The Draft 2021 Budget Policy Statement Note

On 25th January 2021, the National Treasury released the [Draft 2021 budget policy statement], in line with section 25 of the Public Finance Management (PFM) Act, 2012 which requires the National Treasury to seek and take into account the views of stakeholders and the public in preparing the Budget Policy Statement (BPS), before submission to Cabinet for approval and the subsequent submission to Parliament. The statement expresses the priority economic policies, structural reforms and the sectoral expenditure programs to be implemented under the Medium Term Expenditure Framework for FY 2021/22– 23/24.

As such, we will be reviewing the statement and discuss the following:

i. A comparison of the FY2020/21 budget and the projected FY2021/2022 budget as per the Draft 2021 BPS,
ii. Our analysis and view of key aspects of the budget, including related items such as the Big Four Agenda and post-COVID
iii. recovery strategy, and,
iv. Conclusion and key areas of improvement,

Section I: A comparison of the FY'2020/21 budget and the projected FY'2021/22 budget as per the Draft 2021 BPS

Below is a summary of the major changes as per the BPS 2021 from the revised FY'2020/2021 budget:

Comparison of 2020/21 and 2021/22 Fiscal Year Budgets as per The 2021 Budget Policy Statement				
	FY'2019/2020 Budget Outturn	FY'2020/2021 Revised Budget	FY'2021/2022 BPS	% change 2020/21 to 2021/22
Total revenue	1,737.0	1,829.2	1,985.2	8.5%
External grants	19.8	48.7	46.1	(5.3%)
Total revenue & external grants	**1,756.8**	**1,877.9**	**2,031.3**	**8.2%**
Recurrent expenditure	1,645.2	1,848.2	1,975.2	6.9%
Development expenditure & Net Lending	594.9	641.9	611.0	(4.8%)
County governments + contingencies	325.3	388.0	382.6	(1.4%)
Total expenditure	2,565.4	2,878.1	2,968.8	3.2%
Fiscal deficit excluding grants	**(828.5)**	**(1,048.9)**	**(983.7)**	**(6.2%)**
Deficit as % of GDP	8.2%	9.4%	7.9%	(16.0%)
Net foreign borrowing	340.4	427.5	345.5	(19.2%)
Net domestic borrowing	450.4	572.7	592.2	3.4%
Total borrowing	790.8	1,000.2	937.7	(6.2%)
GDP Estimate	10,156.6	11,131.9	12,435.7	11.7%

Key take-outs from the table include:

i. The 2021 BPS points to an 3.2% increase of the total expenditure, to Kshs 3.0 tn from Kshs 2.9 tn in the FY' 2020/21 revised budget,
ii. Recurrent expenditure is set to increase at a higher rate than development expenditure; with recurrent increasing by 6.9% to Kshs 2.0 tn from Kshs 1.8 tn as per the revised budget, while development expenditure is projected to decline by 4.8% to Kshs 611.0 bn from Kshs 641.9 as per the revised FY'2020/21 budget,
iii. The budget deficit is projected to decline to Kshs 983.7 bn (7.9% of GDP) from the projected Kshs 1,048.9 bn (9.4% of GDP) in the FY 2020/21 revised budget; The decline is in line with the International

Monetary Fund's (IMF's) recommendation, as the country seeks to reduce Kenya's public debt requirements,

iv. Revenue is projected to increase by 8.2% to Kshs 2.0 tn from the projected Kshs 1.9 tn in the revised FY 2020/21 budget, with measures already in place to work towards increasing the amount of revenue collected in the next fiscal year,
v. The total borrowing requirement is expected to decline by 6.2% to Kshs 937.7 bn from Kshs 1,002.2 bn as per the FY 2020/21 revised budget , in a bid to reduce Kenya's public debt burden which is estimated at 69.6% of GDP as at December 2020, 19.6% points above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%, and,
vi. Debt financing for the 2021/22 budget is estimated to consist of 37% foreign debt and 63% domestic debt, a change from the 43% foreign and 57% domestic as projected in the revised FY' 2020/21

. **Section II: Analysis and house-view on key aspects of the BPS:**

Below we give our analysis and view on various aspects of the Budget Policy Statement:

1. **Revenue**

In FY 2021/22, revenue collection including Appropriation-in-Aid (A.i.A) is projected to increase by 6.9% to Kshs 2.0 tn, up from the estimated Kshs 1.8 tn in the FY 2020/21, mainly underpinned by the ongoing tax policy reforms and revenue administration. Ordinary revenues will amount to Kshs 1.8 tn in FY 2021/22 up from the projected Kshs 1.6 tn in the revised FY 2019/20 budget.

