The FY 2019/20 Pre-Budget Discussion Note

The National Treasury is set to release the 2019/20 fiscal year (FY) budget on 13th June 2019). As such, a lot of pre-budget discussions are taking place ahead of the official release and we have taken the time to also write a note with our views before the budget is officially released. In this note, we discuss the following:

i. Summary and comparison of the 2019/2020 and 2018/19 fiscal year budgets as per the National Treasury FY2019/20 Budget Estimates,
ii. Section II: A comparison and analysis of the key budgetary aspects of the 2019/20 and 2018/19 Budget Estimates and,
iii. Conclude by giving our overall view of the budget estimates we have so far, ahead of the release of the official 2018/19 Budget Statement.

Section I: Summary and comparison of the 2019/2020 and 2018/19 fiscal year budgets as per the National Treasury FY2019/20 Budget Estimates

Below is a summary of the budget estimates as per the 2018 BPS released in February 2018:

Key Highlights of the 2019/20 proposed Budget (Ksh. Billion)			
	2018/2019	2019/2020	%Change
National Government	1,764.1	1,841.3	4.4%
Judiciary	16.1	18.9	17.3%
Parliament	35.1	43.6	24.2%
County Allocation (Inc. conditional)	376.5	371.6	-1.3%
Consolidated Fund Services	962.6	805.8	-16.3%
Overall Budget	**3,154.4**	**3,081.2**	**(2.3%)**
Source: Parliamentary Budget Office and National Treasury FY2019/20 Budget Estimates			

The Total FY'2019/20 budget inclusive of the three arms of government, county allocation and the Consolidated Fund Services (CFS) is estimated at Kshs 3.08 tn, a 2.3% reduction from the Kshs 3.2 tn upward revised FY'2018/19 budget; mainly due to a 16.3% reduced allocation to CFS. The budget, however, is expansionary compared to the initial FY'2018/19 budget which was at Kshs 3.07 tn but was later adjusted upwards by Kshs 80.0 bn, which is equal to a 2.6% increment. Assuming the current budget ends up experiencing the same adjustments, we shall end up at Kshs 3.2 tn.

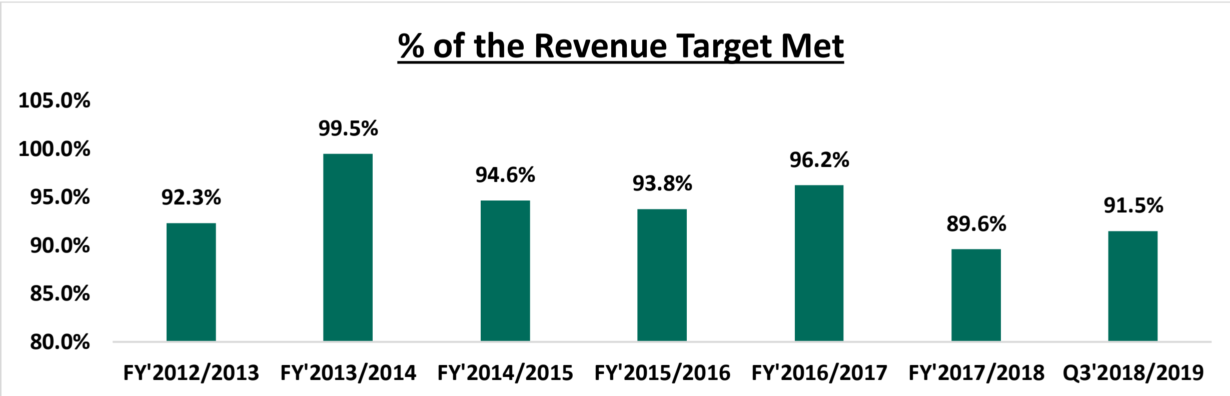
Section II: A comparison and analysis of the key budgetary aspects of the 2019/20 and 2018/19 Budget Estimates

Item	FY'2018/2019 (Revised)	FY'2019/2020	Change y/y
Total revenue	1,852.6	2,115.9	14.2%
Grants	48.5	38.8	-20.0%
Total revenue & external grants	**1,901.1**	**2,154.7**	**13.3%**
Total expenditure	**2,509.1**	**2,762.5**	**10.1%**
Fiscal deficit including grants	**(608.0)**	**(607.8)**	0.0%
Deficit(excluding grants) as % of GDP	6.6%	5.4%	
Net foreign borrowing	287.0	324.3	13.0%
Net domestic borrowing	321.0	283.5	-11.7%
Total borrowing	**608.0**	**607.8**	**0.0%**
GDP Estimate	9,990.0	11,346.5	
Source Budget Summary, 2019			

1. **Revenue**

Total revenue collected is expected to increase by 14.2% to Kshs 2.1 tn from the Kshs 1.9 tn as per the revised FY'2018/2019 revised Budget mainly driven by a 12.2% rise in ordinary revenue to Kshs 1.9 tn from an estimated Kshs 1.7 tn in the revised FY'2018/2019 budget.

