Budget Analysis 2018

Institute of Economic Affairs

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INSIDE

Key Messages

Generally, there is a signal that through Budget 2018/19, the government of Kenya is committed to the "Big Four' economic plan. This is evident from increased focus and shift in budgetary allocation particularly to the agriculture sector for food and nutrition security. In addition, continued large budget share to the infrastructure sector and national security as enablers of the "Big Four" is another claim to this commitment. However, for a successful journey into this plan combined with pursuit of fiscal consolidation agenda whose aim is to increase room for additional resources for service delivery, the government needs to note the following below:

Efforts to contain expenditure and comply with fiscal responsibility

- The government should enforce a comprehensive framework, austerity measures and others to curb growth of expenditure especially rise in recurrent expenditure, given that Consolidated Fund Serice (CFS) will account for 32% of the entire GoK budget. Some of these measures include; a combination cutting on non-core expenditure items, streamlining public service sector and wean parastatals off transfer.
- To curb anticipated rise in debt payment and indeed rise in debt interest payment by 31% in 2018/19 from the previous year the Government has to deliberately implement fiscal consolidation policy in line with prudent debt management to ensure we keep within debt sustainability levels.
- Proper appraisal should inform selection of projects to be funded through borrowing to ensure high yield and mitigate cost overruns that may lead to contingent liabilities.

Efforts to curb public wage bill

- The government needs to muster political will to fully implement the Capacity Assessment and Rationalization of Public Service (CARPS) programme as well as employing retrenchment programmes and temporarily freezing employment.

Efficiency in spending

- At the outset, there is need to enhance capacity on revenue forecasting and temper expected donor funds in order to address cash management and delays in release of funds.
- To enhance up take of development budget for improved service delivery the government should continuously build capacity to synchronize planning and procurement processes as well as address administrative capacity in regular monitoring and reporting of projects.

Domestic revenue mobilization

For overall improved revenue performance, measures to mitigate factors that may under economic growth including; boosting of private sector growth through repeal of interest rate capping and external risk such as rise in global oil prices are critical.

Tax reforms should focus on reviewing exemption regime of both VAT and corporate tax, transparency in tax expenditure. Further efforts is needed towards efficiency in tax collection and sealing tax leakage.

1.0 Introduction

This analysis of Budget 2018/19 interrogates the extent to which it is aligned to the government fiscal consolidation agenda (lowering budget deficits). In particular, it focuses on big ticket expenditure items, how the overall budget will be financed and alludes to the effect of the foregoing on the *"big four"* economic plan[1] that will be pursued by the government from 2018-2022.

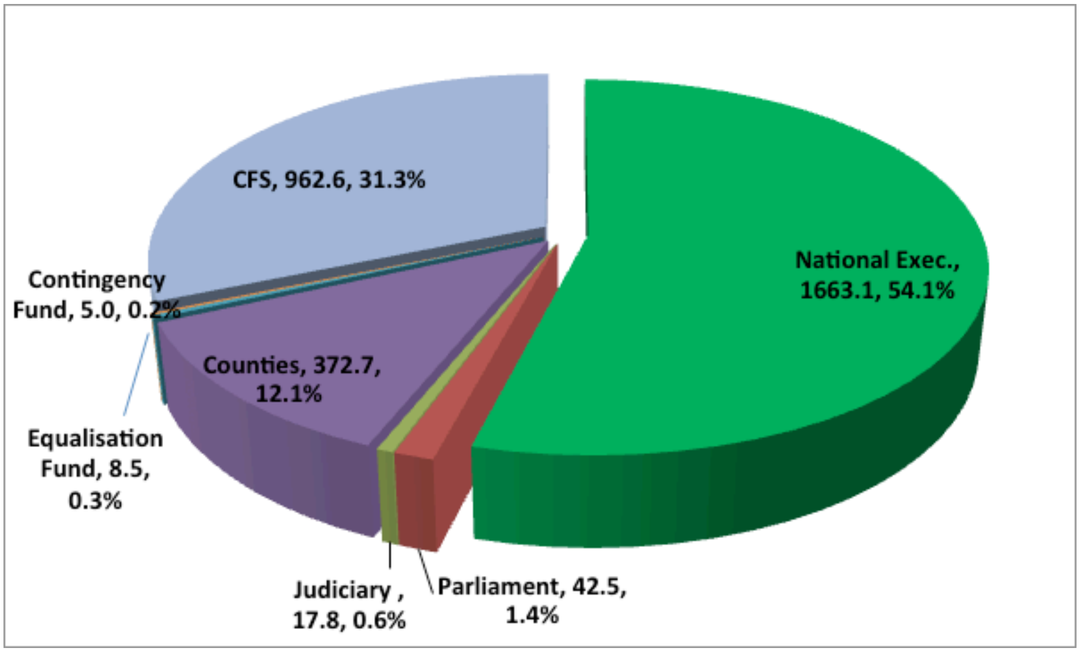
In terms of organization, this analysis first presents an overview of the entire budget, then proceeds with expenditure analysis that looks at issues of mandatory spending and what this means to budget flexibility, implications of public wage bill and a brief on what is expected in terms of sectoral priorities. The final section focuses on where funds to finance this budget are expected to come from.

