The Draft 2023 Budget Policy Statement Note

On 18th January 2022, the National Treasury released the Draft 2023 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'2023/24– FY'2026/27.

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

i. A comparison of the FY2022/23 budget and the projected FY2023/2024 budget as per the Draft 2023 BPS,
ii. Our analysis and view of key aspects of the budget,
iii. Conclusion and key areas of improvement,

Section I: A comparison of the FY'2022/23 budget and the projected FY'2023/24 budget as per the Draft 2023 BPS

Below is a summary of the major changes as per the BPS 2023 from the revised FY'2022/2023 budget:

Comparison of 2022/23 and 2023/24 Fiscal Year Budgets as per The 2023 Budget Policy Statement				
	FY'2021/2022 Budget Outturn	FY'2022/2023 Revised Budget	FY'2023/2024 BPS	% change 2022/23 to 2023/24
Total revenue	2,199.8	2,512.7	2,897.7	15.3%
External grants	31.0	28.1	48.1	71.2%
Total revenue & external grants	**2,230.8**	**2,540.8**	**2,945.8**	**15.9%**
Recurrent expenditure	2,135.3	2,352.7	2,422.3	3.0%
Development expenditure & Net Lending	540.1	596.6	796.4	33.5%
County governments + contingencies	352.4	440.6	422.3	(4.2%)
Total expenditure	3,027.8	3,389.9	3,641.0	7.4%
Fiscal deficit excluding grants	**(828.0)**	**(876.7)**	**(743.3)**	**(15.2%)**
Deficit as % of GDP (Including grants)	6.3%	5.8%	4.3%	(1.5%)
Net foreign borrowing	142.5	298.4	198.6	(33.4%)
Net domestic borrowing	605.3	550.9	496.6	(9.9%)
Total borrowing	747.8	849.3	695.2	(18.1%)
GDP Estimate	12,752.2	14,521.6	16,290.3	12.2%

Key take-outs from the table include:

i. Revenue is projected to increase by 15.3% to Kshs 2.9 tn from the projected Kshs 2.5 tn in the revised FY'2022/23 budget, with proposals by Kenya Revenue Authority such as Excise duty amendments to increase stamp duty fees on various commodities. The government is also planning to integrate KRA Tax System among other measures in a bid to close on tax evasion gaps hence increasing the amount of revenue collected in the next fiscal year,
ii. The 2023 BPS points to a 7.4% increase of the total expenditure, to Kshs 3.6 tn from Kshs 3.4 tn in the FY' 2022/23 revised budget,

iii. Development expenditure is set to increase at a higher rate than recurrent expenditure; with development expenditure increasing by 33.5% to Kshs 796.4 bn from Kshs 596.6 bn as per the supplementary budget, while recurrent expenditure is projected to increase by 3.0% to Kshs 2.42 tn from Kshs 2.35 tn as per the FY'2022/23 supplementary budget. However, the recurrent expenditure will still constitute the largest allocation of 66.5% while development will be allocated 21.9%, which remains unsustainable,
iv. The budget deficit is projected to decline to Kshs 743.3 bn (4.3% of GDP) in FY'2023/2024, from the projected Kshs 876.7 bn (5.6% of GDP) in the FY'2022/23 revised budget. The decline is in line with the International Monetary Fund's (IMF's) recommendation for fiscal consolidation, as the country seeks to reduce Kenya's public debt requirements. However, the fiscal deficits for FY'2020/21, FY'2021/22 and FY'2022/23 have been 8.2%, 6.3% and 5.8%, respectively, averaging 6.8%. As such, the projected 4.3% fiscal deficit for FY'2023/24 seems too ambitious, especially with the subdued business environment which will hamper revenue collection necessary for bridging the deficit,
v. The total borrowing requirement is expected to decline by 18.1% to Kshs 695.2 bn from Kshs 849.3 bn as per the FY'2022/23 revised budget, in a bid to reduce Kenya's public debt burden which is estimated at 62.3% of GDP as of October 2022, 12.3% points above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, as well as, the IMF threshold of 50.0% for developing countries, and,
vi. Debt financing for the FY'2023/24 budget is estimated to consist of 28.6% foreign debt and 71.4% domestic debt, a change from the 35.1% foreign and 64.9% domestic as projected in the revised FY' 2022/23.

