

2011 BUDGET OUTLOOK PAPER

**PRESENTATION TO PARTICIPANTS OF PUBLIC SECTOR HEARING
FOR 2011/12-2013/14 MTEF BUDGET**

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INTRODUCTION

THE ROLE OF BOPAs

- An important tool for strengthening the preparation of budgets and management of public resources in Kenya.
- It provides a clear link between policy, planning and budgeting; [previously disconnected/disjointed]
- It helps to maintain fiscal discipline by establishing hard budget constraints for Government by ensuring that expenditures in the medium-term are consistent with prudently available resources; and
- With a hard budget constraint, the Government has to ensure that expenditures are prioritized in order to achieve it's overall policy objectives.

INTRODUCTION (Cont...)

2011 BOPA

- The 2011 BOPA2009 is the 7th since its production in 2004.
- It sets out the background and broad fiscal parameters for the 2011/12 budget and the medium-term, consistent with Government strategies and policies
- Ensure maintenance and sustenance of **macro-economic stability**, including the role of fiscal policy in achieving this. Without a stable macro-environment the necessary environment for private sector activities will simply not be there; and
- Provide **indicative sector ceilings** as a guide to Sector Working Group MTEF budget preparation, as scarcity of resources demands that we prioritize on the key programs that will achieve our national objectives.