In addition to providing information to stir up public debate of the budget, the Institute of Economic Affairs (IEA)-Kenya through this brief, points out policy concerns and issues that parliamentarians may consider in their scrutiny and interrogation of the budget.

2.0 Overview of Budget 2018/19

The pie chart below gives an overview of the proposed budget for the government of Kenya (GoK) in 2018/19. It shows how this budget of Ksh 3.07 trillion, up by 29.3% from the revised budget 2017/18 will be distributed between the two levels of governments. This is captured in both value (Ksh billion) and in percentage terms.

How Budget 2018/19 (Ksh 3.07 Trillion) will be shared



The national executive takes the largest share, 54.1% of the total estimated budget, whereas the other two arms of government, parliament and the judiciary take a combined 2%. Technically, about 87.6% of this budget remains at the National Government. This denotes that despite increasing public interest in County Governments, public accountability of the National Government in service delivery is imperative.

Of note is the significant size of Consolidated Fund Service (CFS), about 31.3% which is estimated to go up by 32.4% from the revised 2017/18 budget owing to significant increase in debt redemption and interest payment. It is thus one of the drivers for increase in the total estimated government expenditure outlay, the other being the proposed budgets for both the Judiciary and the Parliament.

[1]This plan by the government targets to create jobs and transform lives through value addition in the manufacturing sector, food security and nutrition, universal health care coverage and provision of at least 500,000 affordable new homes by 2022.

About 12.1% of the total GoK budget will be allocated to the 47 County Governments. In addition, 14 marginalized Counties will benefit from about 0.3% of the total budget as Equalization Funds amounting to Ksh 8.5 billion.

Focus on the national budget of Ksh 1,663.1 billion (ministries, department and agencies-MDAs) from a perspective of how funds or type of spending spent (economic classification of expenditure) is telling of the big expected budget items. On one hand, nearly 50% of this budget is anticipated to go towards salaries for public officers. On the other hand about 20% of this national government budget will go into infrastructure related state corporations for development of roads, energy, water and ICT projects as transfers from their parent ministries.

Moreover, for a general idea of how the overall budget for 2018/19 compares with the revised budget 2017/18 and how it will be financed at a macro level, this information is provided in the table below. Given that it captures the overall budget for 2018/19 [2]and how it will be financed thus provides an indication of government's journey in pursuit of fiscal consolidation (reducing budget deficit) agenda. It gives a snapshot of the overall budget and financing for Budget 2018/19.

Budget Outturn (Ksh Billion)

	Revised 2017/18	Budget 2018/19	% change
Revenue			
Total Revenue	**1,647.2**	**1,949.2**	**18.3**
Ordinary Revenue (incl. RDL)	1,490.4	1,743.0	16.9
Grants	59.2	48.5	-18.1
Total Revenue & Grants	**1,706.4**	**1,970.0**	**15.4**
Expenditure			
Total Discretionary Expenditure	1,993.3	2,072.1	4.0
National Executive	1,638.2	1,692.6	3.3
Parliament	24.4	36.8	50.8
Judiciary	11.8	15.2	28.8
Transfer to County Gov'ts	306.2	314.0	2.5
Equalization Fund	7.7	8.5	10.4
Contingency Fund	5.0	5.0	0.0
Non-Discretionary Expenditure			
Consolidated Fund Service (excl. internal & external debt redemption)	382.6	490.5	28.2
Total Overall Expenditure	2,375.9	2,562.6	7.9
Financing:			
Deficit after grants	**(669.5)**	**(592.6)**	**-11.5**
Net domestic borrowing	332.4	271.9	-18.2
Other domestic financing	3.8		-100.0
Net foreign financing	331.1	298.9	-9.7
Repayments			
Total	**667.3**	**570.8**	**-14.5**

Source: *QBER 3rd Quarter 2017/18 and Budget Statement 2018*

Total revenue and grants are anticipated to increase nominally by 15.4% from Ksh 1,706.4 in 2017/18 to 1,970 billion in 2018/19. Conversely overall expenditure outlay is expected to rise from Ksh 2,375.9 billion to Ksh 2,562.6 billion, a nominal growth of 7.9% over the same period.

The resultant deficit given that expenditure outlay is bigger than projected revenues is Ksh 592.6 billion in 2018/19, an anticipated reduction by 11.5% from the previous year. It is however noticeable from the table that particularly for 2018/19 the total anticipated deficit of Ksh 592.6 billion and how it will financed (Ksh 570.8 billion) does not balance. To this effect, the IEA-

Kenya notes the following in the computation and disaggregation of the budget information for 2018/19 from the table above:

1. The computed budget deficit of Ksh 592.6 billion is different from Ksh 558.9 cited in the Budget Statement FY 2018/19. Given that other documents including the Financial Statement and the Estimates of Revenue were not publicly available by the time of doing this analysis makes it difficult to compare and validate budget deficit financing information provided.
2. Secondly, budget financing information provided in the Budget Statement 2018 is not comprehensive and detailed to facilitate interpretation and analysis calling for effective budget transparency and timely publicization of important budget documents.
3. Even with inconsistencies of budget deficit information for 2018/19, its computation based on overall expenditure and anticipated total revenue and grants denotes a reduction from budget deficit according to revised budget for 2017/18. Thus a hint of direction towards fiscal consolidation. However this anticipated deficit is about 6% of GDP and significantly above the East African Community Monetary Union protocol's fiscal target of 3% by 2020/21. This implies the need for a comprehensive expenditure control –austerity measures and revenue mobilization plan in order for the government to realize this target.