. **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 2023/24, revenue collection including Appropriation-in-Aid (A.i.A) is projected to increase by 15.3% to Kshs 2.9 tn, up from the estimated Kshs 2.5 tn in the FY 2022/23, mainly underpinned by the ongoing tax policy reforms and revenue collection measures geared towards increasing the tax base. Ordinary revenues are expected to amount to Kshs 2.6 tn in FY'2023/24 up from the projected Kshs 2.2 tn in the revised FY 2022/23 budget.

Revenue collection grew by 6.7% for the period to December 2022 to Kshs 989.7 bn compared to a growth of 19.6% to Kshs 926.3 bn over a similar period in 2021. This decline is attributed to the fact that the previous financial year's growth was pegged on a lower base, a contraction recorded in the FY'2019/2020 which had experienced the effects of COVID-19. The decline led to a revenue shortfall of Kshs 82.9 bn against a prorated target collection of Kshs 1,070.8 bn.

To address the shortfall, going forward, the government has been implementing various tax policy measures intending to improve collections. Some of the reforms implemented include:

i. Kenya Revenue Authority (KRA) is mandated to reduce the Value Added Tax (VAT) (which is tax charged on supply of taxable goods or services made or provided in Kenya and the imported taxable goods and services) gap to 19.8% from 38.9%, minimize Corporate Income Tax gap to 30.0% from the current 32.2% recorded in FY'2022/23, integrate KRA tax system with telecommunication companies, and expand the tax base to include the informal sector targeting 2,800 SMEs,

ii. KRA will also implement Rental Tax Measures and enhance Customs Border and Control through technical capacities to improve revenue collections, and,
iii. The government will also strengthen revenue mobilization efforts by finalizing on the development of the National Tax Policy and the Medium Term Revenue Strategy (MTRS) to guide on how to further boost revenue collection.

We are of the view that the higher targeted revenue collection for FY'2023/2024 was expected given the current administration's focus on expanding the tax base to include the informal sector, increasing the exercise duty tax, and the roll-out of the e-TIMS system to improve VAT collection margins. However, the upward revision of taxes comes at a time when the business environment remains subdued, underpinned by the elevated inflationary pressures and the aggressive depreciation of the Kenyan shilling that has suppressed business production levels. As such, the low production performance will weigh down on the projected revenue performance.

2. Expenditure

As per the 2023 BPS, total expenditure is set to increase by 7.4% to Kshs 3.6 tn from Kshs 3.4 tn in FY'2022/23. Development expenditure is set to increase at a higher rate than recurrent expenditure; with the development expenditure increasing by 33.5% to Kshs 796.4 bn from Kshs 596.6 bn as per the FY'2022/23 supplementary budget, while recurrent expenditure is projected to increase by 3.0% to Kshs 2.42 tn from Kshs 2.35 tn as per the FY'2022/23 supplementary 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 66.5% against 21.9%, respectively.

In line with the Government's consolidation strategy, total expenditure and net lending for the twelve months to December 2022 came in at Kshs 1,369.2 bn, which was Kshs 403.1 bn below the prorated amount of Kshs 1,772.3 bn. Recurrent spending amounted to Kshs 550.6 bn while development expenditures and transfer to County Governments were Kshs 121.7 bn and Kshs 141.1 bn, respectively.

Recurrent expenditure falling below target by Kshs 38.6 bn against the prorated target of Kshs 589.2 bn was mainly attributable to lower than targeted expenditure on pensions and other CFC domestic interest. Due to the lower than expected expenditure side, coupled with the rise in revenue collections during the twelve months to December 2022 an overall deficit excluding grants of Kshs 381.3 bn was recorded, which was below the prorated deficit of Kshs 701.5 bn for the period. This deficit was financed through net domestic financing of Kshs 269.3 bn and net foreign financing of Kshs 177.9 bn.