Revenue collection declined by 14.0% for the period to December 2020 to Kshs 800.1 bn compared to Kshs 912.1 bn collected over a similar period in 2019. This decline is attributed to the tough operating environment due to the Covid-19 pandemic which has adversely affected revenue performance from March 2020. The decline led to a revenue shortfall of Kshs 109.6 bn against a target collection of Kshs 907.7 bn.

To address the shortfall, going forward, the government has been implementing a raft of tax policy measures through the Tax Amendment Law and the Finance Act, 2020, intending to improve collections. Some of the reforms implemented include:

i. Reversal of tax measures put in place in April 2020 to cushion the economy from the impact of the COVID-19 pandemic. The reversal took effect from January 2021,
ii. Strengthening Audit function in the Domestic Taxes Department,
iii. Enhanced Debt collection Programme that will leverage on the iTax debt module to reconcile and facilitate collection of debt,
iv. Compliance level reviews with a focus on enforcement risk framework to support targeted enforcement, and,
v. Aiding the resolution of tax disputes through the Alternative Dispute Resolution (ADR) and fast track conclusion cases before Tax Appeals Tribunal and Court Tax Appeals Tribunal & Court.

We are of the view that the higher targeted revenue collection will be driven by the prospects of an economic recovery. The draft BPS has indicated that the government is set to cut back on borrowing and instead opt for higher taxation, KRA has positioned itself to collect more by introducing a raft of tax amendments that are aimed at widening the tax base and other than raising taxes the government should also look at sealing tax leakages within KRA.

2. **Expenditure**

As per the 2021 BPS, total expenditure is set to increase by 8.5% to Kshs 3.0 tn from Kshs 2.9 tn in FY 2020/21. Recurrent expenditure is set to increase at a higher rate than development expenditure; with recurrent increasing by 6.9% to Kshs 2.0 tn from Kshs 1.8 tn as per the revised budget, while development expenditure is projected to decline by 4.8% to Kshs 611.0 bn from Kshs 641.9 as per the revised FY'2020/21 budget. One of the key concerns lies in the proportion of recurrent expenditure compared to development spending which as per the BPS is expected to come in at 76.4% against 23.6%, respectively.

In line with the Government's consolidation strategy, total expenditure and net lending for the twelve months to December 2020 came in at Kshs 1,191.0 bn, which was Kshs 67.9 bn below the projected amount. Recurrent spending amounted to Kshs 798.7 bn while development expenditures and transfer to County Governments were Kshs 262.8 bn and Kshs 129.5 bn respectively.

The scaled-down operations of the National Government in 2020 due to Covid-19 Pandemic and lower than projected payments in compensation of employees, pension and foreign interest, led to the recorded recurrent expenditure falling below target by Kshs 67.9 bn. Due to the lower than expected expenditure side, coupled with the rise in revenue collections during the twelve months to December 2020 an overall deficit of Kshs 362.8 bn was recorded, which was below the projected deficit of Kshs 371.8 bn for the period. This deficit was financed through net domestic financing of Kshs 345.4 bn and net foreign borrowing of Kshs 17.2 bn.

The quality of fiscal consolidation remains a concern as a majority of the cuts to government expenditure fell on development spending, which could potentially compromise the growth potential of the economy. To reduce government expenditure, and in turn what needs to be plugged in through borrowing, we suggest the following:

i. Encouragement of Public-Private Partnerships (PPPs) which will involve the private sector in development, increase efficiency while reducing pressure on the government. The recently launched Kenya Pension Funds Investment (KEPFIC), that allows pension funds to invest up to 10.0% of their Assets Under Management (AUM) on infrastructure and alternative investments is a step in the right direction since it will not only reduce the infrastructural burden of debt but also deepen and enhance the capital market,
ii. Reduction of the public wage bill - through rationalization of the public office roles we currently have by getting rid of redundancies in the representation of counties and constituencies, and, etc. and re-looking at the salaries, allowances and benefits earned,
iii. Better efforts to fight corruption , as funds lost to corruption are estimated at roughly a third of the national budget (Estimates from the Ethics and Anti-Corruption Commission), and Kenya being engaged in the fight against corruption since the 1960's, without successfully being able to get rid of recurrent scandals involving huge sums of public funds, and,
iv. Development budget absorption needs to improve as most fiscal years end in an under-absorbed development budget and an over-spent recurrent budget. Development projects need to be prioritized and better planning incorporated to match fund availability to project execution, and measures taken to improve the public procurement process; while also being prudent in recurrent spending.

