowing pattern, with Treasury bonds accounting for 83% of the total domestic debt by March 2023. This modification was meant to reduce the risks associated with short-term refinances by extending the maturities of debt. However, the scholars note that these strategies have led to a greater interest burden on the national budget, resulting in a massive rise in the debt service-to-revenue ratio.

Domestic Borrowing, Debt Servicing Costs, and Public Debt Sustainability

Kenya's debt service-to-revenue ratio rose to 60% in 2023 from 18.7% in 2013 (Agusto and Co., 2024). It was also predicted that the rate will further rise to 63.5% in the 2024/25 fiscal year, further increasing the fiscal pressure (Agusto and Co., 2024). High interest rates and the expanding maturity profile of domestic debt instruments are cited by the authors as the causes of this trend. (Agusto and Co., 2024). Using data from 1999 to 2021, Kithandi (2023) uses ARDL modeling to examine the long-term impacts of public domestic debt on private investment, which is operationalized as gross fixed capital. The study offers proof of a crowding-out effect, which states that rising domestic government borrowing, including that of Treasury securities, has a detrimental effect on private investment. Increased internal borrowing brings about an increase in the fiscal costs related to debt servicing. Using the Generalized Method of Moments estimation, Aladejare (2020) examines the effect of debt servicing costs on the economic sustainability of 20 sub-Saharan African nations. The study discovered that increasing debt servicing requirements results in the shrinking of the fiscal space and reduces public investments, as well as weakens the country's economic resilience. The study provides compelling evidence that debt servicing costs are a critical channel through which domestic borrowing influences fiscal stability.

Conceptual Framework

Figure 1.1: Conceptual Framework
Mediating Variable

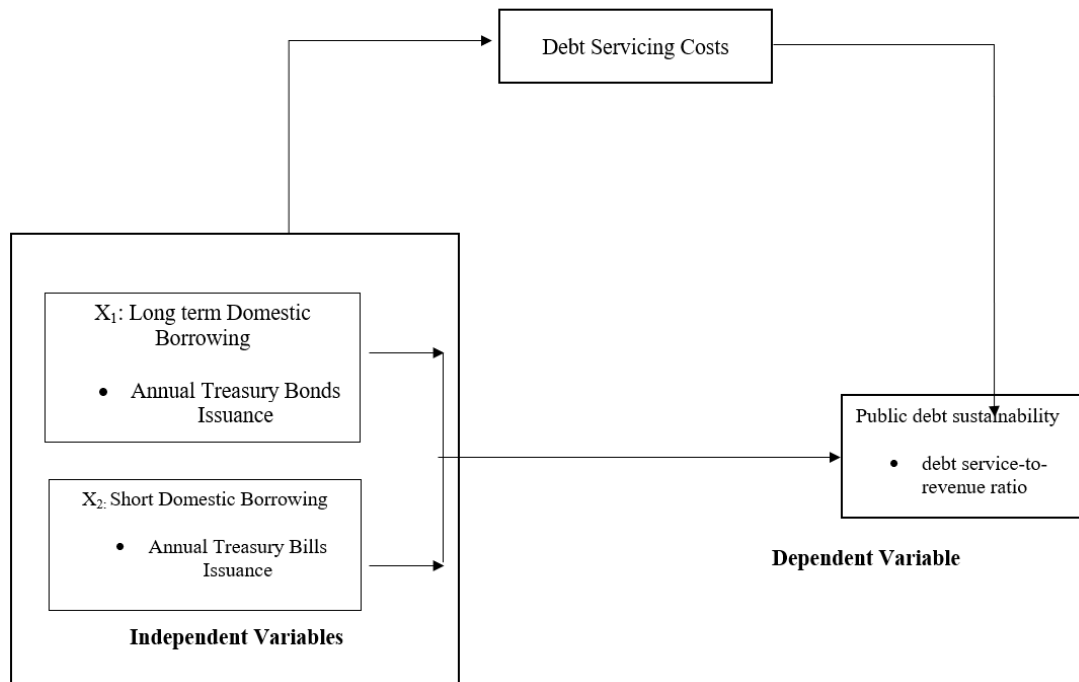


Figure 1.1 above illustrates the relationship between domestic borrowing through government bills and bonds and the sustainability of public debt in Kenya. The independent variables are the public debt raised through treasury bonds and treasury bills, whereas the dependent variable is public debt sustainability. The mediating variable is the debt servicing costs.

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