The new regime had proposed a raft of austerity measures to ensure fiscal consolidation and lower fiscal deficit. One key proposal was to cut down the FY'2022/23 budget expenditure by almost Kshs 300.0 bn and ensure that the consolidation efforts continue going forward to ensure budget surplus in 3-years' time mainly by lowering the recurrent expenditure. However, from the BPS 2023, the projected recurrent expenditure is still high and increased by 3.0% despite the significant increase in the development expenditure. As such, the quality of fiscal consolidation remains a concern and this could potentially compromise the growth of the economy and the intended budget surplus in the future. To reduce government expenditure, and in turn what needs to be plugged in through borrowing, we suggest the following:

i. **Enhancing Public-Private Partnerships (PPPs)** – The government should involve the private sector in development as this will increase efficiency while reducing pressure on the government. This should be done by removing bottlenecks to PPPs and joint ventures to attract more private investors to attract more development projects especially the infrastructure ones. Key to note, Kenya Pension

Funds Investment (KEPFIC) is also encouraging the PPP initiative as it allows pension funds to invest up to 10.0% of their Assets Under Management (AUM) on infrastructure and alternative investments. The consortium is currently on a path to mobilize USD 250.0 mn to bridge the USD 2.0 bn annual infrastructure funding deficit,

ii. **Reduction of The Public Wage Bill** – This should be done 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 relooking at the salaries, allowances and benefits earned,

iii. **Privatization of Parastatals** - The government should revive economic performance of parastatals or privatize poorly performing ones to release capital, lower debt and also to prevent the widening of debt from losses and inefficiencies. Fortunately, the government has identified this as a suitable approach and through the National Treasury and Economic Planning and Privatization Commission has finalized the draft on Privatization Bill 2023 which is awaiting public participation. The regulation will form a Privatization Authority to oversee and enhance the privatization process,

iv. **Enhancing Efforts to Fight Corruption** – The government should ensure efficiency and advance 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). Kenya has been 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 that are inflating the expenditure but not impacting the lives of the common Kenyan, and,

v. **Prioritizing Impactful Development Projects** – To ensure fiscal consolidation and manage expenditure, the government should give priority to completing ongoing development projects after thorough auditing. Further, it is essential for the government to also concentrate on ensuring that Development budget is more concentrated on projects that have high social benefits and high economic return. Going forward, 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 2023/24 is set to decline by 18.1% to Kshs 695.2 bn from Kshs 849.3 bn, in FY'2022/23, as per the supplementary budget. The public debt requirement mix is projected to comprise of 28.6% foreign debt and 71.4% domestic debt, compared to the 35.1% foreign debt and 64.9% domestic debt as per the revised FY'2022/2023 budget. However, despite the projected focus on increasing the domestic borrowing front, the debt mix still stood at 50.2% for domestic debt and 49.8% for foreign borrowing as of October 2022, indicating Kenya's reliance on external borrowing.

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

i. On a positive note, 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 continued depreciation in value of the shilling against the dollar, where the local currency depreciated by 9.0% against the dollar in 2022 vis-à-vis 69.3% of the total debt being US dollar denominated, 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 when the government's appetite for local debt is high, the rates on government securities remain attractive. As a result, more commercial banks will be inclined not to lend to the private sector due to elevated credit risks on borrowers, and this has been exuberated by the elevated Non Performing Loans in the private sector coming in at 13.7% in Q3’2022 due to tough economic situations.

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 62.3% as at October 2022, from 52.0% during the same period in 2018 with half of the debt being external. The surging levels of public debt have elevated the risk of debt sustainability with International Monetary Fund categorizing Kenya as one of the country’s under risk of high debt distress. As of December 2022, Kenya’s debt service to revenue ratio stood at 51.0%, which is 21.0% above the recommended IMF’s threshold of 30.0%. The sustained level of debt service to revenue ratio above the recommended threshold is a worrying sign, elevating the refinancing risk following shocks arising from the pandemic and global supply disruptions accelerated by the ongoing Russian-Ukrainian conflict.