In recent years there has been underperformance in revenue collections and the Government has not been able to meet its revenue target with the worst year being FY'2017/2018 where it only managed to raise 89.6% of the targeted total revenue mainly due to a shortfall of Khs 195.0 bn in ordinary revenue



As per the Q3'2018/2019 Budget outturn, the Kenya Revenue Authority (KRA) had only managed to raise Kshs 1.2 tn against a target of Kshs 1.3 tn representing 91.5% of the targeted revenue collection and it is doubtful that it will meet its target. The continued underperformance has been attributed to ambitious revenue targets set by the Government masking the true budget deficit position. For instance the Kshs 2.12 tn revenue estimate is a Kshs 35.0 bn upward revision from Kshs 2.08 tn as per the 2019 Budget Policy Statement which in effect mitigates the rise in the fiscal deficit as a percentage of GDP inclusive of grants to around 5.4% of GDP only slightly higher than the 5.1% envisioned in the BPS 2019. Despite the Government's fiscal consolidation efforts, the ambitious revenue targets have often led to the rationalization of the budget later on with the development expenditure mainly taking the hit.

Going forward, KRA plans to improve collections through implementing these reforms:

- Roll out of the Integrated Customs Management System (ICMS) to seal loopholes at the Customs and prevent concealment, undervaluation, misdeclarations and falsifications of import documents,
- Implementation of the Regional Electronic Cargo Tracking System (RECTS) to tackle transit diversion,
- Enhancement of scanning activities to detect concealment,
- Scaling-up of on-going and routine activities such as Pre-Verification of Conformity (PVOC), benchmarking and auctions,
- Data matching and use of third-party data to enhance compliance by the integration of iTax with IFMIS,
- Expansion of the tax base by targeting the informal sector, betting lotteries & gaming houses, pursuing non-filers of tax and increasing the focus on taxation of international transactions and transfer pricing, and,
- Use of third-party information to identify non-compliant property developers and ensure they are included in the tax base;

3. **Expenditure**

As per the budget books estimates, total expenditure is set to increase by 10.1% to Kshs 2.8 tn from Kshs 2.5 tn as per the revised FY'2018/19 Budget. Key to note

According to the budget books estimates, development expenditure is set to increase by 14.8% to Kshs 684.1 bn from Kshs 595.7 bn in FY'2018/2019 with the highest percentage of the outlay expected to support critical infrastructure. Recurrent expenditure, on the other hand, is estimated to increase by 10.4% to Kshs 1.7 tn from Kshs 1.5 tn as per the revised FY'2018/2019 budget.

In terms of budget absorption, development expenditure absorption which has been lagging behind has picked up with funds utilized in development expenditure and net lending surpassing the budgeted target by 3.9% as per the Q3'2018/2019 budget outturn. The higher development expenditure was on account of higher than targeted absorption for development partners' (externally) funded programmes/projects and SGR phase I disbursement not being factored in the target.