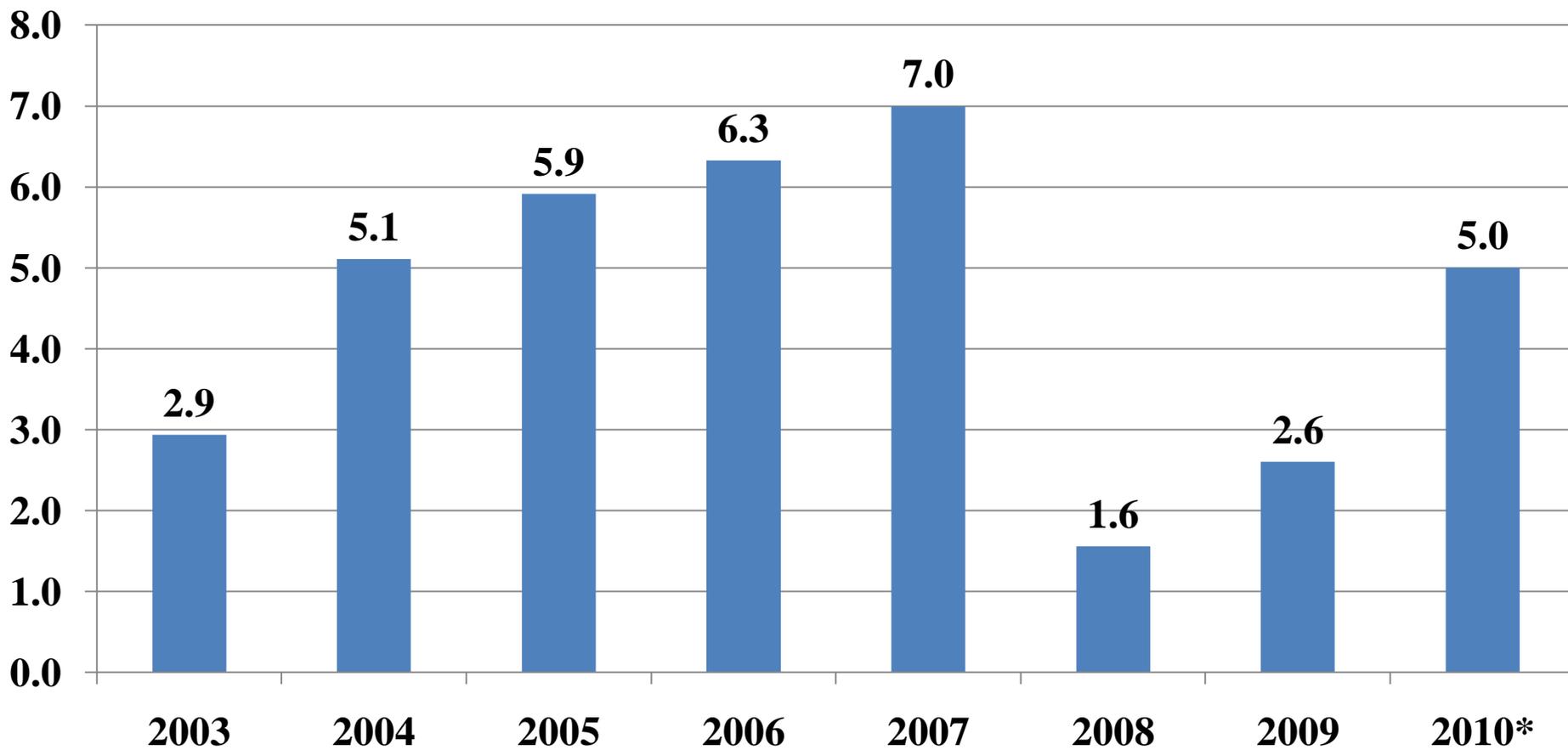
2011 BOPA--MAIN MESSAGES

- Economy bouncing back from major shocks in 2008-09, but downside risks remain
- Need for gradual unwinding of the temporary fiscal and monetary stimulus so as to:
 - Pre-empt inflationary tendencies
 - Restore public finances to sustainable paths
- Continued structural reforms to improve competitiveness
- Continued spending in priority sectors (infrastructure and social), while laying the framework for a decentralized system