3.0 Expenditure Analysis

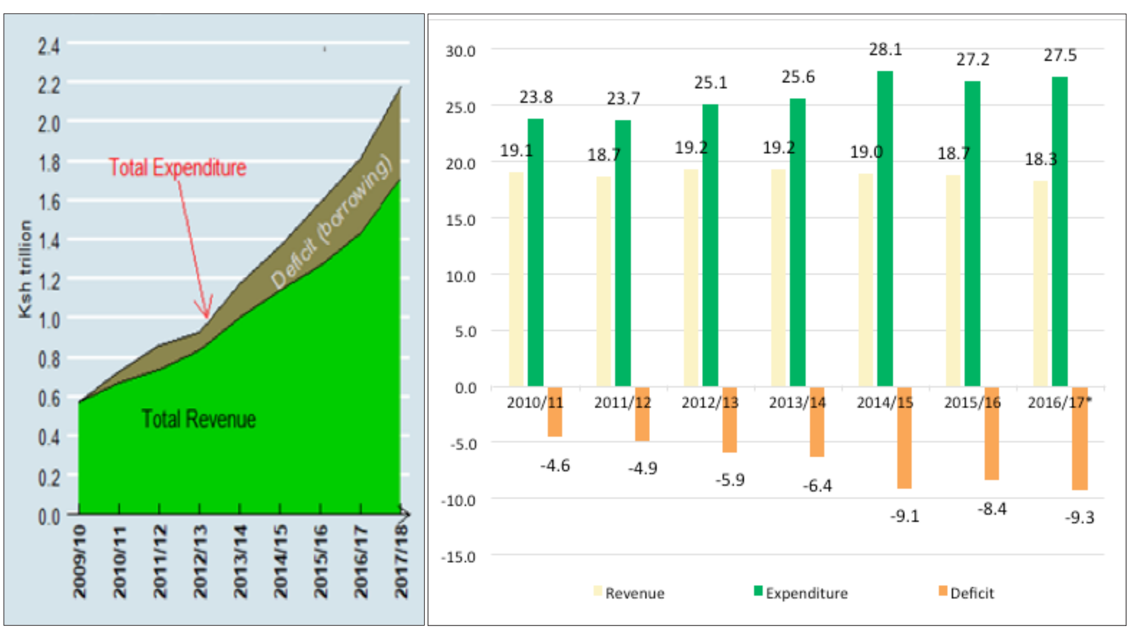
The following section looks at the big ticket spending areas and their implication on Budget 2018/19, in an attempt to interrogate whether anticipated expenditure is in line with the medium term fiscal consolidation path.

Part of the analysis looks at the implication of CFS as mandatory expenditure, public wage bill which is implied as a non-discretionary expenditure. Furthermore, this brief analyses allocation to MDAs organized by the different sectors in order to understand the shift and focus of spending in 2018/19 and whether in line with the Budget Policy Statement 2018.

Expansionary fiscal stance the reason for widening fiscal deficits...

Government's expenditure has persistently been on an upward trend over the last decade from 22.3% of GDP in 2008/09 to 27.5% of GDP in 2016/17. This has been more pronounced from the 2013/14 after coming to effect of devolution as shown in the chart below.

Increased spending is attributed to setting up County governments and other Constitutional offices immediately in the 2013/14 period. Further down the line spending picked up due to public servants wage adjustments and in particular from implementation of infrastructure development including energy projects, first phase of the SGR (Ksh 398.1 billion, equivalent to 6.1 percent of GDP)[3] as well as from rising debt service.



Source: *QEBR First Half FY 2017/18 and Statistical Annex 2017 Budget, National Treasury*

