The FY 2020/21 Pre-Budget Discussion Note

The National Treasury is set to release the 2020/21 fiscal year (FY) budget on 11th June 2020. As such, we will be discussing the aspects of the proposed FY'2020/21 budget and give our views on the same before the budget is released. In this note, we discuss the following:

i. Section I: A comparison and analysis of the key budgetary aspects of the 2020/21 and 2019/20 Budget Estimates, and,
ii. Conclude by giving our overall view of the budget estimates we have so far, ahead of the release of the official 2020/21 Budget Statement.

Section I: Changes in the 2020/2021 Budget from the 2019/2020 Budget,

The Kenyan Government budget has been on the rise over the years and this is the first year that we have seen a slight decline. The government is looking at budget consolidation as tax revenues reduce due to the fiscal measures undertaken to support the citizen due to the ongoing Covid-19 Pandemic.

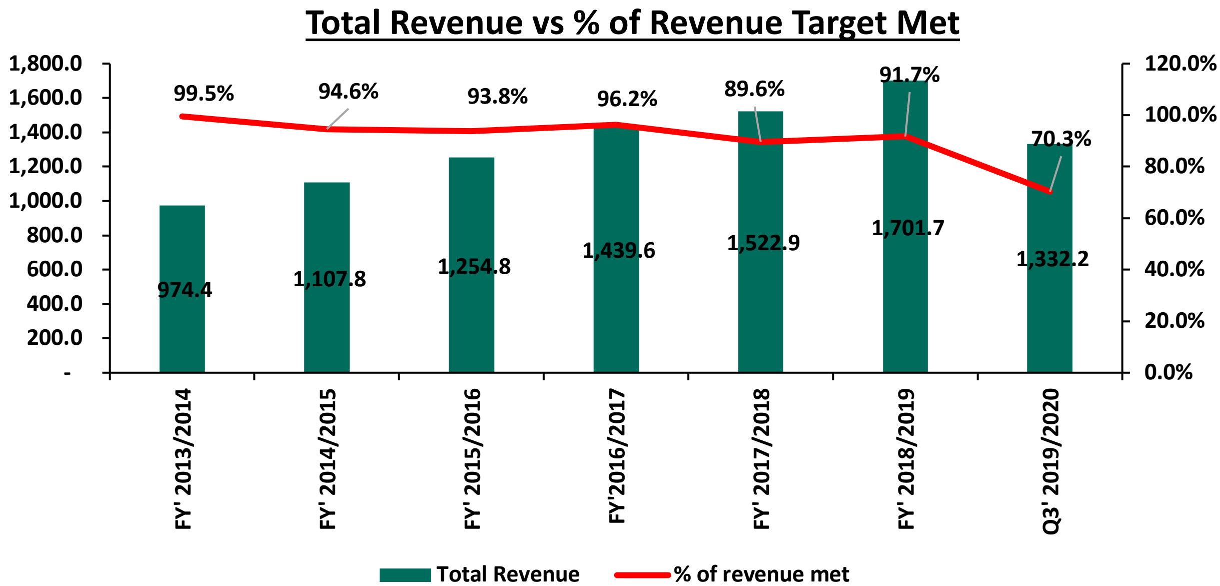
The total FY'2020/21 budget is estimated at Kshs 3.2 tn, a 2.6% increase from the Kshs 3.1 tn revised FY'2019/20 budget, mainly due to an 18.1% increase in the Consolidated Fund Services (CFS) to Kshs 1.0 bn from Kshs 0.9 bn in the FY'2019/20 revised estimates. The increase in Consolidated Fund Services expenditures is mainly as a result of an increase in public debt servicing expenses which will form 88.0% of the total CFS expenditure.

The table below summarises the key buckets and the projected changes

Item	FY'2019/2020 (Revised)	FY'2020/2021 Estimates	Change y/y
Total revenue	1,893.9	1,854.1	(2.1%)
Grants	44.6	36.1	(19.1%)
Total Revenue & External Grants	**1,938.5**	**1,890.2**	**(2.5%)**
Recurrent Expenditure	1,257.4	1,167.4	(7.2%)
Development Expenditure	617.9	584.3	(5.4%)
Total expenditure	**2,774.4**	**2,712.9**	**(2.2%)**
Fiscal deficit including grants	**(835.9)**	**(822.7)**	(1.6%)
Deficit(excluding grants) as % of GDP	5.6%	7.6%	
Deficit(including grants) as % of GDP	7.8%	7.3%	
Net foreign borrowing	333.5	349.8	4.9%
Net domestic borrowing	473.2*	486.2*	2.7%
Total borrowing	**806.7**	**836.0**	**3.6%**
Borrowing as a % of GDP	6.9%	6.5%	-
**Figures as per the Parliamentary Budget Office May 2020 Report*			
Source Budget Summary, 2020			