I. RECENT ECONOMIC DEVELOPMENTS

After shocks in 2008-09, economic recovery is now underway

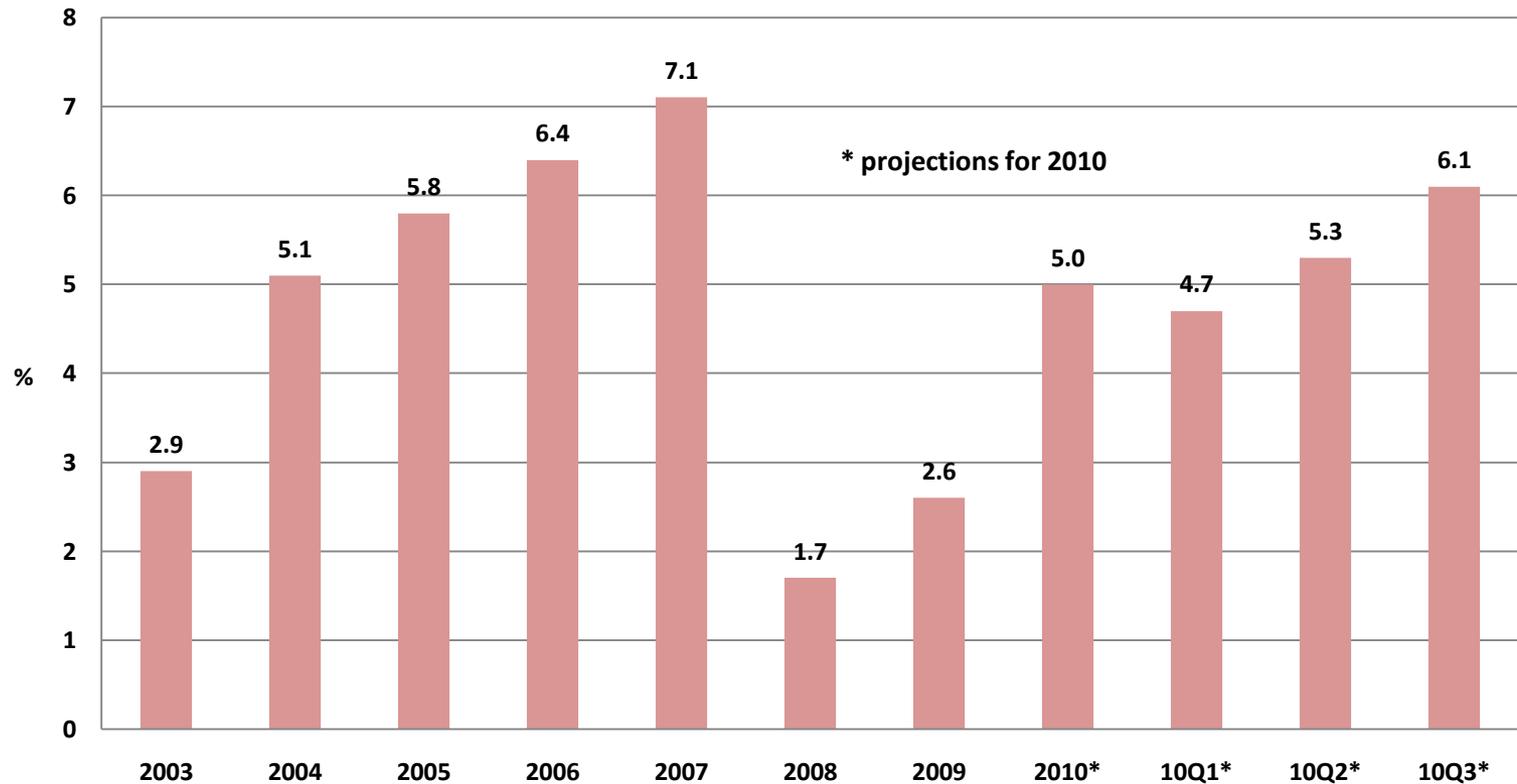