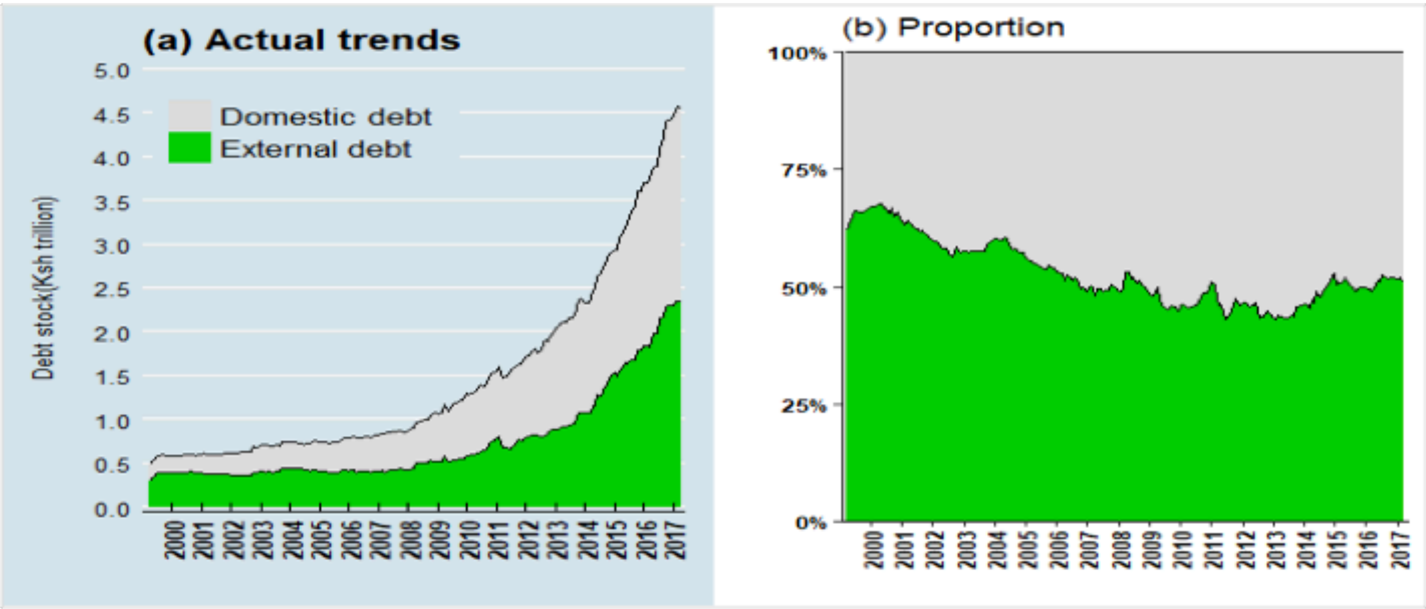
Owing to expenditure growing at a faster pace than revenue, budget implementation has resulted to budget deficits. This is indeed shown by the chart above where deficit has widened significantly from 6.4% in 2013/14 to 9.3% in 2016/17.

Notably slight reduction in spending following revision of budget initially to 26.1% of GDP in 2017/18 was a signal of government's effort of beginning to rein on expenditure. However, this was countered by further revision of the budget that saw it go up to about 27% of GDP owing to spending on election rerun in October 2017 and on provision of food subsidies in response to drought.

Given the above scenario the government has continued to borrow internally and externally in order to plug in hole created by expanded spending relative to revenue raise. Hence financing budget deficits over time has as a consequence resulted to steady rise of Kenya's stock of debt as depicted by the charts below. In fact, public debt as a percentage of GDP has increased from 48.4% in 2013/14 to 51.5% in 2016/17 with an almost equal split between domestic debt and external debt.

Preliminary estimates for 2017/18 show further rise of debt to 58.1% of GDP. So far, the argument by the government is that this is still within sustainability thresholds of 74% net present value of debt to GDP.

Domestic debt versus external debt



Source: *Various issues of KNBS Economic Survey*

Whereas this may be the case, the IEA-Kenya reiterates that it is important to appreciate that attendant to increasing stock of debt is rise levels of debt servicing (see table below). For example, debt service as a percentage of GDP in the period 2012-2016 averaged above 5%. In 2018/19, debt service is expected to increase by 34.1% from the previous financial year. Related to this, interest payment for both internal and external debt is estimated to increase by 31% from Ksh 305.1 billion in revised budget of 2017/18 to 399.98 billion in 2018/19.

Trends in Consolidated Fund Services (CFS)- Ksh Bn							
Item	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**% age**
Public Debt	331.17	324.92	417.20	466.51	649.40	870.62	34.07
Pensions	28.15	32.36	43.00	55.69	71.90	86.25	19.97
Salaries & Allowances	3.72	4.07	4.44	4.00	4.15	4.19	0.96
Miscellaneous Service	0.13	0.13	0.13	0.13	0.13	0.13	0.00
Subscriptions to Int'l Orgs	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Guaranteed Debt	1.18	1.01	0.94	1.02	1.29	1.37	6.20
Total	364.35	362.49	465.71	527.35	726.86	962.56	32.43
% Total Public Spending	23.20	24.64	19.81	21.09	27.50	31.94	

Source: *Various issues of Estimate of Recurrent Expenditure*

The IEA-Kenya notes that in part, this situation is partly explained by dynamic changes in the composition of external debt in favor of bilateral and commercial banks which are more expensive. In an attempt to address some of the challenges related to this, the government focus, as noted in the Medium Term Management Strategy is to reduce domestic debt and enhance long term concessional external debt.

In the midst of this, the government has made forays into the international market for bonds. Recently, the government successfully issued a USD 2 billion Eurobond which although increasing the maturity profile of external debt obligation, government must be aware of imminent exchange rate risks and increasing vulnerability to developments in the international markets .

