The FY 2018/19 Pre-Budget Discussion Note

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The National Treasury is set to release the 2018/19 fiscal year (FY) budget today (14th June, 2018). As such, a lot of pre-budget discussions are taking place ahead of the official release at 3:00 pm, 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. A comparison of the 2018/19 and 2017/18 fiscal year budgets as per the 2018 Budget Policy Statement (2018 BPS),
ii. The fiscal year 2018/19 budget estimates as per recent news,
iii. Our analysis and view of key aspects of the budget, including related items such as the Big Four Agenda, and,
iv. 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: Comparison of the 2018/19 and 2017/18 fiscal year budgets as per the 2018 Budget Policy Statement (2018 BPS)

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

Amounts in Kshs bns unless stated otherwise					
Comparison of 2018/19 and 2017/18 Fiscal Year Budgets as per The 2018 Budget Policy Statement					
	2018/19	% change 2017/18 to 2018/19	2017/18	% change 2016/17 to 2017/18	2016/17
Total revenue	1,853.9	12.8%	1,643.1	12.9%	1,455.4
External grants	50.5	(14.8%)	59.2	0.8%	58.8
Total revenue & external grants	1,904.4	11.9%	1,702.4	12.4%	1,514.2
Recurrent expenditure	1,501.5	7.8%	1,392.8	13.3%	1,228.8
Development expenditure & Net Lending	612.9	5.7%	579.6	(27.3%)	797.0
County governments + contingencies	377.7	7.7%	350.7	16.4%	301.2
Total expenditure	2,492.1	7.3%	2,323.1	(0.2%)	2,327.0
Fiscal deficit	*(587.7)*	*(5.3%)*	*(620.7)*	*(23.6%)*	*(812.8)*

Deficit as % of GDP	*(6.0%)*	*1.2%*	*(7.2%)*	*3.4%*	*(10.6%)*
Net foreign borrowing	214.7	(33.6%)	323.2	(30.3%)	463.9
Net domestic borrowing	373.0	25.3%	297.6	(14.7%)	349.0
Total borrowing	587.7	(5.3%)	620.8	(23.6%)	812.9
GDP Estimate	9,790.8	13.1%	8,654.6	13.0%	7,659.7

Key take-outs from the table include:

i. The 2018 BPS points to a 7.3% increase of the budget, to Kshs 2.5 tn from Kshs 2.3 tn in the fiscal year 2017/18,

ii. Recurrent expenditure is set to increase at a faster rate than development expenditure; with recurrent increasing by 7.8% to Kshs 1.5 tn from Kshs 1.4 tn, while development will increase by 5.7% to Kshs 612.9 bn from Kshs 579.6 bn in FY 2017/18,

iii. The budget deficit is projected to decline to 6.0% of GDP from an estimated 7.2% of GDP in the FY 2017/18; 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 12.8% to Kshs 1.9 tn from Kshs 1.6 tn in FY 2017/18, with measures already in place to work towards increasing the amount of revenue collected in the next fiscal year, as highlighted below under the revenue section,

v. The total borrowing requirement is expected to decline by 5.3% to Kshs 587.7 bn from Kshs 620.8 bn, in a bid to reduce Kenya's public debt burden which is estimated at 55.6% of GDP as at 2017 by the IMF, 5.6% 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 of the 2018/19 budget is estimated to consist of 37% foreign debt and 63% domestic debt, unlike 52% foreign and 48% domestic in 2017/18 and 57% foreign and 43% domestic in 2016/17, where the foreign borrowing targets were more than the domestic borrowing targets. This can be good for debt management as it reduces the country's exposure to external shock but might end up crowding out the private sector in terms of loans/borrowing.

Section II: The FY 2018/19 budget estimates as per recent news

We note that recent news points to a Kshs 3.1 tn budget, which would mean:

i. A 32.2% increase of the budget from Kshs 2.3 tn in the FY 2017/18, an increase we have not seen in recent fiscal years despite the budget being expansionary year after year,

ii. With a revenue & grants estimate of Kshs 1.9 tn, this points to an increase of 13.0% from Kshs 1.7 tn in the FY 2017/18, and,

iii. With a budget of Kshs 3.1 tn and revenue & grants at Kshs 1.9 tn, this would leave Kshs 1.1 tn as the deficit. The deficit will have increased by 85.1% from Kshs 620.7 bn in the FY 2017/18 and the budget deficit to GDP estimate will be 11.7%, a rise from 7.2% in the current fiscal year. This would lead to increased borrowing, which we would like to point out is not where we want to be as a country. Keep in mind we were targeting a gradual budget deficit to GDP decline, having promised the IMF 6.0% in the FY 2018/19 and eventually 3.0% by 2021/22. This budget estimate does not seem to be in line with our deficit and debt management targets as previously highlighted by the government.

Given the source of these estimates is still uncertain, we shall rely more on the breakdown as per the 2018 BPS for purposes of this note as we await the official budget statement release.