Chart 1: Real GDP growth



* Forecast

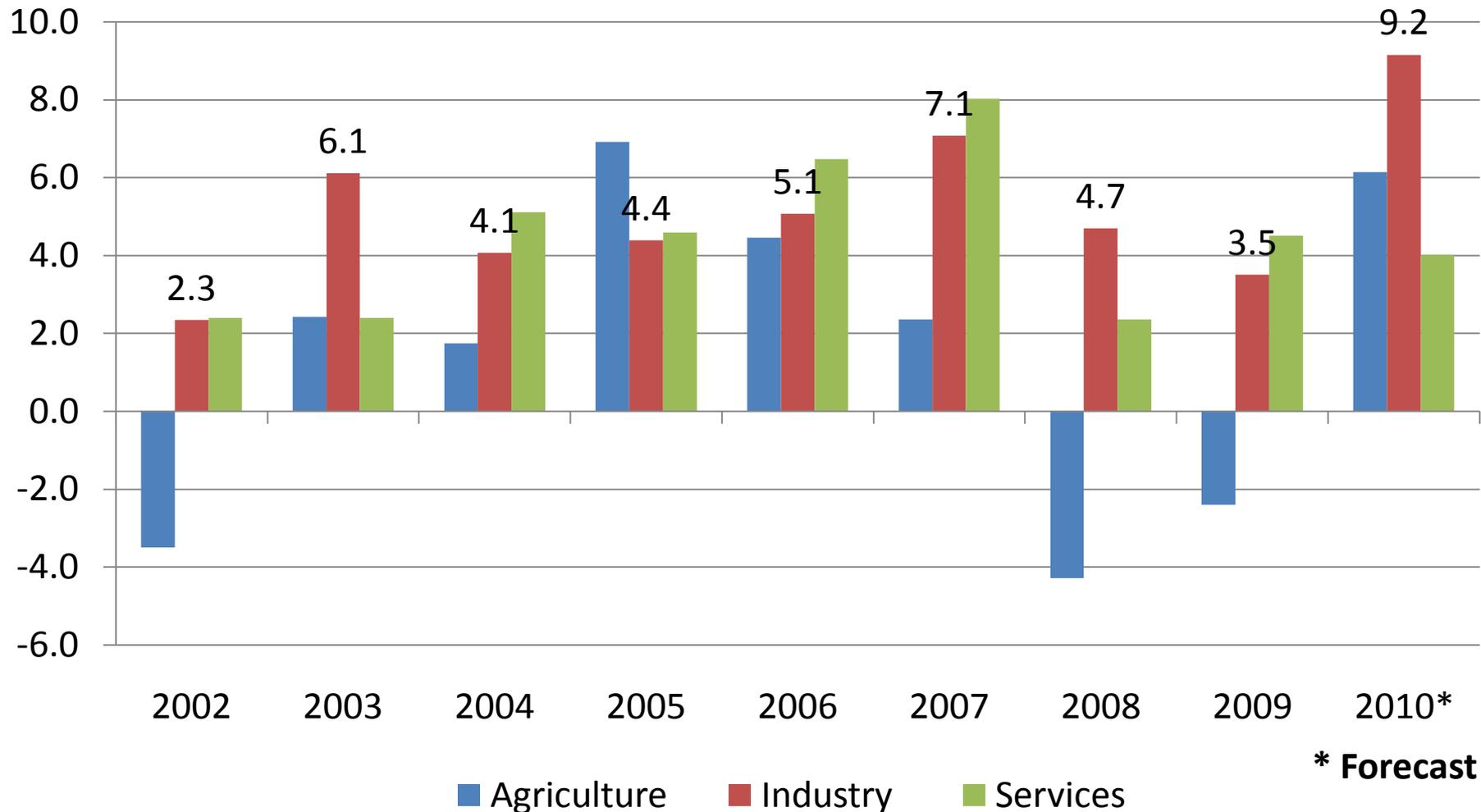
2010 quarterly real GDP growth