1. **Revenue**

The government has continuously missed its revenue target with the lowest collections versus the target being reported during the third quarter of 2019/2020, where collections came in at Kshs 1.2 tn, a 70.3% of the revenue target. For the next financial year 2020/2021, the government projects that total revenue will contract by 2.1% to Kshs 1.85 tn from the Kshs 1.89 tn in FY'2019/2020. The decline is mainly due to a 1.3% decline in ordinary revenue to Kshs 1.62 tn from an estimated Kshs 1.64 tn. The reduced target is due to the reality of the fact that tax collections shall be lower on account of the fiscal measures by the president to cushion businesses and individuals against the effects of the pandemic.



Source: National Treasury

The revenue collection still remains ambitious under the current economic situation. However, as per the 7th Corporate Plan Report, KRA plans to improve revenue collection through the following ways;

i. **Tax base expansion**: KRA plans to raise the number of tax payers by 3.1 mn to 7.0 mn tax payers from 3.2 mn tax payers who filed their returns in 2017/18. However, given the recent layoffs seen during the onset of the Coronavirus pandemic, we foresee that KRA will not be able to achieve this target,

ii. **Strengthening of the debt management strategies:** Through the use of data analytics to facilitate debt collection and fast-tracking of the debt recovery process timelines, KRA anticipates that it will be able to address the rapid growth rate in the debt portfolio, and,

iii. **Robust Intelligence collection Investigation:** This will be achieved through the implementation of the Intelligence Gathering System (IGS) and the Cyber-command centre which will play a role in enhancing their data security. We believe that this will assist KRA in preventing tax frauds as well as assist in sealing loopholes in the revenue collection.

2. Expenditure

As per the budget books estimates, total expenditure is set to decline by 2.2% to Kshs 2.71 tn from Kshs 2.74 tn as per the revised FY’2019/20 Budget. The Treasury estimates that the post COVID-19 Economic Stimulus Package will cost Kshs 53.74 bn. The proposed FY’2020/21 budget will see Kshs 2.6 bn allocated to the Ministry of Health under the COVID-19 Emergency Response Project, which will go towards mass testing of Coronavirus patients. However, the Budget and Appropriations Committee (BAC) recommends that resources being expended under the COVID-19 Emergency Response Fund should be appropriated through the National Assembly for legislative scrutiny and oversight. We believe that given the high cases of Coronavirus infections seen in the last weeks of May 2020, the aforementioned amount will not be sufficient to fight the pandemic.

The key highlights from the expenditure estimates include:

i. Recurrent Expenditure

For the FY’2020/2021, recurrent expenditure has been revised down by 7.2% to Kshs 1.2 tn from Kshs 1.3 tn in FY’2019’20 Budget. Ministerial recurrent expenditure is expected to decline by 3.1% to Kshs 1.20 tn in FY’2020/2021 from Kshs 1.24 tn in FY’2019/2020. Major outlays in form of recurrent expenditure are expected to go to Teachers Service Commission, Ministry of Defence, State Department for University Education, and State department for Interior who will receive Kshs 264.0 bn, 106.2 bn, 107.0 bn, and, 128.0 bn respectively translating to 52.0% of the recurrent expenditure budget. Given the inadequate financing for the implementation of the government projects and the high costs of construction of the projects, the State department for transport has seen its recurrent expenditure allocation reduce by 18.2% to Kshs 0.9 tn in FY'2020/21 from Kshs 1.1 tn in FY'2019/20.

