The Draft 2019 Budget Policy Statement Note

The Treasury released the draft 2019 Budget Policy Statement, which outlines the current performance of the Kenyan economy, as well as give the medium term outlook. The Budget Policy Statement (BPS) is a Government policy document that sets out the broad strategic priorities, policy goals, together with a summary of Government's spending plans, as a basis of preparing the FY 2019/20 budget.

According to Section 25 of the Public Finance Management (PFM) Act, 2012, the National Treasury is supposed to prepare and submit to Cabinet the BPS for approval. Subsequently, the approved BPS is submitted to Parliament, by 15th February each year. Parliament shall not later than 14 days after the BPS is submitted table, discuss a report, containing its recommendations, and pass a resolution to adopt it with or without amendments. The Cabinet Secretary shall then take into account resolutions passed by Parliament in finalizing the budget for that Fiscal Year.

In this note, we review the contents of the 2019 BPS by discussing the following:

i. A comparison of the FY2019/20 budget and the projected FY2019/2020 budget as per the Draft 2019 BPS and,
ii. Our analysis and view of key aspects of the budget, including related items such as the Big Four Agenda
iii. Conclusion and key areas of improvement

Section I: A comparison of the FY'2019/20 budget and the projected FY'2019/2020 budget as per the Draft 2019 BPS

Below is a summary of the major changes as per the BPS 2019 from the revised FY'2018/2019 budget

Comparison of 2018/19 and 2017/18 Fiscal Year Budgets as per The 2018 Budget Policy Statement				
	FY'2017/2018 Budget Outturn	FY'2018/2019 Revised Budget	FY'2019/2020 BPS	% change 2018/19 to 2019/20
Total revenue	1,487.2	1,852.6	2,080.9	12.3%
External grants	26.3	48.5	51.6	6.4%
Total revenue & external grants	**1,513.5**	**1,901.1**	**2,132.5**	**12.2%**
Recurrent expenditure	1,319.6	1,541.0	1657.3	7.5%
Development expenditure & Net Lending	485.7	595.7	670.9	12.6%
County governments + contingencies	306.2	372.4	376.5	1.1%
Total expenditure	2,111.5	2,509.1	2704.7	7.8%
Fiscal deficit excluding grants	**(597.9)**	**(608.0)**	**(572.2)**	(5.9%)
Deficit as % of GDP	6.8%	6.1%	5.0%	
Net foreign borrowing	331.6	287.0	306.5	6.8%
Net domestic borrowing	273.7	317.1	271.4	(14.4%)
Other domestic financing	2.6	3.9	-5.7	
Total borrowing	608.0	608.0	572.2	(5.9%)
GDP Estimate	8,845.9	9,990.0	11,346.5	13.6%

Key take-outs from the table include:

i. The 2019 BPS points to a 7.8% increase of the budget, to Kshs 2.7 tn from Kshs 2.5 tn in the FY' 2018/19 revised budget,

ii. Recurrent expenditure is set to increase at a slower rate than development expenditure; with recurrent increasing by 7.5% to Kshs 1.7 tn from Kshs 1.5 tn as per the revised budget, while development expenditure is projected to increase by 12.6% to Kshs 670.9 bn from Kshs 595.7 as per the revised FY'2018/2019 budget,

iii. The budget deficit is projected to decline to Kshs 572.2 bn (5.0% of GDP) from the projected Kshs 608.0 bn (6.1% of GDP) in the FY 2018/19; in line with the International Monetary Fund's (IMF's) recommendation, in a bid to reduce Kenya's public debt requirements,

iv. Revenue is projected to increase by 12.3% to Kshs 2.1 tn from the projected Kshs 1.8 tn in the revised FY 2018/19 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 5.9% to Kshs 572.2 bn from Kshs 608.0 bn, in a bid to reduce Kenya's public debt burden which is estimated at 57.0% of GDP as at the end of the FY'2017/2018above 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 of the 2018/19 budget is estimated to consist of 53% foreign debt and 47% domestic debt, unlike 47% foreign and 53% domestic as projected in the revised FY' 2018/19 budget which presents a risk of increased exposure to external shock.

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 2019/20, revenue collection including Appropriation-in-Aid (A.i.A) is projected to increase by 12.3% to Kshs 2.1 tn, up from Kshs 1.8 tn projected in the FY 2018/19. This revenue performance will be underpinned by on-going reforms in tax policy and revenue administration. Ordinary revenues will amount to Kshs 1.9 tn in FY 2019/20 up from the projected Kshs 1.7 tn in the revised FY 2018/19 budget.

Revenue collection grew by 13.5% for the first five months to November in the FY'2018/2019, to Kshs 633.7 bn compared to Kshs 548.2 bn, recorded over the same period in the FY 2017/18. The strong growth is partly attributable to a rebound effect, after a poor performance in the previous financial year as well as the effect of the tax policy measures introduced in the Finance Act 2018. Despite the strong growth in total revenue collection, the government recorded a shortfall Kshs 43.3 bn, managing to raise Kshs 633.7 bn against a target of Kshs 677.0 bn.