Chart 1: Real GDP Growth



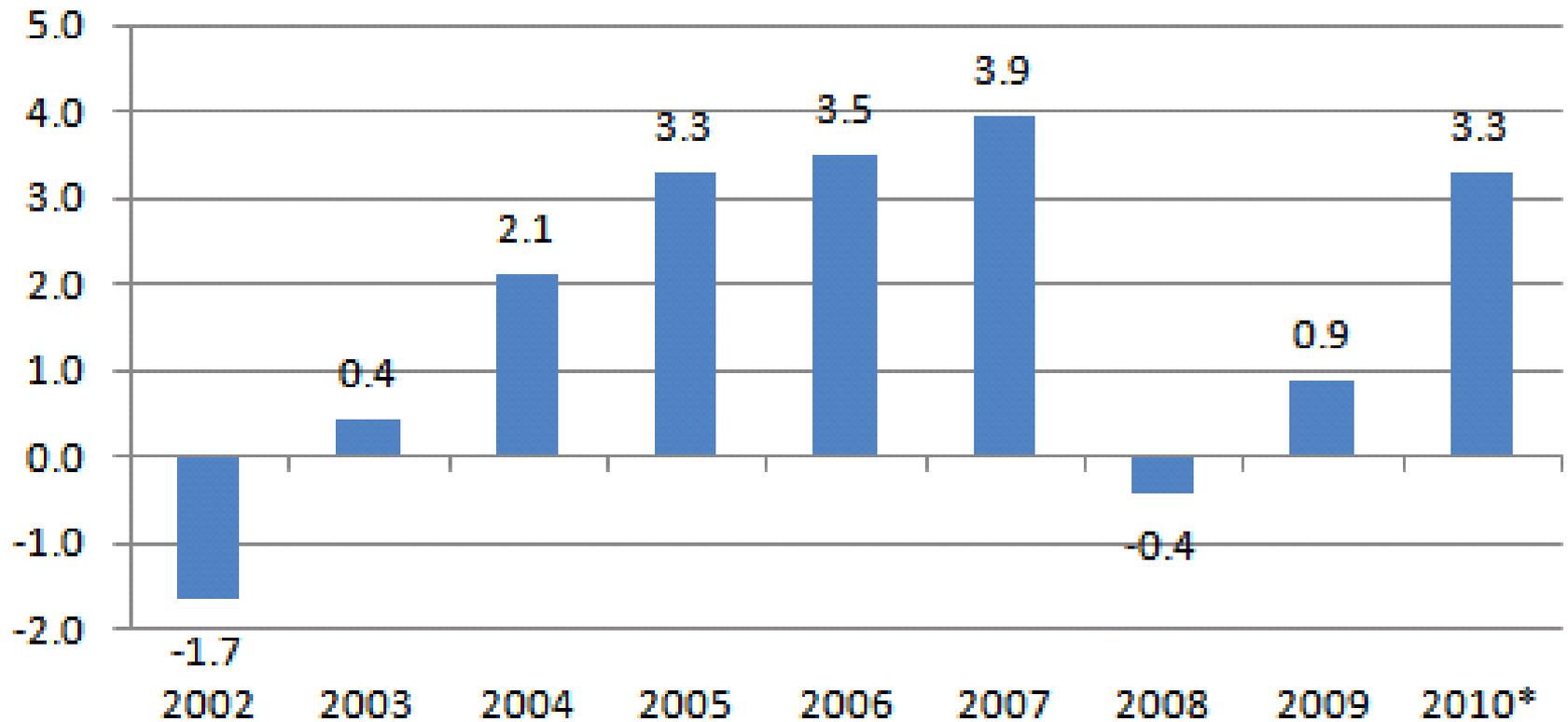
After negative growth in 2008-09, agriculture has rebounded in 2010