Section III: Analysis and house-view on key budgetary aspects and the "Big Four" Agenda

Below we give our analysis and view on various aspects of the budget and other related items such as the Big Four Agenda:

1. Revenue

The revenue collection estimates are expected to increase by about 12.8% - 13.0%, same as the increase between the last two fiscal years.

As at April 2018, the Kenya Revenue Authority (KRA) collected Kshs 1.1 tn, which is 66.6% of the total fiscal year target of Kshs 1.6 tn. With just 2 months to go from there, it is doubtful that the KRA will meet its target, because assuming they collected the same amount monthly, they would be Kshs 27.4 bn short every month for the next two months, as the data suggests they collected Kshs 109.5 bn monthly when they should have been collecting Kshs 136.9 bn.

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

- Roll out of the Integrated Customs Management System (ICMS) to seal loop holes at the Customs and prevent concealment, undervaluation, mis-declarations 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 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,
- Enhancement of investigations, intelligence capacity and KRA's capacity to support revenue collection.

Furthermore, in May, the Treasury released the Tax Laws (Amendment) Bill, 2018, aimed at increasing revenue collected going forward, in a bid to reduce the budget deficit and Kenya's public debt burden. The Bill had the following key points:

- 35.0% tax on individuals earning Kshs 750,000 per month and above, as well as large corporations with a monthly taxable income of more than Kshs 500 mn, and,
- Amendments to the VAT Act that include changing the status of various products such as milk and cream, maize (corn) flour, bread and wheat among others from zero-rated to exempt, meaning that producers of these products cannot claim Value Added Tax (VAT) on inputs from the government, thus passing on these costs to end-consumers.

These changes, as well as the expected 16.0% VAT on petroleum products as from September 2018, are aimed at increasing revenue collections by the KRA and reducing the budget deficit to 6.0% of GDP in the fiscal year 2018/19, and further to 3.0% of GDP by 2021/22, from 7.2% in the current fiscal year. Prices of basic goods, however, will rise, as suppliers will pass on the additional tax cost burden to the final consumers, thus leading to a rise in food and fuel inflation in the period of implementation. As we continue to see significant changes to taxes, we are of the view that this should be accompanied by equally significant reduction efforts in recurrent expenditure, as only this joint effort will lead to a substantial decline in the budget deficit and in turn the public debt burden.

2. Public Debt

From the estimates, the total public debt requirement for the FY 2018/19 is set to decline by 5.3% to Kshs 587.7 bn from Kshs 620.8 bn in FY 2017/18.

The public debt requirement mix however is changing, now comprising of 37% foreign debt and 63% domestic debt, compared to the other two years where foreign debt was more than the domestic debt requirement. This is not cast in stone however, because the current fiscal year's budget also started out as so but eventually got revised to have a larger foreign debt requirement, as the government planned on borrowing quite a large chunk of this through the issue of the two Eurobonds, issued in February 2018. The higher domestic debt composition, if kept as so, could have the following two results:

- Reduce 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
- Lead to crowding out of the private sector because the larger the government's local debt appetite, the less banks have to lend to the private sector as they are the main participants in government securities, contributing about 50% to every auction. Key to note is with the interest rate cap in place, chances of this effect are higher as banks already prefer to lend to the government, which is perceived less risky as opposed to lending to the riskier private sector at 13.5% (with the Central Bank Rate at 9.5% and the law capping lending rates at 4.0% points above the CBR).

Debt sustainability continues to be a key concern, with the public debt to GDP ratio estimated to have hit 55.6% by the end of 2017, 5.6% 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%. Following the recent recommendation by the CBK governor, 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. The decline in the budget deficit as

indicated by the FY 2018/19 budget as per the 2018 BPS is a start in the right direction.

We however remain concerned about the country's debt levels "Unless decisive policies are implemented by the government", as Moody's would put it. 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 outlines in the 2018 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 involvement of the private sector in economic development. The Draft Financial Markets Conduct Bill by the Treasury did not address this,

- 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 debt mix to ensure less is borrowed from external sources, 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. As per the 2018 BPS, the government plans on adopting a deliberate approach to diversifying currency structure so as to hedge against exchange rate risks especially for new loan commitments. External commercial borrowing will 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). Stakeholder engagement meetings with real estate developers by the Ministry of Housing and Urban Development point to PPPs as a way to involve the private sector in the implementation of the Big Four Agenda of affordable housing. We look forward to this coming to fruition,

- 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, such as the office of the Director of Public Prosecution (DPP), Directorate of Criminal Investigations (DCI) and Attorney General, 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.

3. Expenditure

As per the 2018 BPS, total expenditure is set to increase by 7.3% to Kshs 2.5 tn from Kshs 2.3 tn in FY 2017/18.

Recurrent expenditure is still set to increase faster than development expenditure by 7.8% compared to 5.7%, respectively, which remains a point of concern as we have previously highlighted that increases in revenue collections should be accompanied by correspondent declines in expenditure, specifically recurrent.

In terms of budget absorption, development expenditure absorption seems to be lagging behind more than usual, with 36.3% of the total development expenditure budget being utilized as at April 2018 compared to a historical of at least above 60.0%. This can be attributed to the wait-and-see approach taken last year in terms of investments, ahead of the election period in Q3'2017.