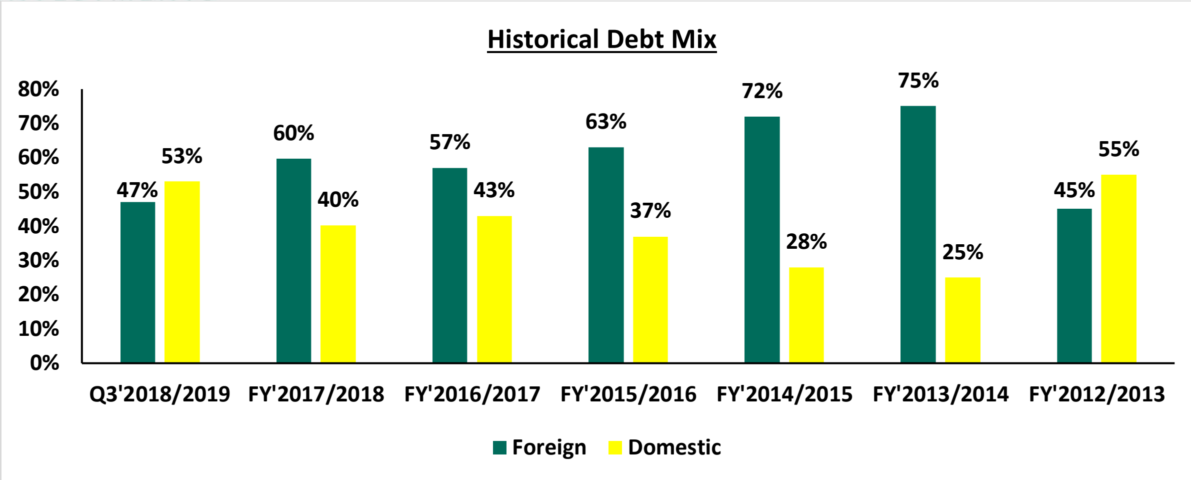
The maintenance of the fiscal deficit at the BPS level has been pegged on increased revenue collections as well as improved performance of the economy. With the risks of slower growth in 2019 due to the delayed onset of long rains and KRA not being able to meet its revenue target, there will be need to reduce the budget through a supplementary in order to maintain the BPS deficit levels. 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 in that respect and create jobs,
- 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 1960s, 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.

2. **Public Debt**

From the estimates, the total public debt requirement for the FY 2019/20 is set to decline marginally by 0.03% to Kshs 607.8 bn from Kshs 608.0 bn in FY 2018/19. This is attributable to an 11.7% decline in net domestic borrowing to Kshs 283.5 bn from Kshs 321.0 bn in FY'2018/2019. Net foreign borrowing is however expected to rise by 13.0% to Kshs 324.3 bn from Kshs 287.0 bn in FY'2018/2019.

Key to note, public debt requirement mix, however, is changing, comprising of 53% foreign debt and 47% domestic debt, compared to 47% foreign debt and 53% domestic debt as per the revised FY'2018/2019 budget. Foreign financing is higher mainly driven by increased project loans by Kshs 4.8 bn. Below is a chart with the debt mix as per recent years' budget estimates:



The current structure, however, does not match the 2019 Medium Term Debt Strategy Paper which recommended domestic debt to be the main source of financing. We expect the debt structure to have the following effects:

- The proposed debt financing could, therefore, carry fiscal risks and costs which were not anticipated under the 2019 Medium Term Debt Strategy which had considered the trade-offs between costs and risk outcomes. This could be aggravated by the fact that the actual fiscal deficit is likely to be higher than the estimated amount
- On the positive, however, the lower domestic debt could reduce the effects crowding out of the private sector due to the government's local debt appetite, with Banks being the main participants in government securities, contributing about 50% to every auction.).

Debt sustainability continues to be a key concern, with the public debt to GDP ratio estimated to be at around 60.0% currently following the issuance of the USD 2.1 bn Eurobond in May 2019, 10.0% 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%. We maintain our view that the country should shift its focus to other non-debt financing arrangements such as Public-Private Partnerships (PPPs) to fund infrastructural projects, we expected increased measures to improve debt management going forward.

We remain concerned about the country's debt levels unless decisive policies are implemented by the government. 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,
- Repealing or reviewing the interest rate cap legislation, which would, in turn, improve private sector credit growth and GDP growth indirectly, while enabling the involvement of the private sector in economic development,
- 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,

- Restructuring the structure of debt, ensuring a larger percentage of foreign borrowing is concessional in order to reduce amounts paid in debt service and diversifying currency sources of foreign borrowing in order to diversify currency risk on externally borrowed funds. External commercial borrowing should also be limited to development projects with high financial and economic returns, a move that will ensure the more expensive debt is invested in projects that yield more than the market rate charged,
- The government should encourage private sector involvement in development projects in order to reduce the strain on government expenditure and hence borrowing, (as of today, other than in energy, we have not been able to consummate any Public-Private Partnerships (PPPs) in areas such as real estate and housing,
- Better governance and accountability to reduce wastage and corruption levels. We hope that the steps strengthen key institutions of probity, and the current ongoing crack-down on corruption scandals will go a long way in enhancing governance, transparency and accountability around public resources, and,
- Making the public investment procedure more efficient through better administration of borrowed funds and improvement of project selection, fund allocation, monitoring and evaluation; and decreasing opportunities for corruption scandals surrounding large borrowed sums.

Conclusion

In conclusion, we have highlighted a few areas that will need improvement going forward, aside from all specific views highlighted in the sections above:

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 maintain the trend as experienced in FY'2018/2019 so far as compared to recent years which have ended 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.