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

i. **Restructuring of Debt Mix**- The government should prioritize concessional borrowing to reduce the amounts paid in debt service and reduce its dependence on commercial borrowings which are usually expensive and has been increasing debt servicing cost. Further, 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. **Enhancing the Capacity of Capital Markets**- The government should channel efforts towards strengthening the Capital Markets structure to ease the pooling of funds by investors to undertake development projects instead of the government heavily undertaking capital projects on their own. Key to note, our capital markets remain dormant with banking markets having mobilized Kshs 4.7 tn in deposits compared to Collective Investment Schemes at only Kshs 0.1 tn, hence the need to increase support to the sector. With a developed Capital Market, it will be easy for the government to partner with private firms to undertake particular projects on Public Private Partnerships hence reduce its deficit,
iii. **Enhance Fiscal Consolidation Efforts**– The main cause to higher fiscal deficit is higher expenditure compared to lower revenue collections consequently leading to increased borrowing to finance the deficit. The new administration has stated its intention to lower the expenditure, however, this has not been reflected in the budget policy statements. Going forward, the government can bridge the deficit gap by implementing robust fiscal consolidation through expenditure reduction by introducing austerity measures and reducing amounts extended to recurrent expenditure and capital intensive projects but mainly focus on projects with high social impact or a higher economic return. The government can also focus on completing pending projects whose economic benefits will be transmitted into the economy and support overall economic growth instead of starting new ones,
iv. **Value Addition and Diversification** – Through value addition and diversification, the government can focus on developing certain sectors to build an export-driven economy by formulating export and manufacturing policies such as value addition and export diversification. Value addition will massively improve the value of agricultural exports as it will involve exporting processed products instead of raw materials to improve earnings. The government should also diversify the manufacturing sector to start exporting variety of products consequently increasing the value of our exports leading to an improved current account. The government has also introduced export and investment promotion levy to discourage importation of goods that can be manufactured locally, and,
v. **Improve the Efficiency of Public Debt Management Office** –The directorate was established to minimize the cost of public debt management, promote development of market for government debt

securities and ensure sharing of benefits and costs of the debt between different generations. However, the authority should also have a mandate of solving Kenya's debt problems which 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

The 2023 Budget Policy Statement is the first to be prepared under the new administration with the main aim of realizing the administration's main objective of achieving the Bottom-Up economic model. The BPS comes at a time when the country, and the rest of the world is undergoing economic turmoil attributable to ongoing Russian-Ukraine Conflict, elevated global inflation, tightened monetary policy and supply chain disruptions. As such, the formulation of the BPS is hinged on solving these problems and ascertain economic recovery with GDP growth projected at 6.1% in 2023 according to Central Bank of Kenya. 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.

From the statement, the implementation of the budget will rely more on increased revenue collection with the treasury putting on proposals to achieve the revenue target of Kshs 2.9 tn. However, the revenue target seems too ambitious given the current depressed business environment which will reduce the level of production consequently weighing down the revenue collection. In line with its manifesto, the new regime has also marginally reduced recurrent expenditure but significantly increased the development expenditure by 33.6% to help push the key development agendas. The increasing expenditure contradicts the austerity measures indicated by the government such as reducing the current budget by Kshs 300.0 bn and continuing on the same trend going forward. 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 743.3 bn compared to Kshs 877.2 mn in the FY'2022/23 with a risk of a larger figure if the economy does not recover as expected. We remain of the opinion that fiscal consolidation can only be achieved with an adequate reduction in expenditure which would in turn reduce the need to borrow.

The projected expenditure for FY'2023/24 is Kshs 3.6 tn, Kshs 251.1 bn higher than the Kshs 3.4 tn expenditure for the revised FY'2022/23. This puts into question the viability of the 4.3% fiscal deficit and the ability of the current administration to realize its goal of having a surplus budget in 3 years' time. However, the government can still achieve its objective, although in longer term, by gradually enhancing its revenue collection and lowering expenditure especially on the recurring through the various recommendations provided above.