The government however expects to close this shortfall in the second half of the financial year as the full impact of the revenue policy measures take effect and as the roll out of the Revenue Enhancement Initiatives (REI) being put in place by the Kenya Revenue Authority (KRA) are finalized. Some of the reforms implemented to improve collections include:

i. Use of third-party information to identify non-compliant property developers and ensure they are included in the tax base
ii. Enhanced scanning to detect concealment and increase efficiency in cargo clearing through procurement of additional scanners and full integration of all scanners;
iii. Use of Regional Electronic Cargo Tracking System (RECTS) to ensure all goods reach the desired destinations and avoid dumping, and
iv. Detection of non-compliance through iTax data matching.Enhancement of investigations, intelligence capacity and KRA's capacity to support revenue collection.

Expenditure

As per the 2019 BPS, total expenditure is set to increase by 7.8% to Kshs 2.7 tn from Kshs 2.5 tn in FY 2018/19. Recurrent expenditure is set to increase at a slower rate than development expenditure, with recurrent increasing by 7.5% to Kshs 1.7 tn, from Kshs 1.5 tn as per the revised budget, while development expenditure is projected to increase by 12.6% to Kshs 670.9 bn from Kshs 595.7 as per the revised FY'2018/2019 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 61.3% against 13.9%, respectively.

In line with the Government's consolidation strategy, total expenditure and net lending for the first five months of the FY'2018/2019 came in at Kshs 829.1 bn, which was Kshs 105.7 bn below the projected amount. Recurrent spending amounted to Kshs 553.6 bn while development expenditures and transfer to County Governments were Kshs 203.1 bn and Kshs 72.2 bn respectively.

The Kshs 553.6 bn recorded in recurrent expenditure was Kshs 80.0 bn below the projected target, which the Treasury attributed to lower than targeted domestic interest payments and pension payments. Due to the lower than expected expenditure side, coupled with the rise in revenue collections during the five months of July-November 2018 an overall deficit of Kshs 216.5 bn was recorded, which was below the projected deficit of Kshs 242.8 bn for the period. This deficit was financed through net domestic financing of Kshs 139.4 bn and net foreign borrowing of Kshs 77.1 bn.

While fiscal consolidation is yielding fruits, the key concern remains on the quality of fiscal consolidation. The World Bank in their Kenya Economic Update, October 2018, as well as the African Development Bank, noted that the majority of 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:

- Encouragement of Public-Private Partnerships (PPPs) which will involve the private sector in development spending, increase efficiency while reducing pressure on the government,
- Reduction of the public wage bill, which is the largest component of recurrent expenditure and top heavy with top ranking officials paid much more than lower ranking civil servants, through rationalization of the public office roles we currently have by getting rid of redundancies in representation of counties and constituencies etc. and re-looking at the salaries, allowances and benefits earned,
- Better efforts to fight corruption that stick, 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. Current efforts are commendable, we want them to stick,

Public Debt

From the Draft Policy Statement, the total public debt requirement for the FY 2019/20 is set to decline by 5.9% to Kshs 572.2 bn from Kshs 608.0 bn, in FY'2018/19, as per the revised budget. The public debt requirement mix is projected to comprise of 53.0% foreign debt and 47.0% domestic debt, compared to the 47.0% foreign debt and 53.0% domestic debt as per the revised FY'2018/2019 budget. The higher foreign debt composition could have the following two results:

- Increase Kenya's exposure to external shock, as the more we owe in foreign currency, the more exposed we are to any shocks in the foreign markets, and
- Reduce the crowding out of the private sector because the lower the government's local debt appetite, the more banks have to lend to the private sector. Key to note however, appetite for domestic debt has been on arise with the Government having accepted more than the weekly quantum in all the T-bill primary auctions in 2019. Meanwhile private sector credit growth remains anaemic coming in at 2.4% as at December 2018. With the interest rate cap in place, chances of continued private sector

crowding out remain high, as banks prefer to lend to the government, perceived less risky as opposed to lending to the riskier private sector.

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 57.0% as at the end of FY'2017/2018, 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, which saw the International Monetary Fund, through their debt sustainability analysis elevating the country's risk of debt stress to moderate from low. Additionally, the increase in the portion of external debt, from 43.2% in February 2014, to 51.7% as at December 2018, also makes the country more susceptible to external market conditions and shocks.

We remain concerned about the country's debt levels, unless the government implements decisive policies. Our suggestions for such decisive policies include:

- Improving revenue collection mechanisms to maximize the amount collected in revenue, which will lead to a narrowing budget deficit and reduced total borrowing. Measures outlined in the 2019 BPS such as a complete overhaul of the current Income Tax Act, strengthening tax administration and expansion of the tax base, if implemented, should be an initial step in the right direction,
- Building an export-driven economy by encouraging growth in the manufacturing sector to increase the value-added exports and hence the value of our exports vis-à-vis imports, leading to an improving current account deficit. This is already in the Big Four Agenda, a commendable step in the right direction,
- The government should encourage private sector involvement in development projects in order to reduce the strain on government expenditure and hence borrowing, and
- Better governance and accountability to reduce wastage and corruption levels. We hope that the recent steps by the president to strengthen key institutions of probity and the current ongoing crackdown on corruption scandals will go a long way in enhancing governance, transparency and accountability around public resources.

Section III: Conclusion

In conclusion, aside from all specific views highlighted in the sections above, we are of the view that these few areas will need improvement going forward,

i. While an increase in taxes is necessary to boost collections and reduce borrowing requirements, this needs to be done prudently, with an aim to still encourage entrepreneurship, growth of SMEs, earnings growth in the private sector; and also take into account the effect of price increases on basic commodity prices and the cost of living, and,

ii. 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.