On the 14th of June 2001, the Minister for Finance in Kenya tabled the 2001/2002 budget to the National assembly. The house will devote most of the time between now and the end of the year debating the Government's economic policy as outlined in the budget speech and budget implementing legislation, specifically the Finance Bill (Tax and Miscellaneous proposals and the Appropriations Bill. This year, the minister also presented the Banking Act amendment Bill with the budget. The purpose of this guide, produced by the Institute of Economic Affairs, is to help members in the budget debate.

**Budget Documents**

**Budget Speech:** Contains statement of economic performance and prospects; Government’s economic policy, objectives and targets; Government’s financial report and forecast; Taxation proposals. Notice of Motion of ways & means

**Financial Statement.** Expected movements in the Exchequer Account for the current financial year and forecast for the coming year, and a summary of the revenue proposals contained in the Finance Bill

**Statistical Annex to Budget Speech.** Key indicators on the economy, government budget, the national debt and international trade


**Finance Bill 2001.** Miscellaneous amendment bill to various tax laws (Income Tax Act, VAT Act, Customs and Excise Act, Penal code) and other changes to the law proposed in the budget.

**Provisional Collection of Taxes and Duties Act:** Temporary legislation to provide for the collection of taxes until Finance bill is passed

**Banking Amendment Bill.** Bill to amend the Banking Act to enact financial reforms proposed in the budget speech. The proposed amendments are to facilitate sharing of credit information among banks and to empower the Central Bank to liquidate Building Societies.

**Estimates of Recurrent Expenditure.** Proposed recurrent expenditure outlays for each Vote and (Ministries and Consolidated Fund Services).

**Estimates of Development Expenditure.** Proposed development expenditure outlays and detailed listing of external (donor) funding

**Fiscal Strategy paper:** This year’s budget documentation is accompanied by a three-year medium term expenditure framework (MTEF) strategy paper for the period 2001/2-2003/4. The MTEF is a World Bank expenditure framework adopted by the Government last year.


**Guide to the guide**

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**Did you know that:**

- The Kenyan Economy shrank by .3% while global and regional economy grew by 4.7%
- Global prospects look bright but Kenyan forecast is 2.9 over next three years
- Budget deficit numbers are inconsistent
- Parliament approved expenditure of Ksh 327 billion last year

On the 14th of June 2001, the Minister for Finance in Kenya tabled the 2001/2002 budget to the National assembly. The house will devote most of the time between now and the end of the year debating the Governments economic policy as outlined in the budget speech and budget implementing legislation, specifically the Finance Bill (Tax and Miscellaneous proposals and the Appropriations Bill. This year, the minister also presented the Banking Act amendment Bill with the budget. The purpose of this guide, produced by the Institute of Economic Affairs, is to help members in the budget debate.
Context and Theme: Nation in Crisis

Economy contracted by 0.3% in 2000, the fifth year of decline and the worst performance since independence. Kenyans living below poverty line has increased from 52% in 1997 to 56%.

Insecurity. Country is beset by clashes in the rural areas, breakdown of law and order in urban areas. In effect, the Minister acknowledges that the Government is failing in its most primary function, protecting lives and property.

Corruption. Corruption and mismanagement in Government has undermined service delivery, and economic competitiveness.

High interest rates. Government borrowing and tight monetary policy has precipitated a high interest rate regime and undermined private investment and job creation.

Confidence crisis. Foreign investors and aid donors have lost confidence, translating into capital flight (outflows exceeding inflows).

Drought. The country suffered the worst drought in forty years. Electricity supply contracted by 41%. Food shortages affected more than 50% of Kenyans. Agricultural output declined by 2.4%.

Lagging behind our East African partners and the rest of Africa. Our economic decline over the last five years contrast sharply with Uganda and Tanzania. Both grew by well over 5% last year maintain (See Chart 1 below). Similarly, and as the Minister observed, that Africa’s exports to the rest of the world grew by 26% in dollar terms last year, ours have stagnated.

What does the Minister propose will rescue Kenya from this?