Chart 2: Sectoral Growth Rates 2002-10



Growth in per capita income is also recovering again, after weakening in 2008-09

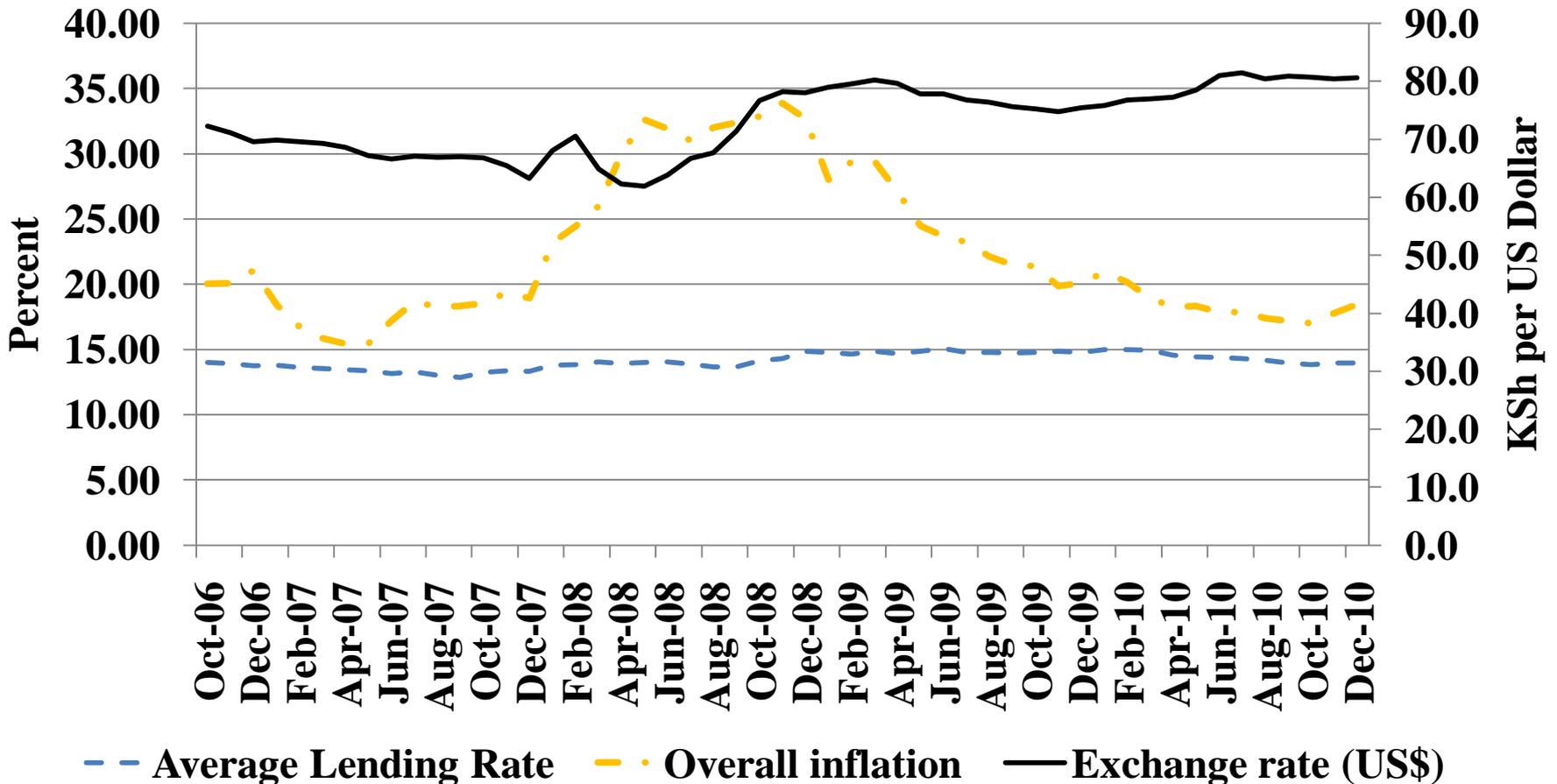
Chart 3: Real GDP per capita growth



* Forecast

Macroeconomic stability has been maintained even during difficult times

Chart 4: Inflation, interest rate and exchange rate



Recent Fiscal Challenges

- Shortfall in revenue collection – By Dec. 2010 it was about KShs. 12 billion
- Cumbersome VAT administration with many exemptions
- Expenditure pressures from:
 - Implementation of Agenda IV items including referendum
 - Implementation of new Constitution
- Shortfall in domestic borrowing, KShs. 30 billion as at end-Dec. 2010

II. MACROECONOMIC OUTLOOK FOR 2011 AND MEDIUM-TERM

Growth prospects

- Growth prospects are favorable with:
 - Recovery in global economy
 - Improved confidence following adoption of new Constitution
- Real GDP growth is projected at 5.7% in 2011 and an average of 6.5% in the medium-term
- While these are significantly lower than the Vision 2030 targets, the fiscal framework is premised on the need to be cautious

Macroeconomic outlook

- Prudent macroeconomic policies should keep inflation at 5% in 2011 and Medium-Term
- Interest rates and exchange rates expected to remain stable
- External payments position expected to strengthen, allowing CBK to gradually build foreign exchange reserves

Main Macroeconomic Indicators Underlying the Medium-Term Fiscal Framework, 2009/10-2013/14

	2009/10 <i>Prov.</i>	2010/11 <i>Est.</i>	2011/12 <i>Proj.</i>	2012/13 <i>Proj.</i>	2013/14 <i>Proj.</i>
<i>Annual percentage change</i>					
National Accounts and Prices					
Real GDP	3.8	5.4	6.1	6.7	6.8
CPI (eop)	3.5	5.0	5.1	5.0	5.0
<i>Percent of GDP</i>					
Investment and Savings					
Investment	22.2	23.6	25.1	26.5	26.6
Gross national savings	15.6	17.0	18.6	20.6	21.4
Central Government Budget					
Revenues	22.7	25.2	25.3	25.3	25.5
Expenditure and net lending	30.1	32.9	31.8	31.3	30.7
Overall balance (excl. grants)	-7.4	-7.7	-6.6	-6.0	-5.2
Overall balance (incl. grants)	-6.5	-6.5	-5.3	-4.7	-3.9
Net domestic debt (eop)	22.2	24.3	24.9	23.6	22.5
External sector					
Current account (incl. official transfers)	-6.5	-6.6	-6.4	-5.9	-5.3
Months of next year's import covers	3.5	3.6	3.8	4.2	4.4