3. **Public Debt**

From the Draft Policy Statement, the total new public debt requirement for the FY 2021/22 is set to decline by 6.2% to Kshs 937.7 bn from Kshs 1,002.0 bn, in FY'2020/21, as per the revised budget. The public debt requirement mix is projected to comprise of 37% foreign debt and 63% domestic debt, compared to the 43% foreign debt and 57% domestic debt as per the revised FY'2020/2021 budget.

The higher domestic debt composition could have the following two results:

i. A decline in Kenya's exposure to external shocks, as the more we owe in foreign currency, the more exposed we are to any shocks in the foreign markets. Given the recent loss in value of the shilling against the dollar, where the local currency depreciated 7.7% against the dollar in 2020, a lower reliance on foreign debt will help control the amount owed in both interest and principle payments, and,
ii. Increase the crowding out of the private sector because the higher the government's local debt appetite, the more the banks are inclined not to lend to the private sector as the rates on government securities remain attractive. Notably, appetite for domestic debt has been on arise, concurrently, interruptions from the Covid-19 pandemic saw banks shy away from lending due to elevated credit risk on the borrowers and thus opting to lend to the government.

Debt sustainability continues to be a key concern, with the country's public debt–to-GDP ratio having increased considerably over the past five years to 69.6% as at December 2020, from 44.3% as at the end of 2013 with half of the debt being external. The ballooning levels of public debt have elevated the risk of debt sustainability. The government has recently received debt servicing suspension from ten Paris club members totaling to Kshs 32.9 bn which is 0.9% of the Kshs 3,771.8 bn of total external debt as at December 2020. The debt suspension will assist in providing the much-needed relief as it reduces pressure on payments falling due from 1st January 2021 to 30th June 2021, as well as, a five year repayment period with a grace period of one year.

Below are some actionable steps the government can take towards debt sustainability;

i. Restructuring the debt mix where the government should go for more concessional borrowing to reduce the amounts paid in debt service. Additionally, commercial borrowing should be limited to development projects with high financial and economic returns, to ensure that more expensive debt is invested in projects that yield more than the market rate charged,
ii. The government can carry out capital expenditure cuts during the current period of distress and focus on completing pending projects whose economic benefits will be transmitted into the economy and support overall economic growth,
iii. The government can focus on developing certain sectors to build an export-driven economy. Encouraging growth in the manufacturing sector will help increase the value of our exports leading to an improved current account, and,
iv. The setting up of the Public Debt Management Authority (PDMA) – to monitor all public debt-related transactions, is a step in the right direction. However, Kenya's debt problems have been more of a lack of fiscal discipline coupled with the inadequate political will to fight corruption so as to avoid pilferage. The authority should also be given the mandate to monitor expenditure and funds allocation to specific projects.

Section III: Conclusion

Just like governments across the world, the FY'2021/2022 bps points to an expansionary budget in a bid to steer the country out of the pandemic driven economic downturn. The budget is however hinged on the hopes of meeting the revenue collection targets, expected to be boosted by the relaxation of the tax cushions that had been implemented during the peak of COVID last year. This premise however ought to be a factor of economic recovery which is still uncertain given the uncertainty surrounding the persistence of the pandemic. In the event of an economic downturn, the measures would be negative discouraging entrepreneurship, growth of SME and depress earnings growth in the private sector. The statement has indicated an increase in government expenditure to key development areas, more so, an increase in allocation to county Governments which will help push the key development agendas. The proposed budget is also set to have a deficit that will be met through a mix of domestic and foreign borrowing which will reach Kshs 937.6 bn with a risk of an even larger figure if the economy does not recover as expected and the breaching the debt ceiling but within the newly proposed Kshs 12.0 tn debt ceiling.