The Minister chose the theme Effective Resource Allocation for Growth and Poverty Reduction. In the policy debate, the House will no doubt want to relate the budget theme to the Ministers candid statement on the critical state of the Nation. Specifically, Members may want to address the following questions,

? Does the resource allocation theme address, and are the policy priorities sufficiently focussed on the most critical and immediate challenges facing the country? In our opinion, the theme, and the policy thrust as a whole, should have focused on the governance, security and restoring confidence.

? Members may also want to examine the policy focus as reflected in the themes over the period that the economy has been declining and assess whether the Government has been focussing on the critical issues:

Recent Themes for the budget


1999/2000 Capital flight, rising

East Africa GDP growth 1997-2000 and forecast to 2003
unemployment, falling commodity prices, unfavourable weather conditions, deteriorating infrastructure.

Budget Theme: Economic Recovery for Sustainable Economic and Social Development

1998/1999: High interest rates, poor state of roads, power supply shortages, insecurity, adverse weather conditions, suspension of ESAF and low investor confidence.

Budget Theme: Fiscal Restraint and a Balanced Budget


Budget Theme: Enhanced Economic Reform for Faster Growth.

Policy Framework: Party Platform (Manifesto Replaced???)

The Minister’s speech highlights the extensive and all inclusive consultation process, that produced the Poverty Reduction Strategy Paper tabled with the budget. The Minister asserts, as does the paper itself, that it reflects the aspirations of all Kenyans. This is not in doubt. That said, Governments in a democracy are elected on a policy platform customarily articulated in their party’s election manifesto.

We have examined the PRSP alongside the KANU Manifesto 1997. The priorities are not substantially different, and in our assessment, the manifesto articulates a more comprehensive, ambitious and robust program than the PRSP (See example below). In the policy debate, the House may want to seek clarification from the Minister whether his Government has relegated the manifesto to the more modest PRSP objectives.

On security:

“KANU believes in the right of every Kenyan to prosperity and live in any part of the country. KANU will work ceaselessly for the security, prosperity and welfare of all citizens within a political climate of peace and stability. The security of our people remains the primary concern of our party”

“The KANU government will deal severely with acts of corruption to routing out this cancer and its adverse effects on the growth of our economy and quality of our governance is absolute”

On growth

“The KANU govt must achieve and sustain GDP growth rate of 8% and above in order to deal decisively with the problems of poverty and unemployment”

Macro-economic Framework

Growth

The Minister has projected that the economy will grow by 2% this year, and by 3.2% over the next two years, an average of 2.9% over the period.

The House may wish to note that these are not policy targets as such but rather, they are forecasts spewed out by an economic model, based on past statistical data. The forecasting exercise is described in detail in the Fiscal Strategy Paper. In effect, it would seem that the Minister has adopted a model forecast as his growth target. This is not the correct way to use an economic model for macroeconomic programming. The purpose of macroeconomic model is to evaluate alternative ways of achieving targets that the policy maker considers feasible. A model cannot generate policy targets, since it cannot “know” what the policy maker wants to achieve.

Fiscal Strategy

This year’s budget is based on a three-year medium term expenditure framework (MTEF) for the year 2001/2 to 2003/4. The framework is elaborated in the Fiscal Strategy Paper which is part of the budget documents tabled by the Finance Minister.

The strategy is predicated on the notion that the private sector is more productive than the Government. Its overarching objective therefore, is to reduce the Government’s claim on national resources, so that more resources are allocated by private sector. To this end, the Government is aiming for a balanced budget at 22% of GDP in 2003/4, in other words, down from an expenditure ratio of 28% and revenue ratio of 23% of GDP in the year that is ending. The targets for this year’s budget are to reduce revenue to 23% of GDP and expenditure to 25%.

External Finance

In recent times, Ministers have factored into the budget external financing (aid) and privatisation
proceeds predicated on conditionalities which, evidently firm political commitment had not been secured. Last year's budget factored in Ksh. 21.7 bn aid but was only able to realise 7.5bn. Expected privatisation proceeds was Ksh.10 billion.