Source: Ministry of Finance

Risks to the Outlook

There are downside risks to the outlook:

- Negative effects of *La Nina* (dry spell in early 2011) could weaken agriculture
- Increase in world oil prices may fuel inflation
- Financial/fiscal fragilities could result in slower-than-expected global economic recovery and hurt our exports

III. MACROECONOMIC POLICIES

Need for Gradual Unwinding of Temporary Monetary and Fiscal stimulus

This should help:

- Pre-empt any inflationary tendencies
- Restore public finances to sustainable paths

Monetary policy

- The CBK will continue to:
 - keep the 5 percent inflation target
 - maintain a floating exchange rate regime
 - gradual accumulation of international reserves to cover over 4 months imports
- The CBK will continue to refine its monetary policy framework to take into account challenges associated with deeper financial intermediation and increased modernization of the financial system

Fiscal policy

- Fiscal policy will support economic activity while allowing for implementation of the new constitution within a context of sustainable public financing:
 - Reduce overall deficit to about 5% in the M-T
 - This should bring down debt-to-GDP ratio to sustainable level (<45%)
 - Maintain fiscal revenue-to-GDP ratio at around 25%
 - Keep budgetary expenditures consistent with M-T priorities

Fiscal policy (cont...)

Implementation of the new Constitution:

- Provide sufficient resources to meet the timeline provided in the transition arrangements
 - Constitution-related expenditures include: drafting of new laws/review of existing legislation; winding up/setting up new offices; capacity building for counties; construction/rehabilitation of county assemblies, National Assembly and Senate; and, establishment of the new judicial system
- Details of the costing are being worked out and will be elaborated in subsequent documents, viz., BPS/BSP

Fiscal policy (cont...)

Measures to improve revenue collection:

- Review tax code to help improve tax compliance, minimize delays, and raise revenue by:
 - Rationalizing existing tax incentives;
 - Expanding the income tax base;
 - Removing tax exemptions as envisaged in the constitution; and
 - Prepare the infrastructure for enhanced collection of property taxes to strengthen the revenue base of the new counties within the devolved system
- Review the VAT legislation to improve administration and compliance.
- Increase automation of KRA processes to help combat tax evasion and to support customs reform

Fiscal policy (cont...)

Expenditure measures:

- Continue **rationalizing recurrent expenditure** to free resources towards development expenditure.
- Continue to **protect pro-poor expenditure** in health and education sectors while limiting new recruitment in the public service to sustainable levels.
- Ensure that development expenditure remains **supportive of critical infrastructure** that will help reduce the cost of doing business and crowd in private sector investment in areas identified in the Vision 2030.

Fiscal structural reforms (cont...)

- New public finance management (PFM) legislation to
 - accelerate reforms in public financial management
 - strengthen cash management system and improve resource management
- Review the procurement legislation
- Fully implement the IFMIS across government Ministries and Departments, and eventually rolled out to country governments
- Performance Based Budgeting (PBB) that will help improve control and accountability

Deficit financing policy

- Continue to reduce the share of domestic financing/borrowing in the overall financing
- Continue to access external concessional financing
- Non-concessional financing including any sovereign bond proceeds will be limited to investment projects that demonstrate revenue streams and of high social returns
- On PPP, the government address any gaps in the legal and regulatory framework that could impede successful implementation of the PPP agenda, and provide for a clear and mandatory regulatory framework to guide PPP investments.