ii. Development Expenditure

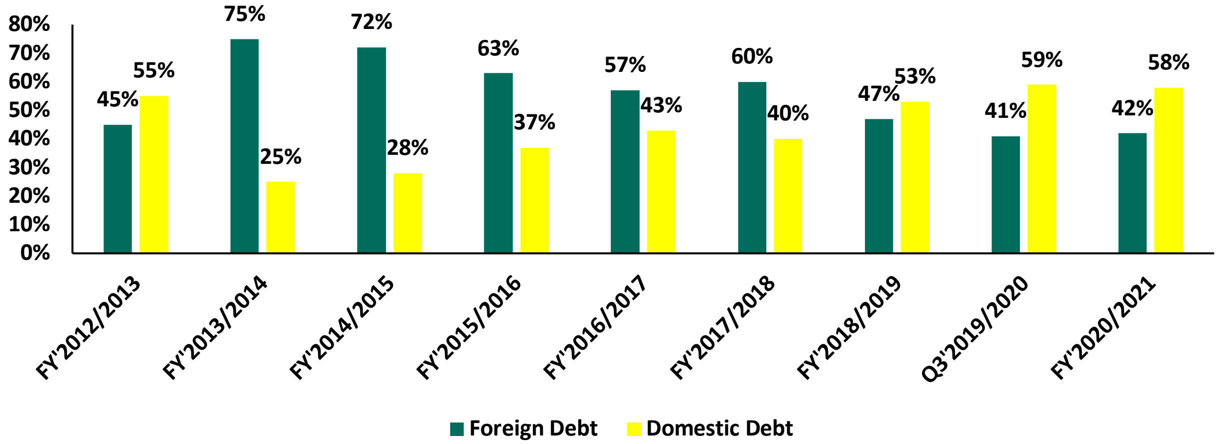
The development expenditure is set to decline by 5.4% to Kshs 584.3 bn from Kshs 617.9 bn in FY'2019/2020 with the key ministries impacted being the State Department of Transport, Ministry of Treasury, State Department of Planning, and Housing and Urban Development whose expenditure has been slashed by Kshs 44.0 bn, 19.0 bn, 19.0 bn, and 17.0 bn respectively. The state department of infrastructure, State Department of Water and Sanitization, Ministry of Energy, and Ministry of Health are set to receive Kshs 121.6bn, 69.7 bn, 67.0 bn, and 49.0 bn for their development needs, which will form 52.0% of the total development budget.

47.1% of development expenditure will be financed through project loans and grants, which are projected to come in at Kshs 274.7 bn, an upward revision from Kshs 241.8 bn in the revised FY'2019/20 estimates. Given the low uptake in external financing seen in 2019, it is expected that the government's project completion in FY'2020/21 will be delayed. In the budget outturn for the period ending March 2020, total development expenditure funded by foreign debt was Kshs 164.6 bn against a budgeted figure of Kshs 225.3 bn reflecting a 73.1% absorption rate. The low uptake can be attributed to lower availability of funding as the foreign funding which is normally directed at development ended Q3'2019/2020 at Kshs 98.4 bn compared to the revised target of Kshs 455.0 bn.

3. Public Debt

Public debt is expected to continue growing in FY'2020/21 as the approximate Kshs 822.7 bn fiscal deficits will be financed through both domestic and foreign debts. The fiscal deficit (excluding grants) as a share of GDP, is expected to come in at 7.6% in FY'2020/2021 from 5.6% in FY 2019/2020. According to the budget estimate, net foreign financing is projected at Kshs 349.8 bn in 2020/21, which is a 4.9% increase to Kshs 333.5 bn in FY 2019/20. However, a decline in programme and concessional loans in FY 2020/21 is expected to be replaced by more expensive semi concessional loans which may result in higher debt service expenditure in the medium term. Net domestic borrowing is expected to increase by 2.7% to Kshs 486.2 bn from Kshs 473.2 bn in FY'2019/2020. Public debt mix is projected at 58.0% domestic debt and 42.0% foreign debt. Below is a chart with the debt mix as per recent years' budget estimates:

Historical Debt Mix



Source: National Treasury

Amid subdued revenue, the Consolidated Fund Services (CFS) expenditure is expected to consume 55.0% of the projected revenue as compared to 46.0% in 2019/2020. CFS expenditure is non-discretionary expenditure and this could tighten the government's fiscal position especially in the current environment. The ability to reduce the expenditure side is very minimal despite the decline in revenue and as such the fiscal deficit is now expected to rise to 7.6% of GDP in FY'2020/2021 from a pre-COVID-19 target of 4.9% of GDP.