This year, the Minister indicates donor commitments totalling 40.5 bn in the budget, made up of Ksh. 26.2bn project aid and Ksh. 14.3bn program aid (budget support). The Minister expects capital receipts from privatisation of Telkom Kenya, Mumias Sugar Company, Kenya Re Insurance Corporation, and Kenya Commercial Bank but the amount is not stated.

The House may want to satisfy itself that this year, firm political commitment on the IMF program conditions has been secured.

**Discrepancy between fiscal strategy targets and printed expenditure estimates.**
The house should take note of large discrepancies between these expenditure targets and the outlays in both this years and last year's printed estimates.

Last year, the House approved Ksh. 305 billion expenditure. It increased this to Ksh. 327 billion through supplementary estimates. This expenditure outlay translates to 37% of GDP before supplementary estimates and 40% after supplementary estimates. (GDP for the fiscal year is estimated as Ksh. 820 billion).

The printed expenditure estimates for the coming year is Ksh. 306 billion. Under the Government’s growth and inflation assumptions, nominal GDP will be about Ksh. 900 billion. In effect, the printed expenditure outlays translate to just over 30% of GDP.

**Accounting Inconsistencies**

**Change in CFS Reporting.** The House may also want to note that the approved expenditure for the ending year given by the Minister in this year’s budget speech and the one's he gave in last year’s budget speech differ by Ksh. 78 billion. Although we cannot be sure, our examination of the accounts points to omission of debt redemption (repayment of principal) in previous budget speeches (although they are reflected in the printed estimates).

The house may want to seek clarification from the Minister as to why debt redemption was not reflected in previous speeches, and why the Minister did not signal this change in practice to the House.

**Deficit and Financing Gap**
Despite considerable effort, we have been unable to construct a consistent fiscal outturn from the various budget documents.

On Pg. 27, paragraph 3 of the Budget Speech, revenue and expenditure for 2000/1 are given as 23.2% and 27.9% respectively, implying a deficit of 4.7% of GDP. Pg. 30, paragraph 3, gives the deficit as Ksh. 15.1 billion equivalent to 1.8% of GDP. The Financial Statement gives the deficit as Ksh. 21,661 Billion. Yet another figure, in Table 1 of the Statistical Annex gives a deficit on a commitment basis and including grants as Ksh. 20.2 billion equivalent to 2.56% of GDP.

The House may want to ask the Minister to clarify these seemingly inconsistent deficit figures.

Deficit can be measured on cash basis or commitment basis, and including or excluding grant. This results on at least four different measures.

To avoid confusion, the House may want to adopt one official definition. The most appropriate would be the deficit on a commitment basis, excluding grants.

**Financing gap**

Similarly, our analysis of the financing of the budget points to significant and widely divergent financing gaps in the various documents, as shown below.

<table>
<thead>
<tr>
<th>Revenue, Expenditure balance indicated in budget documents</th>
<th>Budget Speech</th>
<th>FSP</th>
<th>FinStat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue (incl. Aid)</td>
<td>218.6</td>
<td>218.6</td>
<td>288.3</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>306.5</td>
<td>295.8</td>
<td>306.5</td>
</tr>
<tr>
<td>Implied Fin. Group</td>
<td>87.9</td>
<td>77.2</td>
<td>18.2</td>
</tr>
</tbody>
</table>

FSP—Fiscal strategy paper
FinStat—Financial Statement

Members may wish to ask the Minister to guide
them through the financial statement in order to clarify the source of these inconsistencies.

**Monetary Policy**
The stated objective of the Government's monetary policy is to maintain price stability. The Minister outlined three monetary policy measures namely:
1. To contain money supply growth to 8% of GDP
2. To contain increase in credit to the private sector to 10% of GDP
3. To maintain official foreign exchange reserves at equivalent of 3 months of import requirements

The house may also want to note that these targets do not require any effort on the part of the Government. Money supply has hardly grown at all in the last two years. There is no reason to suppose that it accelerate to over 8%. Similarly, official foreign exchange reserves are presently well over 3 months import cover, while total reserves are well over 5 months import cover.