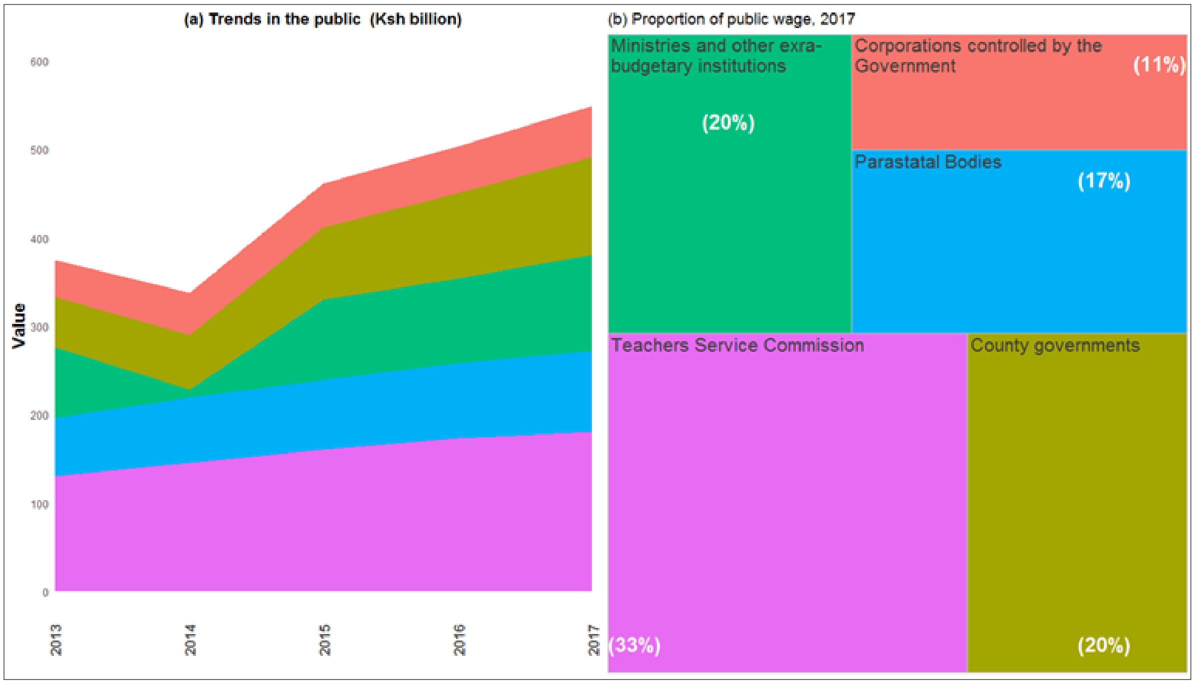
Given the above scenario, the question that begs is requisite government policy action in order to realize its medium term fiscal consolidation plan without undermining the competitiveness of the economy. It is clear that spending is expected to continue, albeit at a relatively lower rate in 2018/19, a good sign but overall efforts to rein on spending are not correspondingly clear. To this end, the IEA-Kenya notes the following:

- The government needs to employ sound revenue enhancement measures (partly discussed in the revenue analysis section of this brief).
- To realistically narrow budget deficits, the government needs to focus attention on reducing recurrent expenditure. For example, recurrent expenditure has in the recent been over 100% of tax revenue. Therefore, reduction in recurrent expenditure can be done by a combination curbing none core spending, streamlining public service sector, employing retrenchment programmes and temporarily freezing employment.
- In addition, there is need for deliberate efforts to lower transfers to parastatals which take up nearly a quarter of the entire national government budget.
- Parliament should oversight borrowing by the government to ensure it is within plans set out in the medium term debt strategy. For example, increased domestic borrowing crowds out private sector and may in turn affect savings and investments as private sector is starved off credit.
- Slowdown in development spending in pursuit of fiscal consolidation, the government should be wary of a likely subdued economy. Therefore this should be countered by providing an enabling environment and incentives for increased private sector investment.
- Proper appraisal should inform selection of projects to be funded through borrowing to ensure high yield and mitigate cost overruns that may lead to contingent liabilities.

3.1 Public Wages and Implications for Budget 2018/19

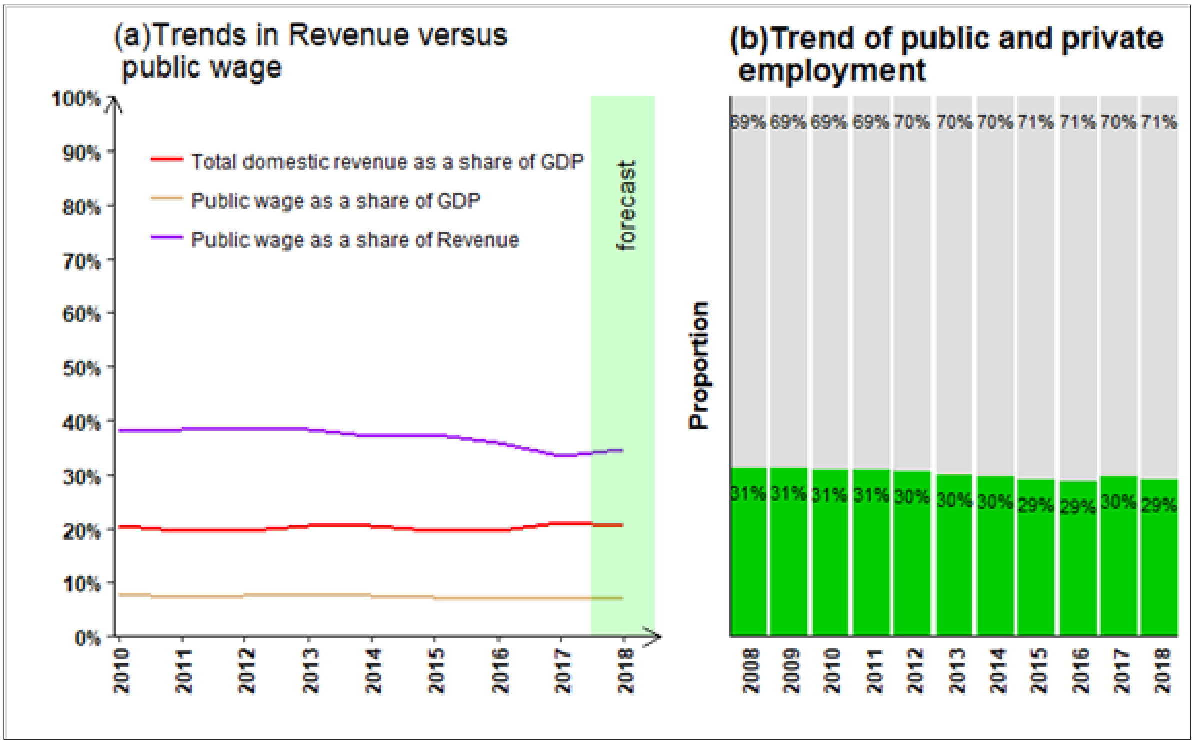
The average annual growth was 10% (from Ksh 375 billion to Ksh 549 billion) significantly higher compared to a nominal GDP growth of 5.5% and population growth of 2.8%.