During FY'2020/2021, the government is expected to repay foreign debt worth Kshs 174.1 bn, which is a 41.1% increase from Kshs 121.5 bn in FY'2019/2020. Public debt servicing expenses are estimated to increase by 17.7% to Kshs 904.7 bn in FY'2020/21 from Kshs 768.8 bn in FY'2019/20 attributable to the 31.7% increase in debt redemptions to Kshs 441.6 bn in FY'2020/21 from Kshs 335.2 bn in FY'2019/20. Interest expense on the domestic debt will cost Kshs. 308.4 bn while foreign debt interest expenses will total approximately Kshs. 154.7 bn. Given the higher levels of maturing debt, it is evident that the domestic debt portfolio carries a higher financing risk given the high-interest costs. Below is a table highlighting the public debt servicing expenses:

Public Debt Servicing Expenses (Kshs bn)				
Item		**FY'2019/20 Revised Estimates**	**FY'2020/21 Estimates**	**% Change**
Interest Payments	Internal Debt	301.8	308.4	2.2%
	External Debt	131.9	154.7	17.3%
	Sub Total	**433.7**	**463.1**	**6.8%**
Redemptions	Internal Debt	213.7	262.0	22.6%
	External Debt	121.5	179.6	47.8%
	Sub Total	**335.2**	**486.2**	**45.0%**
Total Debt Servicing		**768.8**	**904.7**	**17.7%**

Source: National Treasury

Key to note, on the external debt redemptions front, 34.5% (Kshs 62.0 bn) of the total external debt redemptions will be made towards China related debt payments which were used to offset the accruing Eurobond payments.

Conclusion

The proposed budget goes against the FY'2020/21 Medium Term Debt Management Strategy which highlighted that the external borrowing would be reduced on account of the reduction of the semi-concessional debt which would result in a decrease in the interest cost in the debt portfolio. This has however not been the case as the proposed FY'2020/21 budget has seen a proposed 4.9% increase in foreign borrowing to Kshs 349.8 bn from Kshs 333.5 bn in FY'2019/20.

We believe that there is room for more adjustments in the FY'2020/21 budget that will address the current economic crisis brought about by the Coronavirus pandemic and consequently, steer the economy towards a recovery. Given that the longevity of the virus is unknown, we recommend the following amendments:

i. In our view, the Kshs 2.6 bn allocated to the Ministry of Health towards mass testing of Coronavirus patients will not be sufficient. Given that the extent of the crisis is unknown, there is need to further allocation of funds towards the containment of the virus. Allocation of funds towards the recruitment of health workers and acquisition of more equipment will aid in containing the spread of the virus. The should also look into allocating funds that will go into supporting local manufacturing firms that are currently in the forefront of local manufacturing of COVID-19 related equipment,
ii. Despite the measures put in place by government to help cushion the economy against the effects of the pandemic, revenue underperformance will continue to be a challenge given the reduced economic activity and the tax relief measures put in place in April 2020. To mitigate this, the government should consider reducing the expenditure by curtailing all non-essential projects. The key focus of the budget should be towards reviving the economy and as such, all essential expenses should be retained while the other expenses should be focused towards pandemic related spending, and,
iii. A downward revision of the total borrowing targets given the high debt servicing expenses that are estimated to come in at Kshs 904.7 bn in FY'2020/21 from Kshs 768.8 bn in FY'2019/20. The high debt servicing expenses will result from the uptake of semi-concessional loans worth Kshs 124.1 bn. Key to note, previously, fiscal deficit was partly financed through programme and concessional loans, which stood at Kshs 246.2 bn in FY'2019/20. Historically, the national budget has been on an upward trajectory with the total expenditure growing at a 6-year CAGR of 16.6%, outpacing revenue growth, which has grown at a slower 6-year CAGR of 13.1%. Consequently, this has caused the fiscal deficit to continue widening and as such, the government has had to increase its borrowing to fund the fiscal deficit. This has seen the debt to GDP ratio rise to 62.4% in 2020 from 55.4% recorded in 2019, which is above IMF's recommended threshold of 50.0%. Given that semi-concessional debt is more expensive compared to debt from bilateral and multilateral lenders, we believe that the government will continue to face external debt repayment challenges, and as such, the government will need to seek debt restructuring to reduce the debt servicing costs,

We are also of the view that the effects of the coronavirus pandemic may persist up to 2021 and the Kenyan economy will be in a sluggish growth should the budget not address the Coronavirus pandemic and fail to provide a clear roadmap to economic recovery.