More importantly, the House may want to challenge the efficacy and the monetary policy. Specifically, the House may want the Minister to explain the wisdom of a tight money policy in a depressed economy.

**Interest Rates**
The interest rate is the key monetary policy variable. The House may also want to take note of, and seek explanation for the lack of mention of interest rates in the monetary policy statement. Does the Government have an interest rate target? If so, what is it, and how does it relate to the money and credit targets?

**Financial sector reform**
The Minister made reference to “a wide range of reforms designed to strengthen the health of the financial sector” that the Government has implemented over the last several years. At the same time, he observed that financial stability is still threatened by “the large number of small and unstable banks and the increasing portfolio of non-performing loans” (Pg. 28-29).

In effect, the Minister implies that the Government’s prudential regulation is not working. It is noteworthy that lending institutions outside CBK regulation such as SACCOs and Microfinance organizations seldom fail.

The House may want to question the policy which continues to expand the Central Bank’s mandate for a job it is evidently unable to perform satisfactorily.

**Revenue Proposals—Committee of Ways and Means**
Proposal to raise penalties for non-compliance with Customs and Excise taxes. The Minister proposes to increase penalties under the Customs and Excise Tax “to enable the Commissioner to take more punitive measures against non-compliant importers”

The House may want to challenge the Minister to show that non-compliance is as a result of low penalties as opposed to weak enforcement. It is the experience everywhere that compliance with the law and regulations depends not on the severity of punishment but on its certainty. In a corrupt environment, increasing severity without addressing enforcement tends to increase the size of bribes, not compliance.

Proposal to raise of import duty on cloth from 25% and 30% to 35%

Proposal to increase petrol taxes by two shillings
The Minister has proposed to increase tax on petrol by 2 shillings a litre on the justification that this has fallen below inflation. The House may want to ask the Minister whether the Government has a stated policy of indexing taxes to inflation.

Proposal to increase excise factory license fees by Ksh. 25,000 and Ksh. 50,000: The Minister proposes to increase excise factory licenses on the grounds that this will enhance control over the issuance of these licenses.

The House may want to ask the Minister to explain his reasoning. The relationship between enhancing control and increasing license fees is not readily apparent. In addition, the House may want to inquire whether this implies that the Government has lost control over the issuance of these licenses.
Proposal to charge VAT on rental of commercial buildings for business purposes. The Minister introduced VAT on rental of commercial buildings earning rental income of Ksh. 3.6 million per year.

The House may want to consider the likely impact of this tax on the urban property market, the private sector, and small enterprises in particular. Specifically

1. The budget speech misrepresents this as a tax on landlords. It is in fact a tax on tenants.
2. The Ksh. 3.6 million threshold does not necessarily exclude small enterprises. If the purpose of the threshold was to protect small businesses, it should have been based on the rent paid by the tenant as opposed to the rent collected by the landlord.
3. The incidence of the tax will fall heavily on businesses in the large towns, particularly Nairobi and Mombasa
4. The tax will induce offices to relocate to residential areas thus putting pressure on residential rents, and depressing commercial property prices

Ksh. 3.6bn. In percentage terms the largest increase is reflected in pensions & gratuities. Debt service (interest and principal) is projected at just over one third of the total expenditure outlays, and more than double the development budget. On ministerial votes, five ministries will request lower outlays than last year (See Table) These are OP (by 15.7bn), Directorate of Personnel Management (by 4.5bn.), Agriculture and Rural Development (by 1.6bn), Information, Transport & Communication (by 204 mn) and Energy (by 5.3bn). The reductions in OP and Energy reflect emergency outlays last year.

All other votes will request increased allocations. In percentage terms, the largest increase is from the Electoral Commission (66%), followed by the National Assembly (46%), the Public Service Commission (36%) and the Controller and Auditor General’s Office (35%).