A Supplementary Budget II was submitted by the Treasury seeking to reduce development expenditure by 7.0% and increase recurrent expenditure by 1.7%, pointing to a possible over-absorption of the recurrent budget, which is in line with the historical of above 100.0% in past fiscal years. The overall reduction of 0.8% (inclusive of contingencies) is in line with fiscal consolidation but we note that a reduction in recurrent expenditure as opposed to development expenditure would be a more welcome move.

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 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, and,
- A change of mind-set by Kenyans, to view public office as an avenue to serve Kenyans as opposed to an avenue to become rich and famous.

4. Big Four Agenda

The "Big Four" Plan, which is in line with the 3rd Medium Term Plan (MTP) of Kenya's Vision 2030 running from 2018 to 2022, involves:

- Supporting value addition and raising the share of the manufacturing sector to GDP to 15.0% by 2022,
- Enhancing food and nutrition security to all Kenyans by 2022,
- Providing universal health coverage to guarantee quality and affordable healthcare to all Kenyans, and,
- Provision of affordable and decent housing for all Kenyans.

Seeing as this is a 5-year plan, we expect to see the budgets for the next 5 fiscal years aligning to the implementation of the Big Four Plan, with allocation increases to the four sectors highlighted i.e. manufacturing, agriculture, health and real estate. We have seen stakeholder engagement meetings held by ministries responsible for implementation of some of these agendas, key being the affordable housing agenda, where PPPs will be key in financing and implementation, which is commendable.

The Big Four can also be viewed as a social agenda, focusing on key social problems that are faced mainly by the lower-middle to low income portion of the population, such as:

- Affordable housing: the government is looking to construct 800,000 affordable housing units and 200,000 social housing units, with a target to meet at least half of this at 500,000 units in total by 2022. This is to sort out the issue of mushrooming slum dwellings especially in major cities, and encourage home ownership among Kenyans in the lower income bracket,
- Food security: the affordability of food in the country has been an issue for years now, especially affecting the lower income class where food inflation rises the highest, relative to the other income classes. Affordability has been affected by quantities supplied which are lower than quantities demanded, thus leading to the price tending upwards. Achievement of food security will lead to an increase in supply thus a reduction in price, and this will tame food inflation. Food inflation being the largest component of overall inflation, if tamed, will also tame overall inflation in the country,
- Universal Health Care: health is another social issue that needs to be addressed, given the scarcity of public hospitals, which reduces availability of health care services; and the unaffordability of certain medical services, especially for the lower income class who cannot afford to be attended to at the more expensive private hospitals. An improvement of availability and affordability of quality health care services is much needed in the country, and
- Increasing manufacturing activity: this will result in (i) increased export earnings from finished products, (ii) enhanced uptake of the "*Made in Kenya*" brand, and (iii) increased employment, especially of those from TVET educational institutions which are fast coming up to cater for the large chunk of high school leavers who don't make the cut for white

collar courses, and reduce the stigma around blue collar jobs in Kenya. With unemployment above 30.0% according to the UN Human Development Index, which is higher than all other East African countries, Kenya needs to reduce this number in order to improve the living standards of its citizens.

However, we have not seen clear indications of increased budgetary focus on the four sectors. From the 2018 BPS, we have a breakdown of the projected budget ceilings for the FY 2018/19 budget with no clear increase in the two sectors as identified in the table below:

Medium Term Sector Ceilings as a Share of Total Expenditure		
Sector	2017/18 Estimates	2018/19 Ceiling
Agriculture, Rural & Urban Development	2.4%	2.3%
Energy, Infrastructure & ICT	25.5%	24.0%
General Economic & Commercial Affairs	1.2%	1.2%
Health	3.8%	4.1%
Education	23.0%	25.4%
Governance, Justice, Law & Order	12.4%	11.6%
Public Admin. & International Relations	16.5%	16.2%
National Security	8.0%	7.4%
Social Protection, Culture & Recreation	2.8%	3.1%
Environment Protection, Water & Natural Resources	4.5%	4.6%
Total	100.0%	100.0%

Two sectors are easily identified i.e. agriculture and health, but the remaining two are not clear as per this breakdown. There was an indication that the finalization of the detailed budget would ensure the allocations for the FY 2018/19 and the Medium-Term have been realigned to reflect the “Big Four” Plan either directly (as drivers) or indirectly (as enablers). We therefore expect to see a better laid out breakdown in the 2018/19 Budget Statement set to be released.

The Agenda is well laid out in terms of areas of focus, enablers such as adoption of technology, and other outcomes apart from the core such as job creation. Implementation and involvement of the public sector is key in order to ensure that all is implemented as planned and reliance on borrowed funds is reduced, in order to avoid crowding out of the same private sector that is supposed to be involved in implementation.

Conclusion

In conclusion, the budget is no doubt going to be expansionary, in order to support further growth and development of the country. We have highlighted a few areas that will need improvement going forward, aside from all specific views highlighted in the 4 parts of Section III 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 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.