From a wage bill perspective, the national government and its agencies/parastatals are the largest employer in Kenya as they take up 37% of public wage bill in 2017. Teachers Service Commission comes second with 33% as shown by the graph. Growth in the public wage bill is partly due to increased recruitment (662,300 in 2013 to 790,200 in 2017) and general increase in average wage earnings per public sector workers.



Source: *Various Issues of KNBS Economic Survey*

Although public wage bill has been on an upward trend in absolute terms, it is the contrary relative to GDP and revenue from around 2012 up to up to 2016 (see chart). As a percentage of GDP wage bill for the last three years has been below the global average of 7%. It is only in 2017 that it was slightly above 7%. Equally as a ratio of revenue, it is only in 2017 and projections for 2018 where public wage bill is likely to exceed the 35% principal responsibility threshold.

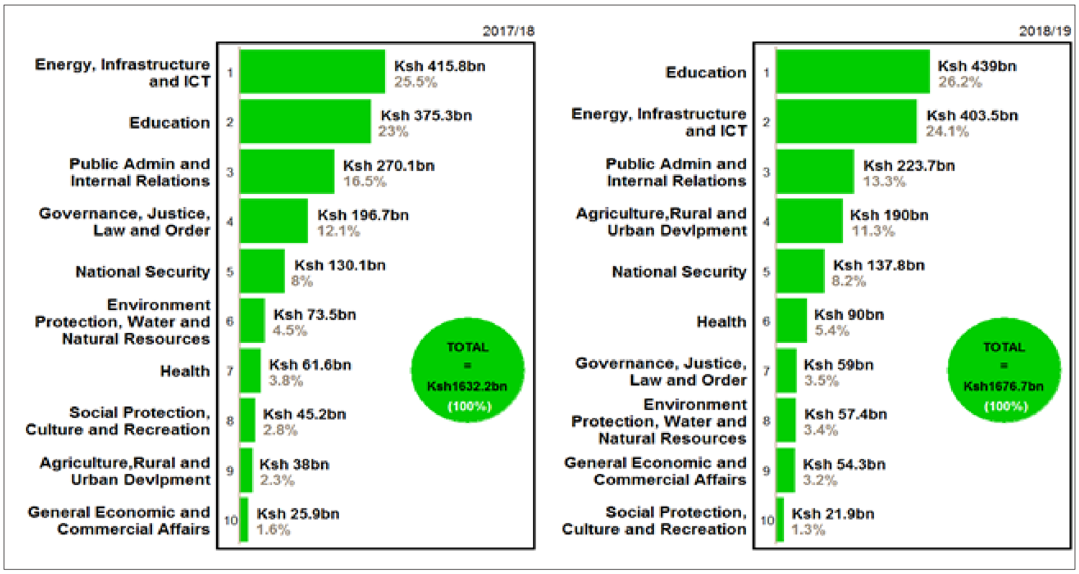


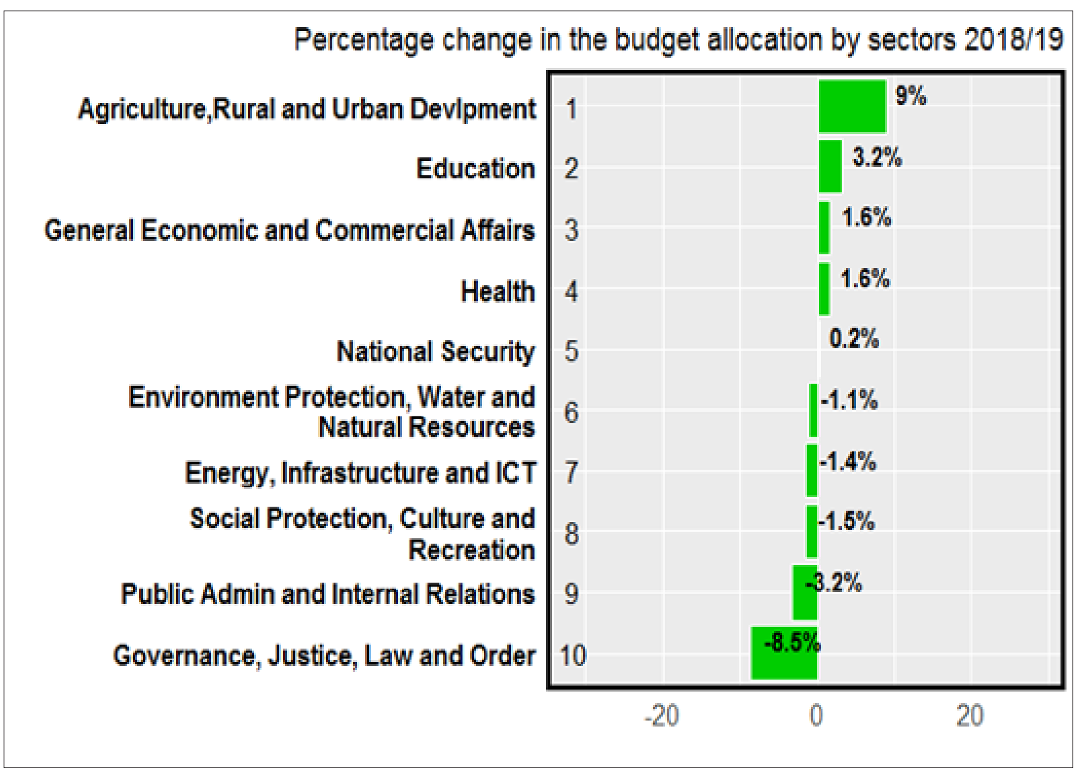
The IEA-Kenya appreciates that if the public wage bill is left unchecked, it could grow to unsustainable level. Besides growing public wage reduces the space for development expenditure as a critical enabler for private sector development. As such, the government needs to muster political will to fully implement the Capacity Assessment and Rationalization of Public Service CARPS) programme as well incorporate temporary freeze in employment.

3.2 Sectoral Priorities

This section looks at anticipated change and shift in sector priorities by the government in 2018/17 relative to 2017/18. It also provides a high level assessment of whether the focus is aligned to Medium Term Plan III -2018-2022. From the two top charts *(page 7)*, the total MDAs budget excluding the judiciary and the legislature is anticipated to increase from Ksh 1,632 billion in 2017/18 to Ksh 1,676.7 billion in 2018/19, a marginal 3% growth.