Core poverty programmes
Last year’s budget speech included a listing of resources that would be “ring fenced” for the core poverty programmes, that is, they would not be affected by expenditure cuts during the year. Expenditure cuts did occur following the withholding of anticipated aid. The House may wish to be informed as to whether the core programs were indeed protected from the expenditure cuts.

In the budget speech the Minister indicates that resources have been earmarked for core poverty programmes and will be ring fenced (Pg 42) but he did not include a listing of the projects as he did last year. The house may want to request the Minister to provide this information.
<table>
<thead>
<tr>
<th>Item</th>
<th>Approved 2000/01</th>
<th>Estimates 2001/02</th>
<th>Change</th>
<th>Change, %</th>
<th>Share, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discretionary Expenditure, of which</td>
<td>211 179</td>
<td>199 082</td>
<td>(12 097)</td>
<td>(5.73)</td>
<td>64.9</td>
</tr>
<tr>
<td>Recurrent</td>
<td>153 807</td>
<td>157 445</td>
<td>3 638</td>
<td>2.37</td>
<td>51.4</td>
</tr>
<tr>
<td>Development</td>
<td>57 372</td>
<td>41 637</td>
<td>(15 734)</td>
<td>(27.43)</td>
<td>13.6</td>
</tr>
<tr>
<td>Consolidated Fund Services, of which</td>
<td>116 265</td>
<td>107 461</td>
<td>(8 804)</td>
<td>(7.57)</td>
<td>35.1</td>
</tr>
<tr>
<td>Public debt</td>
<td>109 937</td>
<td>97 694</td>
<td>(12 243)</td>
<td>(11.14)</td>
<td>31.9</td>
</tr>
<tr>
<td>Pensions and Gratuities</td>
<td>5 902</td>
<td>9 398</td>
<td>3 496</td>
<td>59.23</td>
<td>3.1</td>
</tr>
<tr>
<td>Salaries, Allowances, Misc.</td>
<td>228</td>
<td>235</td>
<td>7</td>
<td>3.07</td>
<td>0.1</td>
</tr>
<tr>
<td>Subscriptions to Int. Organizations</td>
<td>199</td>
<td>133</td>
<td>(66)</td>
<td>(33.17)</td>
<td>0.04</td>
</tr>
<tr>
<td>Total Expenditure Outlays</td>
<td>327 444</td>
<td>306 543</td>
<td>(20 901)</td>
<td>(6.38)</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Quality of the budget speech.
The budget speech is without doubt one of the nation’s most important policy documents. It should be lucid and specific. The House may want to censure for repetitiveness, ambiguity and superfluous statements. The speech contains several general statements of intent, which have been made in previous budget speeches without clear targets and time frames. It is also customary to specify in the budget speech the time when the tax changes will take effect. The Minister did not specify this for most of the tax proposals.

Budget Calendar
1. Policy Debate (up to 7 days from Tue 19 June)
Policy Debate. House will debate the Government’s economic policy and strategies as outlined in the budget speech. Do they adequately address the challenges and imperatives facing the country? Official opposition will be given first opportunity to articulate its alternative to the Government’s proposals. The Finance Minister will respond at the end of the debate.
Key Documents: Budget Speech, Fiscal Strategy Paper, PRSP

2. Vote on Account (1 day)
Policy debate will be interrupted for the Minister to seek approval for up to 50% of the expenditure to spend up to December 31.

3. Committee of Ways and Means (3 days):
Finance Minister will move Motion to constitute House as Committee of Ways and Means. House will debate taxation proposals. Members will have opportunity to amend the proposals during the debate on the Finance Bill.
Key documents: Budget Speech, Finance Bill, Estimates of Revenue

4. Committee of Supply (July 4 – October 31);
House will debate and approve expenditures on a Ministry-by-Ministry basis. Members will have opportunity to propose nominal reductions on specific items (sub-votes) as a sanction for non-performance.

This budget guide has been produced by the budget Information Programme of the Institute of Economic Affairs, a non-partisan, public Affairs forum.
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