IV. 2011/12 BUDGET FRAMEWORK

2011/12 BUDGET FRAMEWORK

Underlying assumptions

- Set against the background of the medium-term macro-fiscal framework outlined above and the Govt's national strategic objectives outlined in Vision 2030's MTP.
 - Real GDP is expected to increase by 6.1 percent in FY 2011/12 underpinned by continued good performance across all sectors of the economy.
 - The projected growth will be updated depending on the likely negative impact of the emerging dry spell.
 - Inflation is expected to hover at around 5 percent
 - Gross international reserves are expected to increase to over 4 months of import cover by June 2012.

2011/12 BUDGET FRAMEWORK (cont..)

Revenue projections:

- Target revenues including AiA of 25.3 percent of GDP (or KShs. 777.3 billion)
- Performance will be underpinned by:
 - On-going reforms in tax policy and revenue administration., and
 - the streamlining of the exemptions regime in line with EAC arrangements

2011/12 BUDGET FRAMEWORK (cont..)

Expenditure forecast:

- Overall expenditures are projected at 31.8% of GDP, down from estimated 32.9 percent in 2010/11.
- The key policy document guiding the Government's funding allocation decisions is the first MTP (2008-2012) of Vision 2030, which provides the overarching development priorities.

2011/12 BUDGET FRAMEWORK (cont..)

Overall Deficit and Financing:

- The overall budget deficit (including grants) in 2011/12 is projected to be about KSh 163.7 billion (equivalent to 5.3% of GDP).
- Net external financing amounting to KSh 58.4 billion (1.9% of GDP) is expected to cover part of this budget deficit, leaving about KSh 105.3 billion (3.4% of GDP) to be financed through domestic borrowing.

V. RESOURCE ENVELOPE AND SECTOR CEILINGS

2011/12 Resource Envelope

Total Available resources	978.7
– Revenue (incl AiA)	777.3
– External Grants	37.8
– External Loans	58.4
– Privatization	0.0
– Net Domestic Borrowing	105.3
– External Commercial Financing	0.0
– Other financing	0.0
Total Expenditure	978.7

2011/12 Resource Envelope (Cont...)

- From the above, it is clear that the total available resources in 2011/12 amount to **KShs. 978.7 billion**
- This resource envelope forms the **basis for setting the sector ceilings**
- The table above clearly demonstrates the notion of a **finite amount of resources** that must be allocated in the most efficient way possible in order to achieve the desired outcomes at least cost.
- However, as always, Treasury receives additional request over and above these ceilings, which obviously cannot be accommodated.

2011/12 Resource Envelope (Cont...)

As can be seen from the Table above, the only way to cater for the additional requests is to:

- ⇒ **Raise taxes**—but tax to GDP ratio is relatively high;
- ⇒ **Borrow more from the foreign sources**—increase external indebtedness and foreign dependency;
- ⇒ **Borrow more from domestic financial market**—this however risks raising interests rates and crowding out private sector investments and growth.
- ⇒ **Create fiscal space** by cutting/rationalizing other expenditures

CONCLUSION

- First, let me reiterate the importance of **prudent fiscal policy in helping sustain macro-stability**. In that context, it is clear that the recent economic recovery has reflected:
 - Implementation of prudent macro-economic policies and key sector strategic interventions; and
 - The increased focus on infrastructure spending
- There is therefore need to safeguard this macro stability by avoiding pro-cyclical fiscal policies

CONCLUSION (Cont...)

- **Secondly**, the **scarcity of resources** calls for the need to prioritize these resources to best achieve Gov't stated policy priorities as well as the implementation of the new constitution.
- **Finally**, need to contain expenditures while at the same time re-allocating towards the key social/economic sectors as envisioned under the Vision 2030.
- Without continued fiscal discipline and macro-stability we will not achieve the objectives of Vision 2030, because the enabling environment for private sector, the key engine of growth, will be absent.

THANK YOU