The ranking of sector budget shares has changed considerably from the previous financial year budget. For 2018/19, Education sector takes the lion share of the budget, 26.2% followed closely by the Energy, Infrastructure and ICT with 24.1% budget share. These two sectors have swopped positions from 2017/18 but by slightly higher proportionate shares of 0.7 and 1.1 percentage points respectively. There is no change in the third position for the Public Administration and Internal Relations (PAIR) sector albeit by a slightly lower proportionate share.





The third chart *(page 8)* shows that in 2018/19 the national government will significantly shift its focus to the Agriculture, Rural and Urban Development sector on the basis of budgetary allocation. Budget share for this sector is anticipated to increase from 2.3% in 2017/18 to 11.3%, accounting for the highest percentage change of (9%) of the ten sectors. This is perhaps a signal of government's commitment to one of the *"Big Four"* Economic Plan of investing in initiative that guarantees food security and improvement of nutrition by 2022. Further form a cursory view significant budget shares to the Energy, Infrastructure and ICT as well as to the National Security, which are critical enablers of the *"Big Four"* plan is perhaps another pointer to government's commitment.

3.3 Efficiency in Spending

Beyond allocation, budget implementation is critical to public service delivery outcomes. As such, the question of public expenditure management, that is, how to improve efficiency of public spending and reduce wastages is pertinent to the government. Relatedly the government has routinely struggled with the challenge of low uptake/absorption particularly of the development budget over the years.

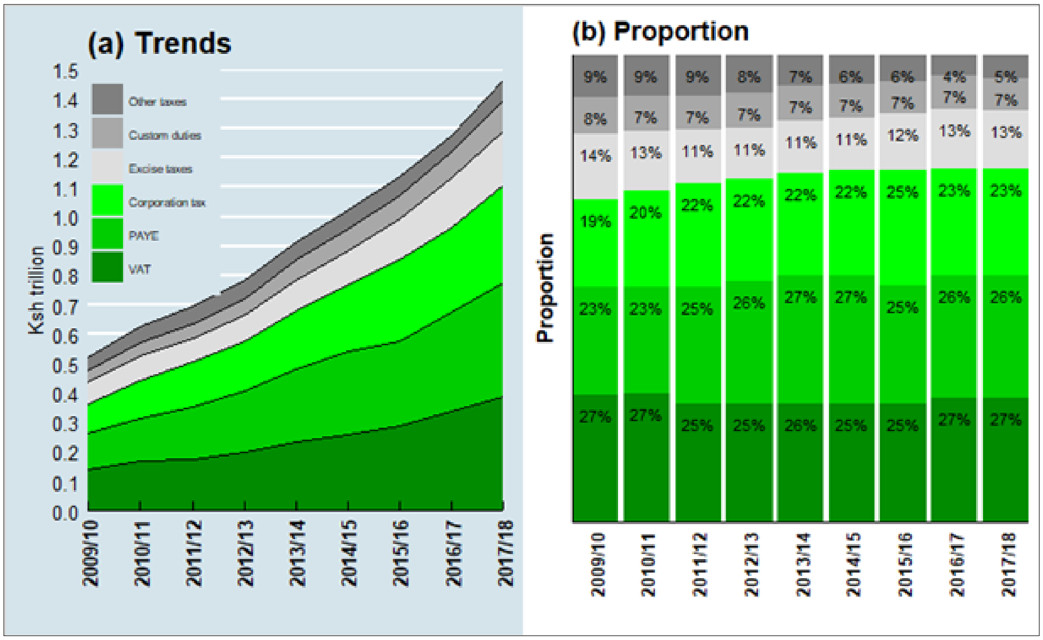
It is commendable that some of the various mitigating measures, including e-Promis may be paying off as against a performance benchmark of at least 80%, absorption of development budget improved from 66.3% in 2015/16 to 69.9% in 2016/17. By the end of March 2017/18 , uptake of targeted development budget was 71%.

Investment in infrastructure development to unlock growth potential is an enabler of the big four plan. Poor absorption rates may undermine realization of some of the big four initiatives and in particular manufacturing. It is commendable the progression made towards improving absorption rate of development but this is still markedly below the 80% benchmark. In this regard, the IEA-Kenya recommends lasting action in relation to tempering expected donor funds, focusing spending on on-going projects as a priority and improvement in administrative capacity in regular monitoring and reporting of projects to address delays in release of funds.

4.0 Revenue Analysis

The BPS 2018 notes that the budget framework for 2018/19 will be underpinned by on-going fiscal consolidation agenda which aims at narrowing budget deficit so as to stabilize Kenya debt position and provide some flexibility for fiscal policy interventions. This brief therefore attempts to interrogate how enhancement of domestic revenue mobilization can support medium term fiscal consolidation plans as noted in the BPS.

The Budget Summary shows that the Budget is to be financed through domestic revenue including AiA of Ksh 1.943.2 billion (19.6 % of GDP) of which ordinary (tax) revenue is projected at Ksh 1,743 billion. In addition to this, grants of Ksh 48.5 billion are expected from foreign governments and international organizations. Thus total revenue and grants works out to Ksh 1,970 billion. Realization of projected revenue is predicated on economic growth and on-going reforms in tax policy and revenue administration.



Source: Various Issues of KNBS Economic Survey

This notwithstanding, it is important to note that although revenue performance in the last decade has been on an upward trend (see chart above), overall revenue mobilization in relation to target has continued to underperform. For example, nine months into the financial year 2017/18, total revenue performance was 10.3% short of target, that is, Ksh 1,037.2 billion against a target of Ksh 1,156.6 billion despite modest rise in collection by 5.3% over the same period in 2016/17 . The biggest underperformance was with AiA, which includes Road Maintenance Levy and fees collection by universities. It missed the target by nearly 50% up from 16% in the previous year. This underscores the persistent challenge of collecting AIA.

Other weak revenue mobilization areas include; taxes on select goods and services through excise duty, PAYE, tax on good and service imported in Kenya, and on international trade and transactions (IDF fees). For PAYE, part of the challenge is with regard to lack of remittance or payment of statutory fees for County Government officers' salaries due to late disbursement of funds as well as reduced collection from corporates due to layoffs.

On the domestic front, economic activity in 2018 is expected to pick up after a dip in GDP growth from 5.9% in 2016 to 4.9% in 2017 upon conclusion of elections in 2017. Reports show that the average fourth quarter GDP rates of the last five financial years was 6.1% and hence brighter revenue outlook going into 2018. Besides, agricultural production might benefit from improved weather patterns and coupled with strong performance in the service sector may fuel economic growth.

Moreover, a steady macroeconomic environment evident from easing of inflationary pressures, stabilizing interest and exchange rates may further fuel economic growth. For example, month-on-month overall inflation fell to 3.7 percent in April 2018 from 4.2 percent in March 2018 largely due to lower food prices. Notably too is that some recovery in tourism receipts and rising remittances has tempered widening current account.

On the external front, global growth is expected to continue strengthening and thus may lead to increased demand and private consumption.

The picture of economic outlook looks good. However there are risks that if not mitigated may end up undermining revenue performance as per projections for 2018/19. Some of these issues are highlighted below by the IEA-Kenya.

First, studies show that revenue performance is strongly linked to economic growth. Despite some positive signs of economic rebound there are a number of policy concerns that may affect economic growth and hence undermine revenue collection. Private sector credit growth and especially to the small and medium enterprises is still subdued owing interest rate capping from September 2016 which may cloud favourable economic outlook. In this respect, the IEA-Kenya recommends a reversal by repealing this the law by the government.

Secondly, trends show that Kenya's economic growth is quite unpredictable and may further be dampened by external factors such as rising international oil prices among other shocks. Therefore policy interventions to mitigate against such shocks are imperative.

Low performance in VAT and income tax affects overall domestic revenue mobilization as they comprise about 70% of total tax revenue (see chart above). It is therefore important that the government reviews the exemption regime of both VAT and corporate tax which are often obfuscate but also not always serving their intended purposes of equity and incentivizing businesses.

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